DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
May 22, 2000

OFFICE OF
CHIEF COUNSEL

Number: **200048002**
Release Date: 12/1/2000
CC:DOM:FS:IT&A
TL-N-6628-99
UILC: 165.13-00
451.13-00
1060. 00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, FORT LAUDERDALE
CC:SER:SFL:FTL

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Loss on Lease and Treatment of Advance

This Field Service Advice responds to your memorandum, dated February 16, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corp A =
B =
County C =
State D =
Building E =
Type F =
City G =
Entity H =
$w =
$x =
$y =
$z =
Tax Year 1 =
Tax Year 2 =

ISSUES:

1). Whether, in Tax Year 1, Corp A may deduct $w attributable to a lease as an abandonment loss under I.R.C. § 165.

2). What is the proper tax accounting treatment for the deferred prepaid revenue and what is the proper allocation for determining basis under section 1060.

CONCLUSIONS:

1) Corp A may not deduct $w as an abandonment loss because there was no qualifying recognition event under section 165.

2) The advance payments for revenue should have been taken into income in the year of the sale. The liability they represented should also have been included in the amount realized upon the sale. As a result, the liability is properly taken into account in determining basis under section 1060.

FACTS:

Corp A was the owner of B and, in Tax Year 1, deducted $w as a loss under section 165 for a lease it claimed was unfavorable and therefore worthless. The lease was with County C in State D and for the use of Building E, which Corp A agreed to employ for B's . Under the terms of the lease, County C was obligated to maintain Building E as a "first class" venue. According to Corp A, County C breached this obligation.

During Tax Year 1, Corp A
of State D. In the complaint, Corp A contended that Building E was not "first class" and had fundamental Type F structural flaws and inadequate amenities and facilities. Consequently, Corp A asserted that the lease was terminated and that B had no further obligation to in Building E.

During Tax Year 1, Corp A was also apparently attempting to B outside State D to City G. However, the County C obtained a Corp A from taking any steps to B to a city outside of State D. Corp A also asserts that its audited financial statements of Tax Year 1 reported the abandonment loss and the lease was no longer listed as an asset. in State D never Corp A's complaint because B was subsequently sold in Tax Year 2 to Entity H and the .
indicate that B continued in Building E for several years after Tax Year 1.

Entity H purchased all of the assets of Corp A used in the operation of B's for an aggregate purchase price of $x and the assumption of certain liabilities associated with the assets. On the date of the purchase, Corp A's financial statements reported an adjusted balance of liabilities of approximately $y. One of the recorded liabilities listed was for deferred revenue in an amount of approximately

$z. The liability represented advance payments received from with respect to the . When B was sold to Entity H an estimate of the fair market value of the as a business enterprise was made along with an allocation of the purchase consideration among the assets . As part of the allocation of the purchase consideration, a reduction in the amount of approximately $z was made for the deferred revenue.

LAW AND ANALYSIS

ISSUE 1

Abandonment losses are deductible under I.R.C. § 165(a), which allows any loss sustained during the taxable year and not compensated for by insurance or otherwise. The requirements for a loss are found in the regulations under section 165. Specifically, Treas. Reg. § 1.165-2(a) allows a loss incurred in a business and arising from the sudden termination of the usefulness of any nondepreciable property, in a case where the business is discontinued or where the property is permanently discarded from use therein, as a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

Treas. Reg. §1.165-1(b) requires that, to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, and fixed by identifiable events. Normally, an abandonment loss requires (1) an intention on the part of owner to abandon the asset, and (2) an affirmative act of abandonment. A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Citron v. Commissioner, 97 T.C. 200, 209 (1991); CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990). The intention to abandon standing alone is not sufficient to establish a recognition event; instead, there must be an affirmative act of abandonment. See Beus v. Commissioner, 261 F.2d 176, 180 (9th Cir. 1958); Citron, 97 T.C. at 210. It is clear that intangible assets such as a lease may be the subject of an abandonment loss. See Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220 (1959), acq. 1973-2 C.B. 2; Solar Nitrogen Chemicals, Inc. v. Commissioner, T.C. Memo. 1978-486.

An abandonment does not result simply from cessation of use. Beus, 261 F.2d at 180; Citron, 97 T.C. at 1257. Thus, participation in a government program which required the taxpayer to discontinue his dairy operation, was not an abandonment where there was no showing of the irrevocable intent to abandon or never use the property again. Strandley v. Commissioner, 99 T.C. 259 (1992), aff'd on another issue, 73 AFTR 2d (RIA) 2118 (9th Cir. 1994).

The mere diminution in value of property is also not enough to establish an abandonment loss. Lakewood Associates v. Commissioner, 109 T.C. 450, 456 (1997), aff'd in an unpublished opinion, 99-1 USTC ¶ 50,127 (4th Cir. 1998). See United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927). Specifically, diminution in value fails to satisfy the requirement under the regulations that a loss be "evidenced by closed and completed transactions, fixed by identifiable events." Sunset Fuel Co. v. United States, 519 F.2d 781, 783 (9th Cir. 1975). See S.S. White Dental, at Id.

Although writing off the lease on its books and to be let out of the lease are indications of abandonment, neither are conclusive in this case. Rather than actually abandoning the lease, Corp A seems to have transferred its interest in the lease to Entity H as part of the sale, since B continued in Building E. See Citron, 97 T.C. at 213, explaining that a sale is not an abandonment. In addition, the litigation that would have allowed Corp A to get out of its lease was never concluded. See Brown v. Commissioner, T.C. Memo. 1996-284, holding that the taxpayer's breach of contract was not, in itself, a closed and completed transaction. may also indicate that Corp A had a claim for reimbursement that would prevent a deduction under section 165(a). See Treas. Reg. § 1.165-1(d)(2)(i) and (3); Estate of Scofield v. Commissioner, 266 F.2d 154 (6th Cir. 1959); Ramsey Scarlett & Co. v. Commissioner, 61 T.C. 795 (1974), aff'd 521 F.2d 786 (4th Cir. 1975).

Lastly, under the special facts of this case, we question whether Corp A could act on its own to abandon the lease. That is, Corp A apparently had contractual obligations to continue in the geographic area, which were inextricably linked to its obligation under the lease. We believe it may have been impossible to separate the lease from these obligations and abandon it alone. Instead, Corp A would have to have waited until before any abandonment was possible. As a result, we conclude that Corp A has not demonstrated the recognition event in Tax Year 1 necessary to obtain a loss under section 165.

ISSUE 2

Recognition of Advanced Payments

Under section 61, gross income includes income from all sources derived. The general rule for the timing of gross income is found in section 451(a), under which the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period.

Rev. Proc. 71-21, 1971-2 C.B. 549, provides procedures under which accrual basis taxpayers may defer inclusion in gross income of payments received (or amounts due and payable) in one taxable year for services to be performed in the next succeeding taxable year. Consistent with Rev. Proc. 71-21, Corp A has been deferring advance payments . See also Artnell Company v. Commissioner, 400 F.2d 981 (7th Cir. 1968), which allows deferral of advance payments in circumstances very similar to the present case.

Section 3.13 of Rev. Proc. 71-21 requires that, if a taxpayer subject to the revenue procedure ceases to exist or its liability to perform the services to which the advance payments apply otherwise ends, then all payments not included in gross income in a preceding taxable year must be included in the taxable year. The advance payments were gross income to Corp A that had been deferred; they cannot be excluded forever. See James M. Pierce Corp. v. Commissioner, 38 T.C. 643, 656 (1962), rev'd on another issue, 326 F.2d 67 (8th Cir. 1964), acq. 1963-2 C.B. 5, holding advance payment of subscription income must be taken into income in the year the taxpayer was sold and stating "[i]f this were not done...these amounts would...escape being taxed altogether." Thus, taxpayer should have included the amount of the deferred advance , $z, in its gross income in Tax Year 2.

Relieved Liability Included in Amount Realized

As a separate matter, the advance payments for also represent a liability of Corp A, from which it was relieved of when B was sold. The amount of the liability should be included in the amount realized on the sale. Treas. Reg. § 1.1001-2(a)(1) provides that, except for discharge of indebtedness income and a liability incurred on acquisition, the amount realized on a sale of property includes the amount of liabilities from which the transferor is discharged as a result of the sale. See Commercial Security Bank v. Commissioner, 77 T.C. 145, 148 (1981), acq. 1986-2 C.B. 1, recognizing that an unreported income item could be included gross income at the same time a liability would be included in amount realized upon sale. Thus, Corp A should added $z, along with other liabilities, to the $x received from Entity H to obtain the amount realized on the sale of B.

Asset Allocation

Section 1060(a) provides that, for purposes of determining the transferee's basis in acquired assets and the transferor's gain or loss in the case of any applicable asset acquisition, the consideration received for the assets shall be allocated among the assets acquired in the acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). Under Treas. Reg. § 1.1060-1T(a)(1), the seller and the purchaser allocate the consideration under the residual method, as described in Treas. Reg. § 1.1060-1T(d). Treas. Reg. § 1.1060-1T(c)(1) provides that the purchaser's consideration is the cost of the assets acquired in the applicable asset acquisition, and the seller's consideration is the amount realized from the applicable asset acquisition under section 1001(b).

Because the prepaid revenues are liabilities of Corp A that Entity H acquired as part of the applicable asset acquisition that are included in the purchaser's cost and the seller's amount realized, the liabilities must be included in the consideration allocated among the assets in the applicable asset acquisition for purposes of determining the transferee's basis in acquired assets and the transferor's gain or loss. The timing of the inclusion of amounts is determined under general principles of tax law.

[redacted]

[redacted]

By: ______________________

GERALD M. HORAN
Senior Technician Reviewer
Income Tax and Accounting Branch
Field Service Division