Trump's $72.9M Refund: Breaking Up Is Hard to Do

by Kristen A. Parillo and Eric Yauch

The partnership abandonment claim purportedly at the heart of an audit dispute between the IRS and President Trump could spotlight the knotty rules around claiming ordinary losses from investments in distressed partnerships.

"Maybe Trump could be a watershed case for resolving this tug of war reflected in several court decisions and IRS rulings on when worthlessness of a partnership interest is an ordinary loss or must instead be treated as a capital loss under the partnership distribution rules," said Jerald David August of Fox Rothschild LLP.

In the wake of *The New York Times*'s September 27 report on Trump's tax returns, *Tax Notes* spoke with practitioners to delve into the claim that the president and the IRS have been engaged in a nearly decade-long dispute over the legitimacy of a $72.9 million refund that Trump claimed in 2009.

Because the *Times* didn't publish any of the returns or other documents on which the report relies, practitioners stressed that they can only speculate based on what has been reported.

> ***'Maybe Trump could be a watershed case for resolving this tug of war reflected in several court decisions and IRS rulings on when worthlessness of a partnership interest is an ordinary loss or must instead be treated as a capital loss under the partnership distribution rules,' August said.***

According to the *Times*, Trump claimed a $72.9 million refund for the 2009 tax year using a provision included in the Worker, Homeownership, and Business Assistance Act of 2009 allowing most businesses to carry back a 2008 or 2009 net operating loss for up to five years. Trump reportedly received the money under the "quick refund" procedures.

However, the refund still had to be reviewed by the Joint Committee on Taxation, which is tasked under section 6405(a) with analyzing refunds exceeding $5 million for corporate taxpayers and $2 million for all other taxpayers. The IRS reportedly sent its audit report of Trump's refund to the committee in spring 2011.

The *Times* reported that "an agreement was reached in late 2014" — it's unclear what kind of agreement was reached and by whom — but said the IRS's audit had resumed and grew to include Trump's returns for 2010 through 2013.

"In the spring of 2016, with Mr. Trump closing in on the Republican nomination, the case was sent back to the committee," the *Times* wrote. "It has remained there, unresolved, with the statute of limitations repeatedly pushed forward."

Digging Deeper

The *Times* report said it's not clear why the case has stalled, but it suspects that the dispute is over the $700 million in business losses Trump reported on his 2009 return that, thanks to the expanded NOL carryback provisions passed by Congress that year, enabled him to claim a refund of taxes he paid in 2005, 2006, and 2007.

According to the *Times*, those losses were likely generated by the partnership associated with his "long-failing Atlantic City casinos." Although not named in the report, that partnership was Trump Entertainment Resorts Holdings LP (TER Holdings), a majority-owned subsidiary of Trump Entertainment Resorts Inc. (TER Inc.), the entity that owned and operated the casinos. According to SEC filings, Trump had a 23.5 percent limited partnership interest in TER Holdings.

In mid-February 2009, just four days before TER Inc. filed for chapter 11 bankruptcy, Trump resigned as chair of its board. That same day, he filed a Schedule 13D/A with the SEC stating that he was abandoning his partnership interest in TER Holdings because he "has determined that his Partnership Interests are worthless and lack potential to regain value."

The *Times* suggested that Trump filed the disclosure to support his position that abandoning his partnership interest entitled him to claim the casinos' losses as a section 165(a) ordinary loss, rather than a less favorable capital loss. The report said the IRS may be challenging that position because Trump received something of value in the restructuring of TER Inc.

After the company filed for bankruptcy in 2009, a battle broke out between investor Carl Icahn and a group of Trump-backed corporate bondholders for control of TER Inc. The bondholders eventually won out, paving the way for the company to emerge from bankruptcy in July 2010. According to a Schedule 13D filed that month, Trump received 5 percent of the stock in the reorganized company, along with warrants to purchase another 5 percent, in exchange for the use of his name and likeness in perpetuity.

The *Times* theorized that the IRS could argue that because Trump received consideration in the deal, his limited partnership interest wasn't worthless and therefore he couldn't claim an ordinary loss, thereby jeopardizing his $72.9 million refund.

Legal Minefield

According to August, Trump likely claimed an ordinary loss on the grounds that he abandoned his interest in TER Holdings because it had become worthless.

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The case law and IRS guidance show that it is possible to obtain ordinary loss treatment from an abandoned or worthless partnership interest, but a successful outcome for the taxpayer is heavily dependent on the facts and circumstances.

If Trump was relieved of his share of partnership debt in connection with the abandonment, he'd have a deemed distribution problem because of Rev. Rul. 93-80, 1993-2 C.B. 239. The IRS held in that 1993 revenue ruling that a taxpayer who abandoned a partnership interest may claim an ordinary loss only if there is no actual or deemed distribution to the partner — such as a deemed distribution relating to relief from liabilities under section 752(b) — or the transaction isn't otherwise in substance a sale or exchange.

Glenn Dance of Holthouse Carlin & Van Trigt LLP said that when he advised clients on walking away from a business, he always made sure that all the partnership's debt is allocated to a continuing partner before the taxpayer abandoned their interest to avoid triggering a big loss that couldn't be used to offset ordinary income.

August said the IRS could also argue that the consideration Trump received in the reorganization — the 5 percent stake in the new company, with warrants to purchase another 5 percent — was sourced from a distribution in liquidation of his partnership interest. That property may, under section 731(a)(2), deny recognition of even a capital loss, he said.

Proving Worthlessness

Given the roadblocks imposed by Rev. Rul. 93-80, Trump's best argument might be that he was entitled to an ordinary loss deduction for worthlessness. He could point to *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), one of the leading cases on partnership abandonment, which said that worthlessness can be a separate and independent ground for claiming an ordinary loss.

However, Trump would have to satisfy the two-prong test for worthlessness. He'd be required to show that he subjectively believed his partnership interest was worthless in 2009 and that objectively, the interest had no liquidating value and no potential future value in 2009.

According to August, a December 2019 Tax Court decision in *MCM Investment Management LLC v. Commissioner*, T.C. Memo. 2019-158, provides a useful road map on how taxpayers can successfully pass the objective test for worthlessness. The court held in *MCM* that a real estate company that suffered financial distress

following the subprime mortgage market crisis was entitled to a $41.5 million ordinary loss deduction for a worthless partnership interest in 2009, the year the company decided to wind down over a five-year period.

The Tax Court found that the taxpayer had proved objectively that the partnership ceased to have liquidating value and potential future value in 2009. A liquidation analysis showed that $51.6 million in proceeds the partnership could generate in a hypothetical 2009 liquidation would fall short of satisfying the $70 million in outstanding senior debt. Other evidence — including a significant decline in expected cash flow, the 2009 decision to wind down, and defaults on project debt and subsequent foreclosures — supported a finding of worthlessness, the court said.

While *MCM* serves as a good model for proving worthlessness, August pointed out that the taxpayer did have the advantage of not having section 752(b) on the table because it hadn't abandoned or otherwise disposed of its partnership interest.

"There was no sale or exchange, so there was no capital loss in *MCM*," August said. However, once the business sells off its properties, it will have to address the deemed distribution issue, he said.

Winning the Battle, Not the War?

For Trump, satisfying the subjective prong of the worthlessness test likely wouldn't be too difficult, given the Tax Court's comment in *MCM* that "the subjective determination of the taxpayer, while not conclusive, is entitled to great weight." Trump would likely cite his February 2009 SEC filing as evidence that he subjectively believed his interest in TER Holdings was worthless.

The objective test would likely be a much bigger hurdle to overcome. The IRS could argue that by receiving something back through the bankruptcy proceedings, Trump can't show that his partnership interest had no liquidating value or no potential future value, said August.

Trump could try to counter that a worthlessness analysis should be based on the business's financial condition at the time he filed his abandonment announcement in February 2009, August said.

"Trump's attorneys could argue that he isn't required to prove that the interest had no value at all in 2009 — just that it lacked substantial value," August said. He noted the Fifth Circuit's comment in *Echols* that the expression "'one man's trash is another man's treasure' best illustrates the subjective nature of worthlessness as a tax term of art."

Trump's tax advisers "may have said a $72 million tax refund was worth more than anything he was going to get out of the company in 2009," said August. He pointed to a comment made in *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015), a case involving a corporation's abandonment of stock. "The court came right out and said it recognized that the tax loss had far greater value than any residual value the taxpayer could ever hope to get from the company," he said.

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Trump could also argue that the stake he received in the reorganized company wasn't significant enough in terms of value to preclude a worthlessness finding, August said. He added that Trump could also argue that receipt of the new stake was separate and distinct from his abandonment and worthlessness claim.

"Maybe Trump can argue that the new company was very different from the one he was involved in before," August said. "He could say he had already abandoned the old partnership 17 months before he got the new stake. That book was closed, and the fact that he got something as part of the reorganization isn't part of his proving the section 165(a) loss."

Nevertheless, even if Trump can prevail on a worthlessness claim, he would still have to wrestle with section 752(b), August said. "He's still being relieved of 23.5 percent of the partnership's liabilities," he said. "Mechanically, it's being shifted somewhere, so there has to be some reckoning with that debt." ■