TAX LOSSES: THE SOLUTION TO PUERTO RICO'S BOND CRISIS?

ARTICLE

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INTRODUCTION

WHEN FACED WITH DIFFICULT CIRCUMSTANCES, ONE MUST FIND alternative ways to visualize the situation in order to identify alternative solutions that might be more advantageous than the traditional obvious ones. In Albert Einstein's words, "[w]e cannot solve our problems with the same level of thinking that created them."[1]

The current economic and financial situation of the Commonwealth of Puerto Rico is extremely sensitive, to say the least. From an economic perspective, the island has been in a recession for almost a decade and shows no signs of recovery.[2] From a financial standpoint, the Government[3] faces collection problems which, in turn, create liquidity issues. These liquidity problems have caused the Commonwealth to default on several of its bond obligations. Further, almost all new revenue sources have been exhausted and the ones in place have been maximized.[4] To add insult to injury, as a consequence of the foregoing the Commonwealth's creditworthiness is as low as it has ever been. Consequently, Puerto Rico's ability to restructure its debt or obtain new credit facilities is impaired.

The factual picture does not end here. Puerto Rico faces other challenges. First, the Government is the largest employer in the island. As such, the Commonwealth's economy heavily depends on its Government's capacity to pay its payroll. Second, the Commonwealth's unemployment rate is almost three times the United States' average rate.[5] Third, the Commonwealth's workforce continues to decline as the island's population contracts. Lastly, almost all of the Government's Retirement Systems are undercapitalized and face actuarial insolvency.

All of these facts, among others that are not mentioned, obviously point out, *inter alia,* that the Commonwealth's ability to continue to repay its bond obligations is compromised. In fact, as previously mentioned, Puerto Rico has already defaulted in several payments of its unsecured debt obligations. More so, the Government has expressed that it is unable to comply with all of its debt obligations, including those which have the full faith and credit of the Commonwealth

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1 *See Einstein Enigmatic Quote,* ICARUSFALLING (Jun. 24, 2009), http://icarus-falling.blogspot.com/2009/06/einstein-enigma.html (last visited May 23, 2017).

2 According to the World Bank, since 2006 Puerto Rico's Gross Domestic Product is negative. *See* THE WORLD BANK, http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries/PR?display=graph (last visited May 23, 2017).

3 The terms *Government*, *Commonwealth* and *Puerto Rico* will be used interchangeably in this article to refer to the Commonwealth of Puerto Rico.

4 Puerto Rico has enacted over fifty taxes in the past four years.

5 As of July 2016, Puerto Rico's unemployment rate is 11.40%, while the United States unemployment rate is 4.90%. *See Databases, Tables & Calculators by Subject*, *Local Area Unemployment Statistics*, BUREAU OF LABOR STATISTICS, http://data.bls.gov/timeseries/LASST720000000000003?data_tool=XGtable (last visited May 23, 2017). *See also Databases, Tables & Calculators by Subject, Labor Force Statistics from the Current Population Survey,* BUREAU OF LABOR STATISTICS, http://data.bls.gov/timeseries/LNS14000000 (last visited May 23, 2017).

pledged. These facts in addition to the Government's cash flow difficulties, have, as expected, made investors anxious and worried about their investments. Consequently, the value of Puerto Rico bonds has decreased dramatically.[6] In sum, Puerto Rico is in the middle of a financial crisis, which media and experts have named "Puerto Rico's Bond Crisis."

Based on the foregoing situation, it is evident that alternative mechanisms to deal with the mentioned crisis must be found. Presently, several proposals are being discussed. For example, the whole reorganization of Puerto Rico's debt, the imposition of a Financial Board that will oversee the Commonwealth's finances[7], and the amendment of Bankruptcy Chapter 9 to allow Puerto Rico to file for bankruptcy, among others. All of these alternatives are viable ones. Nevertheless, all of them have flaws and challenges that must be overcome in order to be practical. More so, all of the mentioned alternatives involve political actors, both at the Commonwealth and Federal Government levels, which might prolong the solution of the Puerto Rico bond crisis. Therefore, even though the proposed options to deal with the Commonwealth's finances are viable, they might not be timely.

Consequently, other possibilities to deal with this situation must be found. Ideally, these other possibilities will not have the hurdles that the current proposals have. One of these alternatives is for the bondholders to abandon their bonds and claim a loss against their federal tax liability. This idea is not a new one. In fact, it has been used many times before, particularly with partnership interests[8] and securities.[9]

This article analyzes the viability of this alternative to the holders of Puerto Rico's debt and when it is practicable to engage in this type of action. To provide the reader with a full understanding of the tax consequences of engaging in a transaction as the one proposed in this article, first, the article provides an overview of the taxation of property transactions, including when these principles are applicable to the debt reorganization and its relation to Puerto Rico bonds. Second, the taxation of distressed debt and its relation to the Commonwealth's current situation will be discussed. After these general concepts have been dis-

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6 As of September 4, 2016, the S&P Municipal Bond Puerto Rico Index (which is a broad, market value-weighted index that seeks to measure the performance of bonds issued within Puerto Rico) reveals a 12.01% one-year return and a 2.53% three-year return. *See S&P Municipal Bond Puerto Rico Index*, S&P DOW JONES INDICES, http://us.spindices.com/indices/fixed-income/sp-municipal-bond-puerto-rico-index (last visited May 23, 2017).

7 It should be noted that when this Article was originally written the Puerto Rico Oversight, Management and Economic Stability Act had not been enacted. As of the date of publication, Pub. L. 114-1987, codified as 48 U.S.C. §§ 2101-2241, was enacted. Said law establishes an oversight board, a process for restructuring debt, and expedited procedures for approving critical infrastructure projects in order to combat the Puerto Rican government-debt crisis. *See* Puerto Rico Oversight Management and Economic Stability Act, 48 U.S.C. §§ 2101-2241 (2016).

8 *See, e.g.*, Rev. Rul. 93-80, 1993-2 C.B. 239.

9 *See, e.g.*, Pilgrim's Pride Corp v. Commissioner of Internal Revenue, 779 F.3d 311, 314 (5th Cir. 2015).

cussed, the article will discuss the tax consequences of abandoning property. This includes: (1) a discussion of whether a loss can be claimed for abandoning property; (2) what constitutes an abandonment of property for purposes of the Internal Revenue Code; (3) what happens to the property abandoned; (4) what amount can be deducted as a loss, if any; and (5) how is the loss characterized. Finally, it is discussed when it is practicable to abandon the bonds at issue.

I. Basic Taxation of Property Transactions

A. *General Overview*

At the outset, the basic principles of the taxation of property transactions shall be discussed. This allows for a better understanding of the tax implications of the abandonment of property. Further, this overview helps non-tax connoisseurs to understand several issues and possible hurdles that will be discussed further on.

Section 1001 of the Internal Revenue Code (hereinafter, "Code") establishes the manner in which gain or loss from the sale or exchange of property should be computed. To this effect, the mentioned Code section prescribes:

> (a) Computation of gain or loss
>
> The gain from the *sale or other disposition of property* shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, *and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.*[10]

A reading of the above quoted Code section reveals that two concepts are at issue: *amount realized* (or as tax experts like to say *realization*), and *basis*. On the one hand, the term *amount realized* is defined in subsection (b) of section 1001 of the Code, and the Treasury Regulations issued thereunder.[11] These establish that "[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than the money) received."[12] The understanding of this concept is essential due to its timing implications.[13]

On the other hand, the concept of *basis* attempts to account for economic value that has already been subject to income taxation in order to prevent the value from being taxed twice.[14] Basis, for purposes of section 1001 of the Code, is

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10 I.R.C. § 1001(a) (2012) (emphasis added).

11 *See* Treas. Reg. § 1.1001-1 (as amended in 2007); *see also* Treas. Reg. § 1.1001-2 (1980).

12 I.R.C. § 1001(b) (2012).

13 For a discussion on how determining when income is *realized* has financial implications that may allow the deferral of gain or the acceleration of loss to the taxpayer's benefit, see DAVID L. CAMERON & ELLIOTT MANNING, FEDERAL TAXATION OF PROPERTY TRANSACTIONS (2012).

14 *Id.*

calculated pursuant to section 1011 of the Code. Both of the previously mentioned concepts appear to be straight forward. However, their application and implications are of the upmost importance for the implementation of the United States Tax System.[15] One of the main issues when dealing with the taxation of property transactions is if a *realization event* occurred. A *realization event* is the lingo tax specialists utilize to describe when a *sale or disposition of property* occurred. This issue is central because if no exchange of property occurred, then there would not be any amount realized and, obviously, no tax implications to account for.

To illustrate, when Taxpayer A sells his car to Taxpayer B for a certain amount of cash, there is a realization event upon the sale of the car. To complicate things, there is also a realization event when Taxpayer A sells his car to Taxpayer B for a certain amount of cash, a promissory note to pay another amount of cash in a certain time, and a diamond ring. In both of these examples Taxpayer A has an amount realized equal to the value of the properties received by him upon the sale of the car (i.e. the amount of cash in the first illustration and the sum of the cash plus the fair market value of the promissory note and the diamond ring in the second example). To calculate Taxpayer A's tax liability, he must subtract the basis he might have in the property being disposed (i.e. the car), if any, from the total amount realized. The result of this computation is the amount that would be subject to taxation.[16] The character of the gain or loss and the tax liability to be paid is determined based on the taxpayer's income and the capacity in which he held the asset.[17]

B. Modification of Debt Instruments: Treasury Regulation 1.1001-3

Both of the previous examples illustrate the occurrence of a sale of property for cash and other properties. Nevertheless, there are other events that do not necessarily constitute a sale *per se* or exchange of property that are treated as such. One of these events is the modifications of the terms of debt instruments.

Treasury Regulation 1.1001-3 provides the rules to determine whether a modification of the terms of a debt instrument constitute an exchange for purposes of Treasury Regulation 1001-1.[18] The general rule is that if a modification of the debt is significant —as defined in Treasury Regulation 1.1001-3— then an

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15 *Id.*

16 If Taxpayer A had a basis in the car of $10,000 and he sold the car for $15,000, then the amount subject to tax liability is $5,000 ($15,000 - $10,000).

17 *See* Section IV.C, *infra*, of this article, for a better understanding of the characterization of the gain or loss.

18 Treas. Reg. § 1.1001-3(a) (as amended in 2013); the underlying principle is that a property has been exchanged for another property, in other words, a debt with certain attributes, terms, and conditions has been exchanged for another debt with different attributes, terms, and conditions.

exchange for purposes of Treasury Regulation 1.1001-1 has occurred.[19] Consequently, gain or loss must be recognized.[20]

In general terms, the application of Treasury Regulation 1.1001-3 requires a two-part analysis. First, one must determine if a modification occurred. Second, one must determine if said modification is significant. Treasury Regulation 1.1001-3(c)(1)(i) defines *modification* as "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise."[21] However, any alteration that occurs pursuant to the terms of the debt instrument is not a modification for purposes of the mentioned regulations.[22] Nevertheless, a change in the nature of the instrument (from recourse to nonrecourse or vice versa) or if the alteration results in an instrument that is not debt for federal income tax purposes, shall be considered a modification for purposes of Treasury Regulation 1.1001-3(c)(1)(i);[23] regardless that the terms of the instrument provide for the change of the obligor, unless this change occurs pursuant to the exercise of an option, included in the terms of the debt instrument, by the holder of the debt.

Once the alternation of the debt instrument constitutes a *modification,* then a determination as to whether the modification is significant must be made.[24] "[A] modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."[25] Notwithstanding this definition, the Treasury Regulation at issue establishes four instances were a modification will be considered a *significant modification* without regards to the general rule previously stated.[26] For example, the change in yield of the debt instrument of twenty-five basis points or five per cent of the annual yield of the unmodified instrument is considered a significant modification.[27] Certain changes in the timing of the payments due under debt are a significant modification if they result in material difference of the scheduled payments.[28] Moreover, certain changes of the obligor, the priority of the debt and the expectations of payments are considered significant modifications.[29] Finally, the change in the nature of

19 *Id.* at (b).

20 I.R.C. § 1001(c) (2012).

21 Treas. Reg. § 1.1001-3(c)(1)(i).

22 *Id.* at(c)(1)(ii).

23 *Id.* at (c)(1)(iii).

24 *Id.* at (b).

25 *Id.* at (e)(1).

26 *Id.* at (e)(1)(ii).

27 *Id.* at (e)(2)(ii).

28 *Id.* at (e)(3)(i).

29 *Id.* at (e)(4).

the debt instrument is also considered a significant modification for purposes of Treasury Regulation 1.1001-3.[30]

As previously mentioned, if the modification of the debt instruments is categorized as a *significant modification*, then it would be considered as an exchange for purposes of Treasury Regulation 1.1001-1.[31] As such, gain or loss must be recognized upon the modification of the debt instrument.[32] Gain or loss to the creditor is measured by the difference between: (1) the new debt issue price, and (2) the old debt tax basis.[33] The character of such gain or loss shall be determined based on whether the taxpayer holds the property as a capital asset or not. If the debt instrument is held as a capital asset by the taxpayer, then the gain or loss recognized from the modification of the instrument must be classified as a capital gain or loss.[34] If not, the character of said gain or loss should be ordinary.

C. Applicability of Property Taxation Principles to Puerto Rico Bonds

On March 2, 1917, the United States Congress approved House Resolution 9533 which created a civil government for the territory of Puerto Rico.[35] Said legislation exempted from taxation all bonds issued by the Government of Puerto Rico, or its political subdivisions. Specifically, section 3 of this statute establishes:

> All bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia.[36]

The Internal Revenue Service has interpreted this provision to exempt from taxation the principal and interest of all bonds issued by the Government of Puerto Rico or by its authority.[37] Notwithstanding this general exclusion, gain or

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30 *Id.* at (e)(5).

31 *Id.* at (a)(1).

32 Treas. Reg. § 1.1001-1(a) (as amended in 2007).

33 If the debt is publicly traded, the issue price is equal to fair market value of the debt. If the debt is not publicly traded, the issue price is equal to the debt principal amount if the debt has adequate stated interest. The debt has adequate stated interest if the stated principal amount is less than or equal to the imputed principal amount.

34 I.R.C. § 1222 (2012).

35 *See* H.R. 9533, 64th Cong. (1st Sess. 1916) (as introduced to the United States H.R. on Jan. 20, 1916).

36 48 U.S.C. § 745 (2012).

37 Rev. Rul. 70-219, 1970-1 C.B. 23 ("All bonds issued by the Government of Puerto Rico, or by its authority, are exempt as to principal and interest from taxation by the United States under section 3 of the Act of March 2, 1917, as amended by the Puerto Rican Relations Act."); *cf.* Kenda K. Thomes, loss resulting from the sale or exchange of the Puerto Rico bonds is subject to taxation.[38]

Consequently, any alteration of the terms of the bonds that constitute a significant modification, pursuant to the Treasury Regulation 1.1001-3, will trigger the recognition of a gain or a loss, depending on the circumstances.[39] The treatment of this gain or loss depends on the holder of the bonds and the capacity in which he is holding them. Ordinarily, unless the bonds are held by a securities dealer for the purpose of selling them to its customers, the gain or loss to be recognized shall be a capital one. This is due to the fact that bonds are considered capital assets.[40]

II. TAXATION OF DISTRESSED DEBT

A. *General Overview*

i. Definition of Distressed Debt

Another aspect that must be considered to properly determine if the abandonment of the Puerto Rico bonds is practicable is the taxation of distressed debt. This is particularly important to determine the viability of this alternative to investors who purchased Puerto Rico bonds after their value decreased. Also, a general understanding of the tax implications of distressed debt is necessary to properly analyze other proposals to the Puerto Rico Bond crisis (i.e. the restructuring of the debt).

Distressed debt is debt issued by a person or entity that has become financially troubled and in danger of defaulting on the debt, or in bankruptcy or likely to default or declare bankruptcy in the near future.[41] As a consequence of these characteristics, distressed debt is always sold at a value less than the face value of the debt. For example, a bond issued with a face value of $1,000 that is bought in the secondary market at $800 is considered to be distressed.

State Taxation of Puerto Rican Obligations: An Interest(ing) Question, 66 CHI.-KENT. L. REV. 903 (1990), arguing that Section 3 of the H.R. 9533 is unconstitutional and the States are not bound by it.

38 Fed. Tax Coordinator Second Series (RIA), ¶ I-4001; s*ee also,* Willcuts v. Bunn, 282 U.S. 216 (1931).

39 Notwithstanding this conclusion, an argument may be made stating that based on 48 U.S.C. § 745 (2012), the sale or exchange of Puerto Rico Bonds are exempt from this taxation also. However, the probabilities of this argument being successful are close to nothing. In fact, in Revenue Ruling 1981-169, the Service stated that any significant modification to a municipal bond is a taxable transaction for purposes of Section 1001 of the Code. *See* Rev. Rul. 81-169, 1981-1 C.B. 429.

40 *See* I.R.C. § 1221 (2012).

41 BLACK'S LAW DICTIONARY 489 (10th ed. 2014).

ii. Taxation of Distressed Debt

As stated, because of the risks involved with this type of debt, usually the price of this debt is subject to a market discount.[42] The Code requires that holders of this type of debt report gain on the disposition or at maturity as ordinary income to the extent their return is attributable to a market discount.[43]

A market discount is defined as the excess of: (i) the stated redemption price of the bond at maturity over (ii) the holder's basis in such bond (i.e. cost).[44] To illustrate, consider a bond, originally issued at par with a ten-year term and a $5,000 face value, paying five percent annual interest with exactly ten years remaining until maturity. If the taxpayer purchases the bond for $4,500 in the secondary market and holds it until maturity, then he will collect $5,000 of principal, and will have a $500 gain. Because the $500 gain is realized as a result of the market discount accrued during the taxpayer's possession of the bond, this amount is treated as interest income in the year of maturity.[45] "By default, market discount accrues ratably (equal daily portions from purchase to sale or maturity)."[46] Thus, in the example, if the taxpayer sold the bond exactly two years from the date of purchase, the first $100 of gain would be the result of the market discount and, therefore, ordinary income. However, "[a]ny income (gain) in excess of market discount would be classified as capital gain."[47]

Taxpayers may elect to accrue market discount at a constant yield.[48] If they decide to do this, the market discount is included in income as it accrues. This would have the effect of increasing the taxpayer's basis in the bond.[49] Once this election is made, the bondholder must include the market discount as it accrues on all the bonds acquired during the year of the election and after.[50] However, this rule does not apply to market discount bonds acquired in the year before the

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42 This article does not discuss the taxation of bonds issued at discount because —to the knowledge of the author— Puerto Rico has not issued this type of bond. In any case, if interested in the taxation of such bonds, see 10 MERTENS LAW OF FED. INCOME TAX'N § 38:59.

43 *See* I.R.C. § 1276(a) (2012).

44 I.R.C. § 1278(a)(2)(A) (2012).

45 "An amount included as ordinary income under the market discount rules is generally classified as interest for tax purposes. There are, however, several exceptions to this rule. Taken together these exceptions blunt most of the important effects of classifying market discount as interest. (These exceptions negate the rule characterizing market discount as interest, but not the rule characterizing market discount as ordinary income.)." Ethan Yale, *Taxing Market Discount on Distressed Debt,* 32 VA. TAX REV. 703, 708 (2013) (internal citations omitted).

46 *Id.* at 707.

47 *Id.*

48 I.R.C. § 1276(b)(2).

49 I.R.C. § 1278(b)(4).

50 *Id.*

election. A taxpayer can revoke his election with the approval of the Secretary.[51] It should be noted that:

> The market discount rules include an anti-abuse rule that suspends interest deductions on a loan "incurred or continued to purchase or carry" debt with market discount. In the absence of this rule, taxpayers could enter into debt-financed purchases of market discount bonds and shelter income by coupling (currently deductible) interest payments with (tax deferred) market discount. The legislative history indicates that tax shelters fitting this pattern motivated enactment of the market discount rules.[52]

From a loss perspective, sections 1276 through 1278 of the Code are completely inapplicable. The reason for this conclusion is simple: since there is no difference between the purchase price and the face value of the debt, there is no market discount. Consequently, no ordinary gain has to be recognized. Further, section 1001 of the Code will apply to determine the amount of the loss. This reality has the effect of taxing the holders of distressed debt above the normal rate applicable to investment securities.[53]

Going back to our previous bond example, if the taxpayer purchases the bond for $4,500 in the secondary market and sells it at $4,000, he will have a $500 loss. Because he did not have any market discount gain, sections 1276 through 1278 will not be applicable.

B. The Importance of Understanding the Tax Implications of Distress Debt in Relation to Puerto Rico Bonds

Even though the basic rules of taxation of distressed debt are straightforward, the main issue with this type of debt is that in certain circumstances *phantom income*[54] must be recognized.[55] Ordinarily, this will occur when the debt is modified. In other words, *phantom income* must be recognized when Treasury Regulation 1.1001-3 comes into play.

As a result of this reality, any reorganization of Puerto Rico's debt should take into account this possibility. It is unlikely for investors to restructure any debt if they think their investment is not secured or they are getting something else in return for such transaction. Therefore, it is almost certain that any restructuring of Puerto Rico's bonds will be subject to Treasury Regulation 1.1001-3. Thus, all the investors that purchased the bonds at a market discount will be

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51 I.R.C. § 1278(b)(2).

52 Yale, *supra* note 45, at 708.

53 *Id.* at 709.

54 *Phantom income* is taxable income without any corresponding economic gain with which to pay the tax. In other words, one must recognize income for tax purposes even though it did not receive any money or property.

55 Commentators suggest that the application of market discount rules to distressed debt is problematic. *See* Yale, *supra* note 45, at 709.

subject to sections 1276 and 1278 of the Code. As such, these investors will have to recognize, to some extent, ordinary gain on their investments.

This reality must be kept in mind because it can affect the Puerto Rico bondholders' willingness to accept any proposal to restructure Puerto Rico's debt. If the bondholders are faced with a situation like this, they might be more persuaded to enter into a transaction as the one proposed in this article.

III. TAX CONSEQUENCES OF ABANDONING PROPERTY

A. *Can the Abandonment of Property Be Deducted as a Loss?*

Section 165(a) of the Code allows taxpayers to deduct any loss sustained during the taxable year that was not compensated.[56] Specifically, the mentioned statute provides: "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."[57] Like many Code sections, section 165(a) only provides the general rule. A reading of this Code provision does not state what constitutes a loss. It only disposes that any loss sustained can be deducted. This generality raises the following questions: Can the abandonment of property constitute a loss?

To properly analyze this question and the Code section 165(a) applicability to a particular situation, such as the question posed, a study of other code sections and of the Treasury Regulations interpreting the section at issue is required. To this effect, Treasury Regulation 1.165-1 provides that any deduction from a loss allowed under section 165(a) is "subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction."[58] Furthermore, the cited regulation states that "[t]his deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder."[59]

Moreover, even though the language of section 165(a) of the Code suggest that *any* type of loss might be allowable, Treasury Regulation 1.165-1(b) reduces the scope of its applicability. In fact, "[t]o be allowable as a deduction under section 165(a), a loss must be evidenced by close and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disasters losses, actually sustained during the taxable year."[60] Also, only bona fide losses are allowed.[61] Moreover, Treasury Regulation 1.165-2(a) establishes:

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56 I.R.C. § 165(a) (2012).

57 *Id.*

58 Treas. Reg. § 1.165-1(a) (as amended in 1977).

59 *Id.*

60 *Id.* at (b).

61 *Id.*

> A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.[62]

Based on the foregoing, it is clear that the abandonment of a property can constitute grounds to claim a loss. This conclusion is supported by case law[63] and the United States Internal Revenue Service, through several Revenue Rulings.[64] In regards to this matter, the Fifth Circuit has stated that "[a]s a general proposition, a taxpayer may claim a loss deduction under I.R.C. §165(a) of the Code on either of two alternative grounds: abandonment or worthlessness."[65]

B. What is an Abandonment of Property for Tax Loss Purposes?

Even though the words *abandon* and *abandoned* are mentioned several times in section 165 of the Code and the Treasury Regulations interpreting said provision, nowhere are these terms expressly defined in the mentioned law and regulations. This fact raises another interrogation: What is an abandonment of property for purposes of section 165 of the Code? The answer is not crystal clear and depends on the fact and circumstances of each case. Case law and Revenue Rulings, however, provide some guidance to answer this query. Also, there is some wording in the regulations that can be construed as to establishing a requirement for an action to effectively constitute an abandonment of property.

Case law reveals that three requirements are necessary to accomplish the abandonment of property, be it real or personal, tangible or intangible. First, the taxpayer must have the intention of abandoning the property. "In determining a taxpayer's intent to abandon, the 'subjective judgment of the taxpayer as to whether the business assets will in the future have value is entitled to great weight and a court is not justified in substituting its business judgment for a reasonable, well-founded judgment of the taxpayer'."[66] Second, there must be some kind of act that establishes the abandonment.[67] This requirement is sup-

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62 Treas. Reg. § 1.165-2(a) (as amended in 2014).

63 *See, e.g.*, Echols v. C.I.R., 935 F.2d 703 (5th Cir. 1991).

64 *See, e.g.*, Rev. Rul. 1993-80, 1993-2 C.B. 239.

65 *Echols*, 935 F.2d at 707.

66 Citron v. C.I.R., 97 T.C. 200, 209 (1991) (*quoting* A.J. Industries, Inc. v. U.S., 503 F.2d 660, 670 (9th Cir. 1974)).

67 *See Echols*, 935 F.2d at 707; *Citron*, 97 T.C. 200; C.R.S.T., Inc. v. C.I.R., 92 T.C. 1249 (1989); *A.J. Industries, Inc.*, 503 F.2d 660; Dezendorf v. C.I.R., 20 T.C.M. (CCH) 1480 (1961). All of these cases deal with the abandonment of property and its tax consequences. The properties abandoned in the mentioned cases include partnership interest, stocks and secured debt.

ported by the last sentence of Treasury Regulation 1-165.2(a) which provides: "For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which *the overt act of abandonment*, or the loss of title to the property, occurs."[68] The cited regulation sentence can be construed as to require an *overt act of abandonment* in order for the abandonment to be deducted as a loss. Third, the taxpayer cannot receive any consideration for the abandoned property.[69] If the taxpayer receives such considerations, no matter how small, no abandonment will occur because a sale or exchange occurred.

The compliance with these requirements is "to be ascertained from the facts and surrounding circumstances."[70] Deciding not to use a property is not an abandonment.[71] If a taxpayer does not take an affirmative act to relinquish (abandon) its interest in the property he will be impaired from claiming a loss under section 165(a) of the Code.[72] In the case of intangible assets, such as partnership interests, the abandonment "should be accompanied by some express manifestation."[73] This requirement is fulfilled by sending a letter indicating the decision to abandon the property and the relinquishment of any and all rights over said property.

For purposes of abandoning securities, which are defined to include certain bonds,[74] Treasury Regulation 1.165-5(i) establishes that "a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security."[75] However, an analysis of "all the facts and circumstances determine whether the transaction . . . [can] properly . . . [be] characterized as an abandonment."[76]

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68 Treas. Reg. § 1.165-2(a) (as amended in 2014) (emphasis added).

69 La Rue v. C.I.R., 90 T.C. 465 (1988).

70 *Dezendorf*, 20 T.C.M. (CCH) at 1482.

71 *C.R.S.T., Inc.*, 92 T.C. at 1249; *see also* Minneapolis, St. Paul & Sault Ste. Marie Ry. Co. v. C.I.R., 34 B.T.A. 177 (1936).

72 *C.R.S.T., Inc.*, 92 T.C. at 1257.

73 Citron v. C.I.R., 97 T.C. 200, 209 (1991).

74 For purposes of Treasury Regulation 1.165-5, *security* is defined to include:

> (1) A share of stock in a corporation; (2) A right to subscribe for, or to receive, a share of stock in a corporation; or (3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

Treas. Reg. § 1.165-5(a) (as amended in 2008).

75 *Id.* at (i).

76 *Id.*

C. What Happens with the Abandoned Property?

A neglected aspect of transactions involving the abandonment of property is what happens to the abandoned property. The case law, revenue rulings and available articles only discuss if the property was effectively abandoned or not, and if the taxpayer can claim a loss on such abandonment. However, an understanding of this issue is necessary to account for what happens to the property upon abandonment of the property. The importance of this analysis lies on the fact that depending on the applicable law, once property is abandoned, other persons or entities might claim the property as theirs.

Notwithstanding the foregoing, the answer to this question requires a case by case analysis. This is due to the fact that, generally, property rights of personal or movable property are determined by the state of residence of the holder of such property. [77] If the property to be abandoned were real, then the law of the *situs* of the property will control the outcome of the disposition of the property.[78]

D. What Amount can be Deducted as a Loss?

The amount of the deduction a taxpayer can claim is the "adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property."[79] Treasury Regulation 1.165-1(c)(1) explains this further and states that the "amount . . . allowable as a deduction . . . shall not exceed the amount prescribed by §1-1011-1 as the adjusted basis for determining the loss from the sale or disposition of the property involved."[80] Furthermore, this regulation requires that for every deduction claimed, "the [taxpayer's] basis of the property must be properly adjusted as prescribed by §1.1011-1 . . . to determine the amount of the loss [that would be] allowable as a deduction."[81] As will be discussed, *infra,* this adjustment is very important because it can make the decision to abandon property more or less viable, depending on the property at issue.

It should be noted, that some expenses incurred in the acquisition of property or in securing the title to the property, may not be deducted and must be capitalized.[82] If this is applicable, the taxpayer's basis on the property is increased by the amount of the expense. Correctly computing the adjusted basis is an essential element of the analysis to determine if the abandonment of bonds is viable.

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77 In Puerto Rico, this general law principle is codified in articles eight to ten of the Civil Code of Puerto Rico. *See* CÓD. CIV. PR art. 8-10, 31 LPRA §§ 8-10 (2015).

78 *See* Treas. Reg. § 1.165-5(i) (as amended in 2008).

79 I.R.C. § 165(b) (2016).

80 Treas. Reg. § 1.165-1(c)(1) (as amended in 1977).

81 *Id.*

82 *See* I.R.C. §§ 263, 1016 (2016).

A wrong computation of the adjusted basis might lead the property owner to reach the wrong decision with regards to the abandonment of the property.

E. Character of the Loss

Tax losses can be characterized in two different groups: ordinary losses and capital losses.[83] "The Tax Code [generally] 'gives taxpayers a break on capital gains while restricting the tax benefits available from capital losses'."[84] "Specifically, capital losses are subject to two limitations: (1) the Tax Code permits capital losses only to the extent of capital gains and (2) the Tax Code limits corporations' ability to carry capital losses to future years."[85] Pursuant to section 165(f) of the Code, capital losses are "[l]osses from sales or exchanges of capital assets . . . ."[86] A capital asset is defined in section 1221(a) of the Code as "property held by the taxpayer (whether or not connected with his trade or business)."[87] However, this definition does not include eight type of assets specifically listed in the mentioned section.[88] Therefore, any loss experienced on property held by the taxpayer upon the sale or exchange of such property —and in which the property is not one of the eight types excluded— will be considered a capital loss. Nevertheless, "[t]he abandonment of a capital asset is not a 'sale or exchange', as that term is used in § 165(f)."[89] Consequently, the abandonment of property, ordinarily, can be characterized as an ordinary loss. In fact, courts have agreed with this conclusion.[90]

Notwithstanding the basic rules previously stated for characterizing losses, Treasury Regulation 1.165-5(i) requires that the abandonment of a *security*,[91] as defined thereunder, must be treated as a *sale or exchange* of a capital asset.[92] Thus, any loss experienced from the abandonment of such property is a capital loss.

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83 *See* Pilgrim's Pride Corp. v. C.I.R., 779 F.3d 311, 314 (5th Cir. 2015).

84 *Id.* (*quoting* Campbell Taggart, Inc. v. United States, 744 F.2d 442, 448 (5th Cir. 1984)).

85 *Id.* at n.5.

86 I.R.C. § 165(f) (2016).

87 *Id.* at 1221(a).

88 *Id.*

89 *See Pilgrim's Pride Corp.*, 779 F.3d at 314.

90 *See id.* (abandonment of partnership interest can be deducted as an ordinary loss).

91 *See* C.R.S.T., Inc. v. C.I.R., 92 T.C. 1249 (1989); s*ee also,* Minneapolis, St. Paul & Sault Ste. Marie Ry. Co., 34 B.T.A. 177 (1936).

92 Treas. Reg. § 1.165-5(i) (as amended in 2008).

IV. ABANDONMENT OF PUERTO RICO BONDS

A. *Can Puerto Rico Bonds be abandoned?*

Based on the legal framework presented above, the abandonment of Puerto Rico bonds, from a Code perspective, is possible. In order to properly abandon these securities, the bondholders must satisfy the three requirements discussed in section IV.B of this article: (1) the taxpayer must have the intention of abandoning the bonds, (2) the taxpayer must realize an overt act of abandonment, and (3) the taxpayer cannot receive any consideration for abandoning the bonds. The fulfillment of these requirements is straightforward.

Notwithstanding the fact that Puerto Rico bonds can be abandoned for tax purposes, the abandonment of the property at issue might not make economic sense. This is because the benefits of entering into this transaction might not outweigh those of holding or selling the property. Thus, other factors come into play to properly analyze the feasibility of engaging in this transaction. These factors include: (1) who is the investor abandoning the bond, (2) the value of the bonds in the market, and (3) the character of the loss that can be claimed.

B. *Who holds Puerto Rico Bonds?*

The first aspect that must be evaluated to determine the practicability of the abandonment of Puerto Rico's debt is to answer: who holds these properties? This is a key element of the analysis due to the fact that not all bondholders can benefit from claiming a loss on their tax return. Because of the tax advantages of holding Puerto Rico bonds (i.e. no income is recognized from the principal or interest generated by them) many types of investors select to invest in these type of securities. Notwithstanding this enormous pool of investors, all of them can be categorized into two groups for purposes of this analysis: (1) institutional investors and (2) individual investors.

The first group of investors, institutional investors, is composed of hedge funds, retirement funds, and bond funds. This group holds a substantial amount of Puerto Rico's debt. Consequently, they have enormous bargaining power with the Government. Because of the complexities of this type of investors, they are more than likely to benefit from being able to claim a loss on their tax returns. This conclusion is based on several assumptions. First, these investors are more likely to generate taxable income from their investments. Thus, claiming a loss is beneficial to them because they can reduce their tax liability. Second, as professional investors, these investors hold diversified portfolios. This will generate different types of gains (capital and ordinary). Thus, being able to claim losses against these gains will also be in their interest. Third, because some of these investors have institutional investment requirements, such as investing only in *investment grade securities*, being able to dispose of the bonds once they do not comply with these requirements, without having to pay to dispose of the bonds (i.e. trading fees), makes the abandonment of the bonds more attractive.

The second group of investors is composed of individual investors. Unlike the institutional investors, the majority of these investors purchased the bonds for their tax-free income and holds them until maturity. These investors might or might not have other income that could be offset by the abandonment of their bonds. As such, the efficiency of entering into a transaction as the one proposed will clearly depend on whether there are gains to be offset on the return. Another factor to be considered is if the investor has other sources of income or not.

In sum, if the investors had gains to report, then they can benefit from abandoning Puerto Rico bonds. However, the analysis does not end here, the abandonment must be financially feasible.

C. The Financial Analysis

Another aspect that must be considered is if the transaction at issue is financially beneficial. For the abandonment of property to be practicable, the amount to be deducted as a loss has to be equal or greater than the fair market value of the bonds at the time of the abandonment. If this is not the case, the taxpayer is better off selling the bonds in the market and making a gain.

As previously discussed, the amount that can be deducted is the *adjusted basis* that the taxpayer has on the property to be abandoned.[93] Consequently, if the fair market value of the bonds exceeds the adjusted basis of the taxpayer in the bonds, it does not make sense to abandon them because the taxpayer will have a gain. However, if the adjusted basis in the bonds is greater than the fair market value of the bonds and the taxpayer has gains or expects to generate gains that he could offset with the losses he will be undertaking by abandoning the bonds, then abandoning the bonds is practicable. In the case when the adjusted basis equals the fair market value of the bonds —which is very unlikely to occur— the viability of abandoning the bonds will depend on if the taxpayer has gains that can be reduced by the abandonment.

To summarize this in a mathematical way:

If: FMV $\leq B(x)$, then abandoning the Bonds is viable

Where:

1. *x* = the tax rate applicable to the taxpayer
2. *B* = Taxpayer Adjusted Basis in the bonds, as computed by section 1211 of the Code and the regulations thereunder; and
3. *FMV* = the fair market value of the bonds at the time of abandonment

Once a determination is made as to the viability of abandoning the bonds, then an analysis of the actual benefit of engaging in such transaction should be conducted. The taxpayer's benefit from abandoning the property can be defined by:

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93 I.R.C. § 165(b) (2016).

$$I=(B-FMV)(1-x) + (TFS)$$

Where:

1. I = the amount the taxpayer reduces his tax liability
2. B = Taxpayer Adjusted Basis in the bonds, as computed by section 1211 of the Code and the regulations thereunder
3. FMV = the fair market value of the bonds at the time of abandonment
4. x = the tax rate applicable to the taxpayer; and
5. TFS = trading fees saved

In the eventuality that the fair market value of the bonds is higher than the bondholder's adjusted basis in the bonds, the result will be a negative number. The negative result reflects the fact that the taxpayer will lose money as a result of engaging in the transaction. However, unlike with a positive result, the result does not reflect the actual amount to be loss.

i. Example

To illustrate, consider a calendar taxpayer who bought $10,000,000 of Puerto Rico bonds. The taxpayer will have a basis equal to the cost of the bonds (i.e. $10,000,000). To simplify things, let us assume no fees were paid for acquiring the bonds and no fees will be paid upon disposition of the securities. Also, let us assume that the taxpayer is subject to a thirty-five percent tax. After two years of holding the bonds, the fair market value of the bonds decreases to $2,500,000. The taxpayer's taxable income for the year at issue is $20,000,000 and he has no other deductions to claim.[94] If the taxpayer were to sell or exchange the bonds, he would be able to recognize a $7,500,000 loss. Thus, he would have to pay $4,375,000 of taxes.[95] However, if he abandons the bonds he can claim a loss of $10,000,000. Therefore, his tax liability would reduce to $3,500,000.[96] As a consequence, if the taxpayer chooses to abandon the bonds he would technically increase his value of the bonds to $3,375,000.[97] That is $875,000 more than if he were to just sell or exchange the bonds. This is true because the taxpayer will reduce his tax liability by $875,000 as a consequence of engaging in the abandonment transaction. Therefore, from a financial perspective, it makes sense to abandon the bonds rather than to sell them.

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94 To further simplify things, let us assume that only ordinary income and losses can be recognized.

95 ($20,000,000 - $7,500,000) * 0.35 = $4,375,000.

96 ($20,000,000 - $10,000,000) * 0.35 = $3,500,000.

97 ($2,500,000 + $875,000) = $3,375,000. This is the result of the savings the taxpayer gained because of having a greater loss deduction (i.e. the reduction of his tax liability, which amount to $875,000 in this example).

D. Alternative Scenarios to the Characterization of the Loss

So far the factors considered have been general ones. Notwithstanding, the proper analysis of the viability of the abandonment of property requires an analysis of the character of the loss to be deducted. Taxpayers will most certainly want to claim ordinary losses. However, as discussed in section III.B of this article, the loss from any security, which is defined to include bonds, abandoned should be characterized as a capital loss.[98] Nevertheless, what if the taxpayers did not abandon the bonds *per se,* but abandoned property that is not a security? In this case, the taxpayers might be able to recognize an ordinary loss.

To accomplish being able to claim an ordinary loss, the taxpayer may create a partnership[99] by transferring their bonds to the partnership in exchange for a partnership interest.[100] Then, the taxpayer can abandon his partnership interest and claim an ordinary loss. As discussed, the abandonment of a partnership interest can be treated as an ordinary loss. [101]

i. Possible Challenges by the Internal Revenue Service

The problem with this transaction is that the transaction can be cataloged as one without a bona fide purpose. As such, the Internal Revenue Service might challenge its validity. To avoid this, forming a partnership with various partners and having the other partners contribute other properties and retain their respective partnership interests after the bond contributing partner abandons his partnership interest might ease the Service's concern regarding the validity of the transaction.

A consideration that must be kept in mind is the fact that the partnership should be structured with limited liability for the partners. This is a very important consideration because once abandoning a partner's partnership interest is abandoned —in a partnership without limited liability— the other partners might become liable for the interest of the abandoned partner.

Another possible challenge that the Internal Revenue Service might raise is that the true property being abandoned are the bonds and not the partnership interest. Nevertheless, based on the language of Revenue Ruling 1993-80, the Service would not look into the partnership assets to make a determination on the character of the loss. The Service will, however, look at "whether or not the loss results from the sale or exchange of a capital asset."[102]

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98 *See* Treas. Reg. § 1.165-5(i) (as amended in 2008).

99 For clarification sake, the term *partnership* is used in this article to identify the tax entity governed by Subchapter K of the Code.

100 Pursuant to I.R.C. § 721, this event shall not be taxable.

101 *See* Pilgrim's Pride Corp. v. C.I.R., 779 F.3d 311, 314 (5th Cir. 2015).

102 Rev. Rul. 1993-80, 1993-2 C.B. 239.

CONCLUSION

The abandonment of Puerto Rico bonds is a viable alternative to Puerto Rico's bondholders. By engaging in the abandonment of the bonds, investors can benefit by claiming greater losses than those they would be able to claim if they sold or exchanged the property. Thus, this action, from a bondholder's perspective, might be more lucrative. However, not all bondholders can benefit from this transaction. Only those bondholders who have an adjusted basis in their bonds equal to or greater than the fair market value of the bonds should consider this transaction.

Prior to deciding whether to actually abandon Puerto Rico bonds, taxpayers should evaluate if their adjusted basis in the bonds is equal to or greater than the fair market value of the bonds. If the fair market value of the bonds is greater, then the taxpayers cannot take advantage from engaging in the abandonment of the bonds. However, assuming the taxpayers' basis in the bonds is greater than the fair market value of the property at issue, the taxpayers must consider if they have gains with which to offset the losses they will be generating. If the taxpayers do not have any gains that could be offset by the losses generated from abandoning the bonds, they must consider if they expect to generate gains in the future. Also, the character of gains they will generate must be considered. These considerations are of the utmost importance. If the taxpayers do not have any gains to offset nor expect to generate any in the future, the abandonment of the bonds in not viable nor practicable.

Once the taxpayers identify that they have gains or expect to generate gains, then they must consider the character of such gains. The reason for this consideration is quite obvious: with the proper planning, the taxpayer can offset the specific gains generated. If the taxpayers generated or expect to generate capital losses, they can proceed to abandon the bonds. After all, if the taxpayer just abandons his bonds, he can claim capital losses. However, if the taxpayers identify ordinary gains, they need to properly plan the abandonment of the bonds. With proper planning, the taxpayer can claim ordinary losses, which usually are preferable. Thus, the potential savings of engaging in a transaction as the one described in this article should be considered by all types of bondholders.

For Puerto Rico, the fact that bondholders can abandon their property should be a source of relief and, without being sarcastic, rejoice. If the bondholders decide to engage in this transaction rather than force the government to pay or restructure its debt, the Commonwealth will be discharged from complying with its obligations in exchange for nothing. However, this scenario is only viable if the bonds can be truly abandoned and no one can claim the bonds as their property after it is abandoned. Therefore, for Puerto Rico to benefit from this scenario, the laws governing the abandonment of property at issue must provide that once abandoned, the bonds may not be claimed by another. If the taxpayer is a Puerto Rico resident, this is viable. Finally, as Puerto Rico can greatly benefit from bondholders abandoning their bonds, the Government should consider mechanisms to incentivize the utilization of this type of transaction.