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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR COMPLIANCE DIRECTOR, INDUSTRY SPECIALIZATION PROGRAM

FROM: Deborah A. Butler
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CC:DOM:FS

SUBJECT: Losses Upon Closure of Restaurant Units

This Field Service Advice responds to your memorandum dated February 7, 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.

ISSUE

A taxpayer closes restaurants that are no longer economically viable and offers them for sale. May the taxpayer deduct losses upon a restaurant's closure if the taxpayer has not sold the restaurant by year-end?

CONCLUSION

Because there has been no retirement of the property under Treas. Reg. § 1.167(a)-8, the taxpayer may not deduct losses upon closure of a restaurant that it has not sold by year-end.

FACTS

A taxpayer who operates multiple restaurant units closes those that are no longer economically viable. Once the taxpayer determines a restaurant is performing poorly, it considers all feasible options for making the restaurant profitable before making the decision to close it.

When the taxpayer decides to close a restaurant, it fires the workforce and notifies employees the closure is permanent. The taxpayer then disconnects all utilities, returns or transfers to other facilities the food, liquor, and smallwares, cleans up the site, posts a "closed" sign, and boards up the windows. Heavier equipment and other building contents generally remain on the premises intact so that the site can be marketed as a restaurant business.

Generally upon closure, the taxpayer moves the restaurant from an active depreciation account to one that shows the property as inactive. In addition, the taxpayer immediately either makes plans to sell the restaurant, to convert it to another concept, or, where the restaurant was leased, to sublease it before the end of the taxable year. For those restaurants for sale that were not sold by year-end (the subject of the discussion below), the taxpayer deducts losses incurred at the time it closes the restaurant and permanently withdraws it from operations. Typically, the taxpayer claims losses for the excess of basis over the estimated realizable value of each restaurant.

LAW AND ANALYSIS

I.R.C. § 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-2(c) cross-references Treas. Reg. § 1.167(a)-8 for determining the allowance of section 165(a) losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income.

Treas. Reg. § 1.167(a)-8(a) addresses gains and losses on retirement. It provides that the term “retirement” means the permanent withdrawal of depreciable property from use in the trade or business. The withdrawal may be made in several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from productive use without disposition as, for example, by being placed in a supplies or scrap account.

Treas. Reg. § 1.167(a)-8(a)(3) provides that a taxpayer may take a loss for an abnormal retirement. Treas. Reg. § 1.167(a)-8(b) defines normal and abnormal retirements and provides that the determination of such shall be made on a facts and circumstances basis. Generally, a retirement shall be considered normal unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. A retirement is considered abnormal if the asset is withdrawn earlier than the taxpayer customarily retires similar assets, or under other circumstances. For example, the abnormal retirement may occur when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of an extraordinary obsolescence.

Although a retirement deduction must be claimed under section 165, the regulation that applies to determine whether the taxpayer may actually take the deduction is Treas. Reg. § 1.167(a)-8. Treas. Reg. § 1.165-2(c); Coors Porcelain Co. v. Commissioner, 52 T.C. 682, 692 (1969), aff'd, 429 F.2d 1 (10th Cir. 1970). Treas. Reg. § 1.167(a)-8(a) provides examples of permanent withdrawals that are retirements. They are: a sale or exchange, an actual abandonment, or placement in a supplies or scrap account.

The taxpayer of course did not sell or exchange the restaurant. Neither did it abandon the restaurant upon closure. Rather, the taxpayer prepared the restaurant for future sale. Thus, for there to be a retirement under Treas. Reg. § 1.167(a)-8(a), the taxpayer must have placed it in a supplies or scrap account.

Upon closure of the restaurant, the taxpayer moved it from an active depreciation account to one that shows the property as inactive. Nevertheless, this transfer to an inactive account does not satisfy the regulation's requirement that the account be a supplies or scrap account. A restaurant held for sale is not the type of property placed in these accounts. That is, the taxpayer's restaurant is not a supply item, and the taxpayer does not intend to scrap the building but rather intends to sell it. Accordingly, the taxpayer does not have a retirement under Treas. Reg. § 1.167(a)-8(a).

Treas. Reg. § 1.167(a)-8(a)(3), however, provides for loss recognition where there is an abnormal retirement. Thus, for there to be any possibility here of a retirement---permanent withdrawal from use in the trade or business, the taxpayer's retirement would have to be an abnormal one as defined under Treas. Reg. § 1.167(a)-8(b). Dell v. Commissioner, T.C. Memo. 1985-246. To claim an abnormal retirement, the taxpayer must show that the "loss arose from the sudden, unexpected termination of the usefulness of the property (as through a casualty or extraordinary obsolescence.)" De Cou v. Commissioner, 103 T.C. 80, 89 (1994).

An example of an obsolescence can be found in Tanforan Co., Inc. v. United States, 313 F. Supp. 796 (N.D. Calif. 1970), aff'd, 462 F.2d 605 (9th Cir. 1972). There the taxpayer's race track became obsolete because of several factors, including legislation affecting the race track industry, the necessity of making expensive repairs and improvements, and the condemnation of a prime area of the taxpayer's already-inadequate parking lot. Tanforan, however, is distinguishable from the present situation, because any efforts by that taxpayer to continue to use its property would have been fruitless. In addition, the primary events leading to that taxpayer's terminating the use of its property all occurred during the same brief time period. Those events could not have been "reasonably anticipated." Tanforan, at 802.

In the present situation, there always was the possibility the taxpayer would continue its restaurant's operation. Yet, there was nothing sudden or unexpected about the taxpayer's decision to close the restaurant. Because of the restaurant's poor performance, the taxpayer studied the restaurant's economic viability and made considerable efforts to improve its performance. Furthermore, the possibility of the restaurant's closure existed for some time because of the taxpayer's knowledge of the restaurant's poor performance. It was only after the taxpayer's considerable efforts to improve the restaurant's viability that it finally determined the restaurant did not meet its operating standards, had to be closed, and offered for sale. Simple nonuse of a restaurant does not meet the requirements of an abnormal retirement. Dell v. Commissioner. There was no casualty here, nor was there an extraordinary obsolescence under Treas. Reg. § 1.167(a)-8(b). Accordingly, the taxpayer cannot take a loss deduction upon closure of a restaurant.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

There are some litigation hazards of which you should be aware. First, Treas. Reg. § 1.167(a)-8(a) several times uses the phrase "for example" when defining retirement. Generally, the regulation has been interpreted as applying only to the specific examples enumerated therein. It is conceivable, however, that a taxpayer could argue, and convince a court, that the list of examples is merely illustrative, that another situation may also satisfy the definition.

It also is conceivable a taxpayer may convince a court that its discontinued use of an underperforming restaurant is abnormal because Treas. Reg. § 1.167(a)-8(b) likewise uses the "for example" phrase. That regulation's mention of an asset's being withdrawn earlier than customary "or under other circumstances" could be equally problematic. Furthermore, the regulation provides that the deermination shall be made on a facts and circumstances basis. These factors, coupled with the De Cou opinion's statement that the regulation is "clear that damages caused by a casualty is just one example of an abnormal retirement," at 89, also could pose a hazard.

Please call if you have any further questions.