

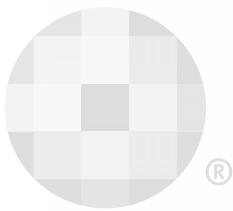
# Corporate Tax Watch

By Debra J. Bennett\*

## Abandonment of Stock: The Proposed Regulations

On July 30, 2007, the IRS issued proposed regulations addressing the character of a loss from the abandonment of securities.<sup>1</sup> The IRS has decided that an abandonment of securities isn't an event apart from worthlessness but that abandonment "establishes the worthlessness of the security to the taxpayer." The preamble to the proposed regulations provides that the abandonment of a security that is a capital asset is treated as a loss from the sale or exchange of a capital asset on the last day of the taxable year pursuant to Code Sec. 165(g)(1). Code Sec. 165(g)(3) provides an exception to the general rule of capital treatment, allowing an ordinary loss for a worthless security that is a capital asset if (1) the security is owned by a domestic corporation, (2) the security is a security of a domestic or foreign corporation affiliated with the security holder,<sup>2</sup> and (3) a gross receipts test is satisfied by the issuer.<sup>3</sup> As with worthless securities, the preamble does explain that if the requirements of Code Sec. 165(g)(3) are satisfied, *i.e.*, the ownership and gross receipts tests, then the loss will be ordinary. Thus, unless the abandoned security satisfies the requirements of Code Sec. 165(g)(3), the loss from abandonment will be governed by Code Sec. 165(g)(1) and be capital if these regulations are finalized in the current form.

Is this the right answer? The preamble states that characterizing an abandonment loss of a security under Code Sec. 165(g), with other worthless security losses, "furtheres the legislative intent to eliminate 'peculiar and anomalous results.'" This reference is to the legislative history of the predecessor of Code Sec. 165(g). Apparently, the IRS believes this language



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indicates that the statute was enacted to remove the “peculiar and anomalous results” that arise from treating losses from the worthlessness of securities as ordinary losses and losses from the sale or exchange of securities as capital losses.<sup>4</sup>

Going back this far in history, it is curious that worthlessness resulting in an ordinary loss is considered “peculiar and anomalous.” It is correct that a sale of a capital asset should result in capital gain or capital loss unless excepted by statute or otherwise. It is also clear that stock, securities and debt instruments are capital assets in most circumstances since no exception to Code Sec. 1222 applies. But an event of abandonment or worthlessness is not a sale or exchange, the important distinction being that abandonment or worthlessness occurs without the receipt of consideration for the property being abandoned or deemed to be worthless. Is this enough to warrant different treatment? In the eyes of many courts, the answer has generally been yes. As just one example, in *G. Gannon*,<sup>5</sup> a partner in a law firm walked away from his interest in the firm to build his own practice, the taxpayer claimed an ordinary loss for the amount of his investment in the partnership, which the IRS disallowed. The Tax Court held that the taxpayer had sustained a loss and the loss was an ordinary loss because he did not receive any consideration for the asset that he lost, therefore, sale or exchange treatment could not apply.<sup>6</sup>

The significant amount of case law holding that worthlessness and abandonment are different from a sale or exchange due to the lack of consideration should give one pause in concluding that the tax character should be the same. The preamble to the proposed regulations states that the legislative history indicates that the treatment of worthless securities should be the same as to sale or exchange treatment “because both losses represent a loss of capital in a transaction entered into for profit.” However, if we draw an analogy to the treatment of a similar asset, we find an “anomalous and peculiar result.” A debt instrument that is not a security is also a capital asset and it is also entered into for profit.<sup>7</sup> However, a worthless bad debt is entitled to an ordinary deduction under Code Sec. 166 and, such deduction can be claimed for debts that are wholly or partially worthless.<sup>8</sup> Conversely, a loss arising from the sale or exchange of a debt instrument that is not a security is a capital loss. So, similar to the partnership interest described above, if a debt instrument is worthless or cancelled, the

loss is ordinary as long as the requirements of Code Sec. 166 are satisfied, but if the debt instrument is sold at a loss, the loss is capital.<sup>9</sup> Accordingly, in most circumstances, the courts recognize the appropriateness of treating worthlessness and abandonment as having differing results from a sale or exchange.<sup>10</sup>

## Worthlessness

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Once Congress decided that losses from worthless securities should be capital in most situations, perhaps the IRS is of the view that all losses on securities should be capital unless qualifying under Code Sec. 165(g)(3). However, the proper treatment of a loss from an abandoned security has long been an area of controversy.<sup>11</sup> The issue was particularly important early in this decade. At that time, it was not unusual to be holding stock of a corporation that although not worthless, had significantly declined in value, so much so that it was unlikely that the stock would ever recover. There was many a taxpayer holding stock that may have lost most of its value, being worthless in the eyes of the holder although not worthless for federal tax purposes.

Establishing worthlessness for Code Sec. 165(g) purposes can be a difficult undertaking. If the stock is still trading, even at a minimal amount per share, the owner may not be entitled to a worthless stock loss because the stock still has value for purposes of Code Sec. 165(g).<sup>12</sup>

For losses generally, in order for a deduction to occur, Reg. §1.165-1(b) requires that the loss be (1) evidenced by a closed and completed transaction, (2) fixed by identifiable events, and (3) actually sustained during the tax year. The regulation further provides that the loss must be a *bona fide* loss and that substance governs in determining the deductibility of a loss.<sup>13</sup> However, with respect to worthlessness specifically, a worthless loss does not necessarily require a “closed and completed transaction” to be deductible.<sup>14</sup> In lieu of the “closed and completed transaction” requirement set forth in Reg. §1.165-1(b), authorities have required that there must be an “identifiable event” evidencing the worthlessness of the securities.<sup>15</sup> Accordingly, the most important factor in establishing worthlessness is whether or not the worthlessness is fixed by one or more identifiable events.

The four most common identifiable events that have been held to indicate worthlessness are (1)

bankruptcy, (2) termination of business operations, (3) liquidation and (4) receivership.<sup>16</sup> An additional event that the courts have frequently considered as indicative of worthlessness is insolvency; however, insolvency alone is not enough to establish worthlessness, since worthlessness requires that there be no present value and no future value.<sup>17</sup> That is, what is important is the occurrence of one or more events that establish current worthlessness and negate any hope of recovery of value, and the time that such event occurs is the time that the security becomes worthless. Accordingly, if there is \$1 of value remaining, there is no worthlessness.

For those taxpayers not meeting the requirements of Code Sec. 165(g)(3), the loss is capital whether it is sold or it is worthless and due to the difficulty in establishing worthlessness it is probably easier to sell the stock to fix the time for deducting the loss. However, for those taxpayers meeting the requirements of Code Sec. 165(g)(3), the difference is significant, *i.e.*, a capital loss on a sale and an ordinary loss on worthlessness. But there is another option, a body of authority indicating that an abandonment of stock results in an ordinary loss. Thus, both the taxpayer who needed to sell his stock for \$1 a share to fix the loss and the taxpayer who had to wait for worthlessness to receive an ordinary loss, could consider abandoning the stock and in either case receive an ordinary deduction.

## Abandonment

As described above, if a taxpayer's loss on securities does not qualify as worthless due to some remaining value, there has historically been another option, abandonment. Unfortunately, there has been no specific guidance regarding abandonment of securities, but many tax practitioners have been of the view that there is a reasonable position that an abandonment of a security results in an ordinary loss, based on analogous authority.

In the context of Code Sec. 165, Reg. §1.165-2 specifically allows a loss incurred with respect to *nondepreciable* property used in a business or a

transaction entered into for profit due to the sudden termination of the usefulness of the property in the business or for-profit transaction. Securities seem to fit into this description if held as investments related to a trade or business. The regulation identifies an overt act of abandonment as an event to which the regulation could apply. The regulation continues by providing that it does not apply to losses sustained through a sale or exchange of

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property and also states that the limitations imposed under Code Sec. 1211 and 1212, relating to limitations on capital losses, do not apply to losses allowable under the regulation.<sup>18</sup> The regulation seems consistent with case law that abandonment does not arise from a sale or exchange

and abandonment results in an ordinary loss deduction.<sup>19</sup> However, it is not entirely clear that this regulation was intended to apply to securities.

Stock is specifically addressed in Reg. §1.165-4(a), which states that no deduction is allowed under Code Sec. 165(a) "solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause."<sup>20</sup> This is the case even if the decline in value is "extensive" so long as "the stock has any recognizable value on the date claimed as the date of loss." The regulation further provides that, "No loss for a decline in value of stock owned by the taxpayer shall be allowed as a deduction under Code Sec. 165(a) except insofar as the loss is recognized under Reg. §1.1002-1 upon the sale or exchange of stock and except as otherwise provided in Reg. §1.165-5 with respect to stock which becomes worthless during the taxable year." The language of the regulation appears to preclude a loss on the abandonment of stock if the loss arises from a decline in value of the stock and potentially limits the circumstances when a loss can be deducted pursuant to a sale or exchange of stock or situations when stock becomes wholly worthless.<sup>21</sup>

However, authority issued by the IRS and the courts following the issuance of Reg. §1.165-4 does not appear to limit the situations wherein a loss can be deducted with respect to stock to a sale or exchange

or complete worthlessness. Most often, the authority citing Reg. §1.165-4 includes facts indicating that the taxpayer retains his shareholder rights, either with the stock currently held or with stock of a reorganized corporation.<sup>22</sup> For example, in LTR 8303003,<sup>23</sup> the IRS stated:

The legislative history behind section 266 of ERTA appears to grant relief to all taxpayers whose value in its motor carrier operating rights have been reduced significantly due to deregulation. *These taxpayers were not entitled to a deduction under section 165 of the Code since no deduction is allowed for a decline in value of property absent a sale, abandonment or other disposition of the property.* [Emphasis added.]<sup>24</sup>

This statement appears consistent with the view of the courts. In *H.F. Batson*,<sup>25</sup> the taxpayer tried to take a worthless stock deduction with respect to stock he still owned. The IRS disallowed the loss, stating that a loss had not been sustained. Citing Reg. §1.165-4, the Tax Court stated, "Petitioner here is attempting to write off as a loss the amount he considered the stocks he bought to have decreased in value. This decrease in value is not a properly deductible loss." Furthermore, in *R.E. Pomeranz*,<sup>26</sup> with respect to a worthless stock deduction for recently purchased stock held by the taxpayer, the Tax Court, citing Reg. §1.165-4 stated, "On the other hand, if the stock still had value as of that date, petitioners are not entitled to any deduction on account of its purchase. Under such circumstances, the taxable event is the disposition of the stock." Moreover, in *N.H. Serris*,<sup>27</sup> a taxpayer attempted to take a deduction for stock that had declined in value but that he was prohibited from selling because of his status as an "insider" under the Securities Act of 1934. With respect to the deduction of the loss, the Tax Court stated:

Section 165(a) authorizes a deduction for 'any loss sustained during the taxable year and not compensated for by insurance or otherwise.' Income Tax Regs. Section 1.165-4(a) explains that a decline in the value of stock in and of itself, even if extensive, is not a realized loss. Generally, in order for a deduction to accrue, *the stock must have been disposed of in a closed transaction or have become completely worthless within the taxable year.* [Emphasis added.]

Even more telling perhaps is the statement in the preamble to the investment adjustment regulations proposed on November 12, 1992, in addressing the addition of Reg. §1.1502-80(c), *i.e.*, the deferral of Code Sec. 165(g),<sup>28</sup> the IRS stated the following:

*Under section 165(a), P may recognize a loss with respect to S's stock if the stock is sold, exchanged, or abandoned.* In addition, section 165(g) provides special rules for recognizing loss with respect to wholly worthless securities. See §1.165-5. However, no loss is allowed solely because of a decline in the value of S's stock due to fluctuations in its market price or similar causes if the stock has any recognizable value on the date claimed as the date of the loss. See §§1.165-4, 1.165-5(f). Section 165(g)(3) treats stock in certain corporations affiliated with the taxpayer as not being a capital asset. [Emphasis added.]<sup>29</sup>

The language of the preamble potentially makes several points: (1) the IRS recognizes that stock can be abandoned; (2) an abandonment of stock may result in the recognition of loss under Code Sec. 165(a); (3) an abandonment of stock is an event not within the purview of Code Sec. 165(g); and (4) an abandonment of stock is not the type of loss encompassed by Reg. §1.165-4, *i.e.*, a loss resulting solely from a decline in value.

Based on the cited authority, although the language in Reg. §1.165-4 is limited to losses recognized under Reg. §1.1002-1, it appears that the purpose of the regulation is to prevent taxpayers from deducting losses with respect to the loss of value of stock in situations where the taxpayer retains the depreciated stock; thus, the decline in value is more akin to a write-off of value rather than a complete disposition. This is also consistent with Code Sec. 165(a) and Reg. §1.165-1(a) and (b) requiring that a loss actually be sustained to be deductible. Accordingly, it appears that Reg. §1.165-2 more properly applies to an abandonment of securities than Reg. §1.165-4, with the only other contender, Reg. §1.165-5, discussed below.

Outside of authority directly on point, in trying to determine the correct treatment, looking to the treatment of similar assets should be instructive. A partnership interest, like stock of a corporation, is an ownership interest. The character of a gain or loss on the sale or exchange of a partnership, like stock, is capital if the interest is held as a capital as-

set. Interestingly, the IRS and courts have supported treating a loss from the abandonment of a partnership interest as resulting in ordinary income if sale or exchange treatment does not apply.<sup>30</sup> In Rev. Rul. 93-80,<sup>31</sup> two situations involving the abandonment of a partnership interest are contrasted. In the second situation of the ruling, D and E owned a limited partnership, LP, as general partners. The limited partners included F. During 1993, LP became insolvent, and F abandoned his limited partnership interest. F took all steps necessary to effect a proper abandonment, including written notification to LP. LP's partnership agreement was amended to indicate that F was no longer a partner. At the time F abandoned the partnership interest, he had a remaining adjusted basis of 200x dollars in the partnership interest. F did not bear the economic risk of loss for any of the partnership liabilities and was not entitled to include a share of the partnership liabilities in the basis of F's partnership interest. F did not receive any money or property on leaving the partnership. In this situation, the IRS ruled that because F did not receive any distributions from LP, actual or deemed, F's loss on the abandonment was ordinary.

In *Citron*,<sup>32</sup> the taxpayer invested \$60,000 in borrowed funds in a partnership, along with three other individuals. The purpose of the partnership was to produce a motion picture. The production failed and the partnership dissolved. Immediately before the dissolution, the partnership had no liabilities, no profits, nor any assets to speak of. The taxpayer did not receive any distributions from the partnership and the facts indicate that it was clear to all involved that the taxpayer had nothing further to do with the partnership.

The taxpayer claimed an ordinary loss equal to his capital invested in the partnership and contended it was from theft or embezzlement or from abandonment. The IRS contended that if any loss occurred, it occurred from a sale or exchange of a capital asset and, accordingly, characterized as a capital loss. The Tax Court held that although there was no loss from theft or embezzlement, the taxpayer had abandoned his partnership interest. The Tax Court further determined that the taxpayer was entitled to an ordinary

loss even though the IRS stated that Rev. Rul. 76-189<sup>33</sup> expresses the view that even where a partnership has no assets or liabilities at termination, any loss of a partner is subject to Code Sec. 731 and results in capital loss. The Tax Court stated:

No rationale or support is provided in the ruling for the supposition deeming the existence of a distribution for purposes of section 731. In order to decide this case under the theory used by

respondent in the ruling, we would be compelled to impute a sale or exchange, even though none had occurred. This we decline to do. Section 165 losses are not limited to certain types of assets, and sections 701 through 761 are not

literally exclusive for purposes of abandonment... Accordingly, petitioners are entitled to ordinary loss treatment with respect to the abandonment of the Vandom partnership interest during 1981."<sup>34</sup>

From the treatment of an abandonment of partnership interest and cancellation of a debt instrument, it could be inferred that the treatment of an abandonment of a security should likewise result in an ordinary loss.

### **Abandoned vs. Worthless**

The proposed regulations indicate the IRS is now of another view, that is, that an abandonment of a security is a Code Sec. 165(g) event. The proposed regulations state, "[A] security that becomes wholly worthless includes a security described in paragraph (a) of this section that is abandoned and otherwise satisfies the requirements for a deductible loss under section 165." Other authority would indicate that abandonment and worthlessness can be mutually exclusive. In earlier authority, the IRS apparently viewed abandonment as an event different from worthlessness, and, thus, although able to coexist, abandonment could occur without worthlessness and vice versa."<sup>35</sup>

The courts also apparently view abandonment as an event that is distinctly different from worthlessness. In *Echols*, the Fifth Circuit Court stated, "Second is the distinction between 'abandonment'

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and 'worthlessness'; either concept can, under proper circumstances, justify a deduction pursuant to Code Sec. 165(a) but each is different in theory, and the elements of one are separate and distinct from the elements of the other. The Tax Court, and the government as well, failed to remain cognizant of those distinctions, failures that contributed in no small part to the reversible error in this case."<sup>36</sup>

In reversing the Tax Court's decision in *Echols*, the Fifth Circuit Court indicated that the Tax Court did not appropriately distinguish between the abandonment of a partnership interest and the abandonment of the partnership assets.<sup>37</sup> Thus, the Fifth Circuit Court reasoned that the Tax Court had incorrectly looked to the acts of the partnership rather than to the acts of the partners. The Appellate Court also noted that the Tax Court failed to address the taxpayer's alternative argument for a loss based on worthlessness. The Fifth Circuit Court stated that the taxpayer's argument for worthlessness was as compelling as his argument for abandonment. The Appellate Court continued by stating that a taxpayer may claim a loss under Code Sec. 165(a) "on either of two alternative grounds: abandonment or worthlessness." Additionally, the Appellate Court noted that the test for abandonment is objective—the abandoning party must manifest an intent to abandon by some overt act or statement reasonably calculated to give a third party notice of the abandonment. The Fifth Circuit Court implies that the test for abandonment may be easier to satisfy than the test for worthlessness. The language of the Fifth Circuit Court is compelling and clearly indicates that, at least the Fifth Circuit Court views abandonment and worthlessness as distinct events.

It should be noted that the preamble indicates that there may be other contexts in which "the tax treatment of securities is unclear or in which abandonment and worthlessness should be treated differently." Thus, it seems the IRS does not believe an abandoned security will always be properly treated as worthless. The proposed regulations do limit the treatment to abandoned securities that otherwise satisfy the requirements for a deductible loss under Code Sec. 165, but it is difficult to understand when a security that is properly abandoned would not meet the general requirements of Code Sec. 165, *i.e.*, the loss is (1) evidenced by a closed and completed transaction, (2) fixed by identifiable events, (3) actually sustained during the tax year, and (4) a *bona fide* loss.

## Conclusion

If the literal language of the proposed regulations is correct, that is, an abandoned security is a worthless security, one could reasonably conclude that the highly subjective test of determining when worthlessness occurs may be overridden by an act of abandonment, because such an act would fix the date of the loss. Thus, if the proposed regulations are finalized, abandonment could remove the uncertainty from a taxpayer's position that worthlessness has occurred in a given tax year. It appears that the IRS has determined that the price of not being able to challenge taxpayers with respect to establishing worthlessness is worth the ability to include abandonment in Code Sec. 165(g). If the regulations are finalized, taxpayers could potentially have the ability to accelerate a worthless security deduction by abandoning the security. However, Reg. §1.165-2(a) states that the tax year in which a loss is sustained is not necessarily the tax year in which the overt act of abandonment occurs. Accordingly, the IRS should provide guidance that Reg. §1.165-2(a) does not apply to abandoned securities to which Code Sec. 165(g) applies if the regulations are finalized.

Additionally, the statement in the preamble, that there are situations where "the tax treatment of securities is unclear or in which abandonment and worthlessness should be treated differently," is confusing and seems to contradict the proposed regulations. Is the IRS saying that all abandonments of securities should be governed by Code Sec. 165(g), as the language in the proposed regulations indicates, or is the IRS saying that only securities that are worthless, if abandoned, will then fall into Code Sec. 165(g)? The proposed regulations state, "a security that becomes wholly worthless includes a security described in paragraph (a) of this section that is abandoned ..." And the preamble states, "The proposed regulations provide, that for purposes of applying the loss characterization rules of Code Sec. 165(g), the abandonment of a security establishes the worthlessness of the security to the taxpayer." Hopefully, the IRS will provide some clarification on the types of abandonments to which Code Sec. 165(g) will not apply, since the proposed regulations are inconsistent in addressing this issue.

## ENDNOTES

- \* All views expressed in this article are those of the author and not necessarily those of Ernst & Young LLP or any other person. All references to "Code Sec." are to the Internal Revenue Code of 1986, as amended ("the Code"), and the regulations thereunder, unless otherwise stated.
- <sup>1</sup> REG-101001-05.
- <sup>2</sup> Code Sec. 165(g)(3); Reg. §1.165-5(d). The affiliation test requires the security holder to directly hold stock of the issuing corporation meeting the requirements of Code Sec. 1504(a)(2).
- <sup>3</sup> Code Sec. 165(g)(3)(B) requires 90 percent or more of the aggregate gross receipts of the issuing corporation for all tax years during which the corporation has been in existence to have been from other than royalties, rents, dividends, interest, annuities and gains from the sale or exchange of stock and securities.
- <sup>4</sup> H. REP. NO. 1860, 75th Cong., 3d Sess., at 18-19 (1938). It is interesting that the IRS would cite legislative history from 1938 given the statutes, amount of authority and body of case law issued since that time, particularly in the area of debt instruments. There is also a significant amount of authority indicating that abandonment and worthlessness can be mutually exclusive. Some of this authority will be addressed below.
- <sup>5</sup> *G. Gannon*, 16 TC 1134, Dec. 18,304 (1951).
- <sup>6</sup> See also *B.P. Citron*, 97 TC 200, Dec. 47,513 (1991); *J.C. Echols*, CA-5, 91-2 USTC ¶50,360, 935 F2d 703; *Tejon Ranch*, 49 TCM 1357, Dec. 42,058(M), TC Memo. 1985-207; Rev. Rul. 93-80, 1993-2 CB 239. See also *G.L. Allen*, 67 TCM 2696, Dec. 49,790(M), TC Memo. 1994-165, wherein the Tax Court concluded that a loss on the confiscation of property by an Indian tribe was held to be ordinary because there was no sale or exchange. The taxpayer was denied access to the property, and, thus, abandoned the property because any attempt to recover the property through legal means would have been expensive and futile.
- <sup>7</sup> Code Sec. 165(g)(2) defines the term "security" as "(A) a share of stock in a corporation; (B) a right to subscribe for or to receive a share of stock in a corporation; or (C) a bond, debenture, note, or certificate, or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form." The definition of a security plays an important role in the analysis of worthlessness because the deductibility of a loss from a worthless security is governed by Code Sec. 165(g) whereas the loss from a debt instrument that is not a security is governed by Code Sec. 166 and the two Code sections are mutually exclusive. See Code Sec. 166(e).
- <sup>8</sup> Code Sec. 166.
- <sup>9</sup> The preamble does refer to Code Sec. 166 bad debt deductions and asks for comments regarding "abandoned debt."
- <sup>10</sup> Other circumstance where an abandonment has been determined to result in an ordinary loss include *Tanforan Co., Inc.*, DC-Calif., 70-1 USTC ¶9452, 313 FSupp 796, *aff'd*, CA-9, 72-2 USTC ¶9492, 462 F2d 605, wherein the District Court allowed an ordinary deduction for the abandonment of racetrack tangible and intangible assets even though the taxpayer later sold the real estate for cash. The District Court based its decision on the fact that (1) the taxpayer's decision to abandon the racetrack was made in 1963, prior to the sale of the real estate; (2) the abandonment would have occurred regardless of whether the taxpayer sold the real estate; and (3) the obsolescence of the racetrack led to the real estate sale. *Solar Nitrogen Chemicals, Inc.*, 37 TCM 1849-71, Dec. 35,569(M), TC Memo. 1978-486 (goodwill abandoned, entitling the taxpayer to an ordinary loss, when the taxpayer leased its operating facilities to affiliated corporations and terminated its business; the lease was treated as a "gradual disposition" of the operating assets in which no goodwill was transferred to lessees because [per stipulation of fact] computation of the rental rate did not include the goodwill). *Kraft, Inc.*, FedCl, 94-1 USTC ¶50,080, 30 FedCl 739, wherein the taxpayer was allowed an abandonment loss for certain intangible assets (source of supply intangibles) that were a component of goodwill, to the extent that the taxpayer proved those assets were abandoned via cessation of production in certain markets.
- <sup>11</sup> This article incorporates several discussions from my earlier articles on this subject: Blanchard, Bennett & Spear, *The Deductibility of Investments in Financially Troubled Subsidiaries and Related Federal Income Tax Considerations*, TAXES, Mar. 2002, at 91; Debra J. Bennett, Corporate Tax Watch, *Code Sec. 165(g): Under the Microscope*, TAXES, Feb. 2003, at 11; Debra J. Bennett, *Rev. Rul. 2003-125: Worthlessness and Deemed Liquidations*, TAXES, Apr. 2004, at 17.
- <sup>12</sup> As an example, in *K.E. Padgett, Jr.*, 53 TCM 332, Dec. 43,758(M), TC Memo. 1987-130, the taxpayer owned 10,000 shares of stock of Itel Corporation. In December 1980, Itel Corporation was involved in a bankruptcy proceeding. At the end of December, the taxpayer sold 4,000 shares of his Itel Corporation stock for \$0.50 per share but had to retain the remaining 6,000 shares because his broker could not or would not sell more than a 4,000 share block. The taxpayer claimed a worthless stock deduction for the remaining 6,000 shares on his 1980 income tax return. The taxpayer subsequently sold the 6,000 shares in 1981 for \$0.75 per share. The IRS disallowed the taxpayer's 1980 worthless stock loss contending that the evidence showed that the stock was not entirely worthless. The Tax Court agreed citing Reg. §1.165-4 for the proposition that no loss was allowed for the decline in the value of the stock.
- <sup>13</sup> See also *Higgins v. Smith*, SCT, 40-1 USTC ¶9160, 308 US 473.
- <sup>14</sup> In some cases in which the taxpayer retains the worthless securities, the insolvency of the issuer, if shown to be substantial with no hope of recovery, alone may establish the worthlessness of the securities, thereby allowing the deduction of a loss with respect to the taxpayer's investment in the securities. See *S. Morton*, 38 BTA 1270, Dec. 10,517 (1938), *aff'd*, CA-7, 40-2 USTC ¶9495, 112 F2d 320.
- <sup>15</sup> See *Chandler*, 1943 TCM LEXIS 238 (1943).
- <sup>16</sup> See *Morton*, *supra* note 13.
- <sup>17</sup> *Id.* See also LTR 8528067 (Apr. 17, 1985), wherein the IRS stated that before a corporation's stock may be deemed worthless, the corporation must be lacking potential value as well as current liquidating value; FSA 200226004 (June 28, 2002); Rev. Rul. 2003-123, 2003-2 CB 1243.
- <sup>18</sup> Reg. §1.165-2(b).
- <sup>19</sup> It should be noted that Rev. Rul. 93-80 determines that the abandonment of a partnership interest would result in a capital loss if there were an actual or deemed distribution from the partnership to the partner pursuant to the abandonment, as in the case of a deemed distribution from the relief of nonrecourse liabilities.
- <sup>20</sup> Reg. §1.165-4(d) states that stock for the purposes of the regulation includes rights to subscribe to or receive a share of stock. It should be noted that an ordinary loss on the abandonment of subscription rights, stock rights, or a similar interest may be precluded by the application of Code Sec. 1234A which provides that the gain or loss attributable to the cancellation, lapse, expiration, or termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of a taxpayer is treated as a gain or loss from the sale of a capital asset.
- <sup>21</sup> Code Sec. 1001(a) provides that gain on the sale or other disposition of property is an amount in excess of the amount realized from the sale or other disposition over the adjusted basis of the property. Thus, abandonment would not appear to fit within the meaning of the term "exchange" for this purpose if the abandoning taxpayer does not receive any type of consideration on the abandonment of stock. Both case law and IRS authority support this conclusion. The Tax Court determined that a sale or exchange had not occurred in *Citron*, *supra*, note 5 (discussed above), when a limited partner abandoned his partnership interest and received nothing in return. In *First National Bank & Trust Company in Macon, Georgia*, CA-5, 40-2 USTC ¶9733, 115 F2d 194 *aff'd*, DC-Ga., 40-1 USTC ¶9412,

the Appellate Court provided that a loss on the abandonment of stock was a capital loss because there was a sale or exchange. As described above, Rev. Rul. 93-80 incorporates two situations where a partnership interest is abandoned. In the first situation, the IRS determines that the loss from the abandonment of the partnership interest is a capital loss because the taxpayer received consideration in the form of relief from nonrecourse liabilities, and, accordingly, a sale or exchange had occurred. However, in situation two, the taxpayer did not receive any consideration, and, thus, the IRS concludes that a sale or exchange had not occurred and an ordinary loss is appropriate. The cited authority would indicate abandonment is generally not considered to be a sale or exchange in the event that the abandoning taxpayer receives no consideration in return for the abandoned asset.

<sup>22</sup> See also TAM 7608230350A (Aug. 23, 1976); TAM 7608239240A (Aug. 23, 1976); TAM 760230410A (Aug. 23, 1976).

<sup>23</sup> LTR 8303003 (Oct. 1, 1987).

<sup>24</sup> See also Rev. Rul. 77-17, 1977-1 CB 44, the taxpayer purchased stock of corporation X on a public stock exchange. A year later, trading on the X stock was suspended due to information of irregular activities. In the same year that trading was suspended, X filed a petition for protection in bankruptcy. The bankruptcy trustee determined that as a group, stockholders of X who acquired their stock through purchases on public stock markets would be allocated 1,000x shares of the new corporation's common stock. The reorganization plan could not be put into effect until it was approved by X's creditors and stockholders. The IRS ruled that the taxpayer was not entitled to a worthless stock deduction under Code Sec. 165(g) because the evidence indicated that the X stock had remaining value.

The IRS does cite Reg. §1.165-4 with respect to the worthlessness of the stock. In Rev. Rul. 77-18, 1977-1 CB 46, on substantially similar facts, the taxpayer was induced to vote on a merger of corporation G into corporation X by the issuance of fraudulent financial statements of X. The IRS concluded that the facts indicated that the stock had remaining value because the bankruptcy trustee decided to continue the operations of the corporation. In the ruling, the IRS also concluded that the taxpayer is not entitled to a theft loss because the taxpayer had a reasonable prospect of

recovery from (1) the claim of rescission for the merger and the restoration of the stock to its former owner and/or (2) the bankruptcy reorganization. At no time did the IRS indicate that a theft loss is not allowed because there had not been a sale or exchange of the stock or complete worthlessness of the stock.

<sup>25</sup> *H.F. Batson*, 46 TCM 1301, Dec. 40,429(M), TC Memo. 1983-545.

<sup>26</sup> *R.E. Pomeranz*, 39 TCM 1010, Dec. 36,762(M), TC Memo. 1980-36.

<sup>27</sup> *N.H. Serris*, 37 TCM 1851-54, Dec. 35,587(M), TC Memo. 1978-500.

<sup>28</sup> Final regulations issued on August 12, 1994, essentially retained the language of the proposed regulations although expanded the deferral from that of Code Sec. 165(g) to that of Code Sec. 165. See T.D. 8560 (Aug. 12, 1994). However, the preamble to the final regulations does not address the change from Code Sec. 165(g) to Code Sec. 165.

<sup>29</sup> 57 FR 53634.

<sup>30</sup> See *G.G. Gannon*, 16 TC 1134, Dec. 18,304 (1951); *Tejon Ranch*, *supra* note 6, at 1985-207; *G.L. Allen*, 67 TCM 2696, Dec. 49,790(M), wherein the Tax Court concluded that a loss on the confiscation of property by an Indian tribe was held to be ordinary because there was no sale or exchange. The taxpayer was denied access to the property, and, thus, abandoned the property because any attempt to recover the property through legal means would have been expensive and futile.

<sup>31</sup> Rev. Rul. 93-80, 1993-2 CB 239.

<sup>32</sup> *Citron*, *supra* note 6.

<sup>33</sup> Rev. Rul. 76-189, 1976-1 CB 181.

<sup>34</sup> See also, *Echols*, *supra* note 6, *rev'g in part and rem'g*, 93 TC 553 (1989), wherein the Fifth Circuit Court held that the taxpayer had abandoned his partnership interest and, therefore, was allowed a deduction under Code Sec. 165(a). It should be noted that if a taxpayer incurs a gain or loss attributable to the cancellation, lapse, expiration or termination of a right or obligation with respect to property which is a capital asset in the hands of the taxpayer, such gain or loss will be treated as gain or loss from the sale of a capital asset. Because a partnership interest can be viewed as a right to property, although not entirely clear, Code Sec. 1234A could prevent deducting an ordinary loss on the abandonment of a

partnership interest.

<sup>35</sup> It should be noted that some case law indicates that abandonment can only occur when the subject property has no remaining value. However, this case law seems limited to situations where the taxpayer claims to have abandoned the property but continues to own the abandoned property after the abandonment, *i.e.*, there is no permanent disposition of the property. See *S. Selig*, 26 TCM 1302, Dec. 28,709(M), TC Memo. 1967-253; *Daily, et. al*, 81 TC 161, Dec. 40,408 *aff'd*, CA-9 (unpublished opinion), 742 F2d 1461 (1984); *R.M. Harris*, 44 BTA 999, Dec. 12,003, *aff'd*, CA-2, 44-2 USTC ¶9363, 143 F2d 279; *E.J. McCarthy*, CA-7, 42-2 USTC ¶9586, 129 F2d 84, *rev'g and rem'g*, 44 BTA 417, Dec. 11,807 (1941); *Texas-gulf, Inc.*, 35 TCM 158, Dec. 33,660(M), TC Memo. 1976-39. Other case law indicates that abandonment can occur prior to worthlessness or in the absence of worthlessness. See *Citron*, *supra* note 6; *Huntington Laboratories, Inc.*, DC-In., 35-1 USTC ¶9121, 11 FSupp 926 (1935), *aff'd*, CA-7, 36-1 USTC ¶9151, 82 F2d 356; *Allen*, *supra* note 6; *J.J. Seerley*, 43 BTA 50, Dec. 11,409 (1940), NA 1941-1 CB 19, petition for review dismissed, CA-7 (Aug. 19, 1942).

<sup>36</sup> In denying the IRS's petition for rehearing, the Fifth Circuit Court stated, "Despite the Commissioner's wishful thinking to the contrary, taxpayers are entitled to take loss deductions under Code Sec. 165(a), not only for assets that the taxpayer abandoned, with or without their having become worthless, but also for assets that have become worthless, with or without having been abandoned. Worthlessness and abandonment are separate and distinct concepts and are not, as urged by the Commissioner, simply two sides of the same coin—abandonment of the worthless property or abandonment of a property with worth." See also *Echols*, *supra* note 6.

<sup>37</sup> The Fifth Circuit Court focuses on an important distinction. It would seem, as discussed above, that an abandonment of all of the assets of an entity, as with the cessation of business operations, could be an event leading to the determination that the ownership interests in the entity are worthless.

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