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Reporting Tax Losses: Pitfalls and Opportunities After *Pilgrim's Pride*

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Taxpayers who do not always pick winners eventually have to deal with disposing of their losers. The tax treatment of losses can vary depending on how the disposition is structured and whether the taxpayer is a corporation or an individual. This article analyzes some of the transactions that result in losses and the reporting positions available to both corporations and individuals. This article also highlights some traps for the unwary. A well informed taxpayer can structure a transaction that results in a loss that offsets income that otherwise would have been taxed.

LOSS CAN BE CAPITAL OR ORDINARY

Treatment of Capital Losses

Taxpayers may have an increase or decrease in value for the assets they own; however, a gain or loss is not reportable on a tax return until there is a recognition event.[1] Section 1001[2] explains that the amount of any gain or loss from the sale or other disposition of property shall be recognized.[3] Section 165 permits a deduction for any loss sustained during the tax year, whether it is a loss on a capital asset or a non-capital asset. The character of the asset determines the nature of the gain or loss. Section 1221 defines capital assets as property other than stock in trade, inventory, property used in a trade or business which is depreciable or amortizable,[4] self-created assets such as copyrights[5] and letters, accounts receivable, U.S. Government publications, commodities derivative financial instruments held by dealers, hedging transactions, and supplies.[6] By excluding these assets, we find that capital assets are investment assets. Assets that are not capital assets give rise to ordinary gain or loss. Section 1231 assets are a hybrid and can result in capital gain when they appreciate and an ordinary loss when they lose value.[7]

Therefore, the sale or exchange of a capital asset will result in a capital gain or loss, and if held for more than one year, it will be long-term capital gain or loss.[8] A taxpayer invests in a capital asset for an extended period to capture appreciation.[9] The tax code is designed to reward investors with favorable

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[1] Unlike income tax reporting, under Generally Accepted Accounting Principles (GAAP) investors are required to carry investments at fair value. This results in unrealized gains and losses each year. *See* FASB 157.

[2] Unless otherwise indicated, all references to ''Section'' or ''§'' are to the Internal Revenue Code of 1986, as amended, and all references to ''Reg. §'' are to the Treasury regulations issued thereunder.

[3] The gain is the excess of the amount realized over adjusted basis, and the loss is the excess of the adjusted basis over the amount realized.

[4] See §1231 for the treatment of depreciable and amortizable assets. While depreciable or real property used in a trade or business is not a capital asset, it is often thought of as one because the gain from its sale can qualify for the preferential tax rates afforded to long-term capital gains. Gain from the sale of a §1231 asset is first subject to ordinary income treatment under the recapture provisions of §1231, §1245, and §1250, and any excess is treated as §1231 gain and included in the netting process with all other capital gains. Section 1231 losses, on the other hand, are ordinary losses. Taxpayers favor §1231 assets because they enjoy the best of both worlds.

[5] See §1221(b)(3) for an election to treat self-created musical works as capital assets.

[6] §1221(a).

[7] *See* n. 4, above.

[8] §1222.

[9] *Compare Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960) *with Davis v. Commissioner*, 119 T.C. 1 (2002)

tax rates for long-term capital gains. Individuals enjoy a maximum federal tax rate of 20%[10] federal tax rate on capital gains.[11] There is also a 3.8% net investment income tax for federal purposes on passive income.[12] Corporations do not have a lower tax rate for capital gain income. However, they can use capital gains to offset expiring capital losses.

While capital gains receive preferential tax treatment, capital losses do not. Corporate taxpayers can use capital losses only to offset capital gains.[13] A corporation's unused capital losses can be carried back to each of the three tax years preceding the loss year or carried forward to each of the five tax years succeeding the loss year.[14] Once this carryback and carryforward period expires, the corporation's unused capital losses expire. Individuals, however, may deduct capital losses to the extent of capital gains plus $3,000 (limited to the amount of the actual loss)[15] and individuals can carry forward unused capital losses until death.[16]

While capital losses cannot offset ordinary income, both corporations and individuals may use ordinary losses to offset both ordinary and capital gain income.[17] Therefore, there is a benefit to structuring losses as ordinary when the right fact pattern is present.

Treatment of Ordinary Losses

The gain or loss resulting from the sale or exchange of an asset that fails the definition of a capital asset is ordinary. For example, the sale of inventory results in an ordinary gain or loss. Also, as discussed above in note 4, the sale of a §1231 asset may give rise to an ordinary loss.

Failure to Satisfy Sale or Exchange Requirement Results in Ordinary Gain or Loss

Courts have held that transactions that fail the sale or exchange requirement can result in ordinary gains and losses regardless of the nature of the asset. For example, the abandonment of stock led to an ordinary loss that offset ordinary business income for Pilgrim's Pride Corporation.[18] While taxpayers use this rule to obtain ordinary losses, the IRS uses this rule to force ordinary income in so-called ''extinguishment'' transactions.[19]

Congress has enacted several provisions that provide sale or exchange treatment for transactions that appear to fail the sale or exchange requirement. For example:

- Courts had ruled that the retirement or extinguishment of debt failed the sale or exchange requirement.[20] Section 1271(a)(1) now treats redemptions as equivalent to a sale or exchange, resulting in capital gain or loss.[21]

- The write-off from a bad receivable may give rise to an ordinary loss.[22] However, debt issued in registered form qualifies as a security under §165(g), leading to a deemed sale or exchange when it becomes worthless. Also, nonbusiness bad debts that become worthless are treated as sold or exchanged.[23]

- The abandonment of an asset is not considered a sale or exchange. However, the abandonment of securities[24] is now considered proof of worthless-

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(gain on sale of a lottery ticket was ordinary); *Lary v. United States*, 787 F.2d 1538 (11th Cir. 1986) (gain on sale of person's blood was ordinary because it failed holding period requirement); *Flower v. Commissioner*, 61 T.C. 140 (1973); *United States v. Woolsey*, 326 F.2d 287 (5th Cir. 1963) (gain on sale of management service contract was ordinary); *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964) (gain on sale of insurance contracts was ordinary); and Rev. Rul. 2004-110 (gain on sale of contract to perform service was ordinary). Note, however, that capital gain may result from the sale of an insurance contract with no cash surrender value. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029.

[10] The maximum tax rate for individuals on ordinary income is 39.6%. The 20% tax rate on capital gains applies to individuals in the highest ordinary income tax rate (39.6%) bracket. A 0% or 15% capital gains tax rate applies to all other taxpayers. *See* §1(h).

[11] Most states tax capital gain and ordinary income at the same rate.

[12] However, capital gains that arise from an active trade or business conducted by an S corporation, partnership, or limited liability company can avoid this tax. §1411(c)(4).

[13] §1211(a).

[14] §1212(a)(1).

[15] §1211(b).

[16] §1212(b)(1). Capital losses of married taxpayers filing joint returns are personal to the spouse who sustained the loss. The capital loss carryover from a joint return year in which one of the spouses dies is allocated between the survivor and the decedent. The decedent's capital loss carryover expires. *See* PLR 8510053; Rev. Rul. 74-175, 1974-1 C.B. 52; *Calvin v. United States*, 354 F.2d 202 (10th Cir. 1965).

[17] Before a taxpayer can use an ordinary loss, the taxpayer must analyze several rules, including the basis limitation rules, the at-risk basis rules, the passive activity loss rules, the economic substance rules, and must determine the correct tax reporting forms.

[18] *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015).

[19] See the discussion below and at nn. 43–45 regarding the extinguishment doctrine.

[20] *Fairbanks v. United States*, 306 U.S. 436 (1939), *McClain v. Commissioner*, 311 U.S. 527 (1941).

[21] Section 1271(a)(1) applies to years after 1983 on debt issued by non-individuals, and after 1997 for debt issued by individuals.

[22] §166(e).

[23] §166(d)(1)(B).

[24] Note that a partnership interest does not meet the definition

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ness and results in a deemed sale or exchange.[25] Note, however, that the worthlessness of stock of an affiliated corporation continues to be ordinary.[26] Also, taxpayers who experience debt relief in connection with an abandoned asset are treated as having sold or exchanged that asset.[27] Courts have held, however, that it may be possible to abandon or forfeit a partnership interest and claim a loss based on its worthlessness without being relieved of partnership liabilities.[28]

- An event causing a security[29] to be worthless is a deemed sale or exchange on the last day of the year in which it becomes worthless.[30]

Section 1234A Mandates Sale or Exchange

Congress enacted §1234A[31] to provide consistent treatment for gains and losses resulting from transactions involving capital assets and rights with respect to capital assets. Section 1234A states:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of —
>
> > (1) a right or obligation (other than a securities futures contract, as defined in Section 1234B) with respect to property which is (or on acquisition would be) a capital[32] asset in the hands of the taxpayer, or a
> >
> > (2) a Section 1256 contract (as defined in Section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset.[33] The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other arrangement).

While §1234A does provide sale or exchange treatment for terminations of contract rights, there had been significant uncertainty as to the section's broader application. For example, (1) is the outright ownership of property, such as corporate stock, considered a ''right or obligation with respect to'' the property, and (2) what types of ''other terminations'' are covered by §1234A?

While §1234A does address the treatment of funds received, it does not specifically deal with the tax treatment of payments made in connection with the termination of a right held by another. These payments may be deductible as ordinary and necessary business expenses under §162(a) or may be required to be capitalized under §263. However, in a field attorney advice memorandum — FAA 20163701F — the IRS Chief Counsel's Office determined that a ''break fee'' paid by the taxpayer to a target company in termination of a merger agreement resulted in a capital loss under §1234A. The Chief Counsel's Office characterized the merger agreement as giving the taxpayer the right to acquire stock in a new parent company, and because stock is considered a capital asset, §1234A applies. By finding that both parties possessed rights under the merger agreement and both parties' rights were terminated, the payment was drawn into the purview of §1234A.

Tax Court Expands Application of Section 1234A

In 2013, the Tax Court weighed in on two important questions raised by §1234A in *Pilgrim's Pride Corp. v. Commissioner*.[34] The Tax Court ruled that petitioner was not entitled to an ordinary loss from the abandonment of corporate securities because §1234A deemed it arose from a sale or exchange. The court held that ''Congress extended the application of §1234A to terminations of all rights and obligations

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of security. Securities are defined under §165(g)(2) 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 of political subdivision thereof, with interest coupons or in registered form.''

[25] §165(g); Reg. §1.165-5(i).

[26] §165(g)(3).

[27] *Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984); *Citron v. Commissioner*, 97 T.C. 200 (1991); *Middleton v. Commissioner*, 77 T.C. 310 (1981); *Freeland v. Commissioner*, 74 T.C. 970 (1980); Rev. Rul. 93-80, 1993-2 C.B. 239.

[28] *See Weiss v. Commissioner*, 956 F.2d 242 (11th Cir. 1992); *In re Kreidle*, 91-1 U.S.T.C. ¶50,371. See also *Echols v. United States*, 935 F.2d 703 (5th Cir. 1991), *rev'g* 93 T.C. 553 (1989), in which the court determined that a loss from the worthlessness of a partnership interest may occur independently of abandonment.

[29] *See* n. 24, above.

[30] §165(g).

[31] Pub. L. No. 105-34 §1003(a)(1) extended §1234A treatment to the termination of rights with respect to all property that is or would be a capital asset in the hands of the taxpayer. Previously, the provision was limited to actively traded personal property, targeting tax straddle transactions where taxpayers were attempting to deduct an ordinary loss on the loss leg of the straddle while retaining the gain leg.

[32] Based on an example in the legislative history to §1234A, which involved a payment to terminate a provision in a lease agreement, tax practitioners have suggested that §1234A may also apply to §1231 assets. *See* S. Rep. No. 105-33 at 135. However, in a case of first impression, *CRI-Leslie, LLC v. Commissioner*, 147 T.C. No. 8 (2016), the Tax Court concluded that §1234A cannot apply to §1231 assets because the statute applies only to capital assets, and in the tax definition of a capital asset, §1231 assets are excluded. See discussion at n. 47, below.

[33] If §1234A applies to §1231 assets, the result would be §1231 gain or loss. However, see nn. 32 and 47.

[34] *Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. 533 (2013), *rev'd*, 779 F.3d 311 (5th Cir. 2015).

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with respect to property that is a capital asset in the hands of the taxpayer or would be if acquired by the taxpayer, including not only derivative contract rights but also property rights arising from ownership of the property.'' Furthermore, it concluded that the examples in the committee reports from the Taxpayer Relief Act of 1997 demonstrate that §1234A applies broadly to derivative contractual rights and obligations, as well as inherent property rights, citing the example of the redemption of a bond,[35] which is intangible property — a bundle of contractual rights.[36] The Tax Court also ruled the rights terminated when the taxpayer surrendered the securities, making clear that abandonment is a type of ''other termination'' intended to be subject to §1234A.

The Tax Court's decision appeared to provide a roadmap to certainty surrounding dispositions of capital assets. The Internal Revenue Code, under the Tax Court's interpretation, would provide parity among various forms of dispositions of capital assets and eliminate the taxpayer's ability to structure transactions that can result in capital or ordinary treatment by just electing to meet or fail the sale or exchange requirement. Whether an asset was sold, abandoned, or terminated, its nature would determine the character of the gain or loss, rather than the type of disposition the taxpayer chooses.

Fifth Circuit Narrows Application of Section 1234A

The Fifth Circuit Court of Appeals[37] reversed the Tax Court decision and held that §1234A does not apply to Pilgrim's Pride Corporation's abandonment loss. The court relied on the plain language of §1234A. In its view, §1234A applies to the termination of rights or obligations with respect to a capital asset, but not to the abandonment of the asset itself. The appellate court held that Congress does not legislate in logic puzzles. Instead, lawmakers would have stated that abandonment of an asset is subject to §1234A if that is what they intended.

Moreover, quoting from *Echols v. Commissioner*,[38] the appellate court reiterated that ''worthlessness and abandonment are separate and distinct concepts and are not, as urged by the Commissioner, simply two sides of the same coin.''[39] The abandonment of corporate securities that had value resulted in an ordinary loss equal to the taxpayer's basis in the asset.

It is important to note that the transaction in *Pilgrim's Pride* would not be at issue today because Reg. §1.165-5(i), adopted after the year in dispute, clearly defines abandonment as an event establishing the worthlessness of a security.[40] Therefore, an abandonment of stock today would be treated as a sale or exchange and would give rise to a capital loss under §165(g). Some commentators have raised a question about the validity of Reg. §1.165-5(i) in light of the appellate court's ruling in *Pilgrim's Pride*, which clearly states that worthlessness and abandonment are separate and distinct concepts.[41]

It is unclear whether the IRS will pursue abandonment transactions in other circuits.[42]

Extinguishment Doctrine and Section 1234A

The IRS regularly applies the extinguishment doctrine[43] to characterize payments received as ordinary income when an asset is terminated or vanishes. In TAM 200427025 and TAM 200049009, the IRS conceded that the scope of the doctrine was significantly limited by the enactment and expansion of §1234A. However, citing *Wolff v. Commissioner*,[44] the IRS continued to assert that the extinguishment doctrine applied in situations not covered by a statute explicitly defining a transaction as a sale or exchange, such as §1234A.[45]

The IRS also ruled that a bargained-for termination fee received in connection with an abandoned merger

[35] Senate Committee Report, Pub. L. No. 105-34, p. 100.

[36] *Id.* at 301. *See Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962).

[37] *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015).

[38] *Echols v. Commissioner*, 950 F.2d 209 (5th Cir. 1991).

[39] See also Rev. Rul. 93-80, where the IRS concluded that its ruling would not change if the partnership interest were found to be worthless rather than abandoned.

[40] Reg. §1.165-5(i)(1).

[41] *See* Ted Dougherty & David Benz, *Fifth Circuit Reverses Tax Court on Character of Abandonment Loss*, BNA Insights (Apr. 29, 2015).

[42] As this reversal occurred in the Fifth Circuit, other jurisdictions may continue to follow the Tax Court when faced with a similar case. At the date of this writing, the IRS has not taken action on the Court of Appeals' decision.

[43] TAM 200427025, TAM 200049009; PLR 200215037; FSA 200238045.

[44] 148 F.3d 186 (2d Cir. 1998), *rev'g & rem'g Estate of Israel v. Commissioner*, 108 T.C. 208 (1997).

[45] TAM 200049009, TAM 200727025. The IRS Commissioner's use of the decision in *Wolff* to support the viability of the extinguishment doctrine after enactment of §1234A is curious. The contract cancellations in the case occurred before 1981, rendering §1234A not applicable. Nevertheless, one point of contention in *Wolff* was whether the legislative history of §1234A proved the taxpayer's position, that Congress intended to change the law that previously required an actual sale or exchange, or the Commissioner's position, that Congress intended merely to clarify that prior law did not permit losses from contract cancellations to be ordinary. The Court of Appeals agreed with the taxpayer. Despite the government's loss and contrary to their position in the case, the Commissioner continues to champion the decision in *Wolff* to support the argument that the extinguishment doctrine still applies in situations not covered by a statute specifically defining a transaction as a sale or exchange. It would seem that such situations are becoming rarer, but one must admire the dexterity of the Commissioner.

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was for lost profits. In PLR 200823012, the IRS stated without analysis that §1234A does not apply and the income is ordinary under §61. It is unclear how this ruling can be reconciled with the legislative history that led to the amendment expanding the application of §1234A. The forfeiture of a down-payment under a contract to purchase stock is identified as a type of interest to which the extension of sale or exchange treatment should apply under the amendment.[46]

Tax Court Rules Capital Asset Does Not Include Section 1231 Asset

In *CRI-Leslie, LLC v. Commissioner*,[47] the taxpayer reported long-term capital gain for receipt of deposits forfeited by buyer pursuant to a contract to purchase real property. The sole issue in dispute was whether ''capital asset'' as used in §1234A extends to property described in §1231. The court concluded that §1221, which defines capital assets, excludes §1231 assets, and therefore §1234A does not apply to §1231 assets. The court did not discuss the example in S. Rep. No. 105-33 at 135, which relates to a payment made by lessee to terminate a provision in a lease agreement that required lessee to restore the property to its original condition at the end of the lease term.[48] The court also did not consider that the term capital asset has often been used by the IRS and the courts to refer to both capital assets and §1231 assets. Importantly, the term capital asset used in §1234A is not capitalized and there is no reference to §1221. We believe the term capital asset should be interpreted broadly unless it is specifically referencing §1221; otherwise certain rulings and statutes would become inoperative. For example, in TAM 200427025, the taxpayer and the IRS agreed that a power purchase agreement was a ''capital asset'' without elaborating whether it is a §1231 asset. In *Commissioner v. Starr Bros., Inc.*,[49] the IRS conceded that a contract under which the taxpayer had the exclusive right to sell the manufacturer's products was a capital asset without elaborating whether it is a §1231 asset. In *Commissioner v. Goff*,[50] the IRS conceded that the taxpayer's exclusive contract right to hosiery products for a certain period of years was a capital asset without elaborating whether it is a §1231 asset. Under §1253, the transfer of a franchise, trademark, or trade name will not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to that asset. Section 1253 is designed to take away the sale or exchange element and force the seller to recognize ordinary income. However, if we apply the ruling in *CRI-Leslie*, taxpayers would be free to argue that §1253 does not preclude the sale from qualifying as an exchange of a §1231 asset. The holding in *CRI-Leslie* applies an extremely narrow definition to the words ''capital asset,'' especially given the examples in the legislative history to §1234A. We believe that the words ''capital asset'' should include §1231 assets unless the words also reference §1221. If the drafters intended ''capital asset'' to refer only to a §1221 asset, they should have said so in the statute. We believe the holding in *CRI-Leslie* is flawed.

Challenges of Reporting Ordinary Losses for Individual Taxpayers

Ordinary losses for individuals are beneficial if they generate a deduction ''above the line'' — before arriving at adjusted gross income (AGI). However, they can be disastrous if they give rise to a deduction that falls ''below the line'' as a miscellaneous itemized deduction. This determination is made based on the character of the asset and the nature of the activity. There is a 2%-of-AGI limitation imposed by §67(a) on miscellaneous itemized deductions and a disallowance of such deductions for purposes of the dreaded alternative minimum tax (AMT).[51] Therefore, individuals must carefully weigh their options when transacting in ordinary losses and should consider the benefit of a capital loss.

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[46] Senate Committee Report, Pub. L. No. 105-34, p. 102.

[47] 147 T.C. No. 8 (2016). See n. 32, above.

[48] The following cases were discussed in the legislative history to §1234A and include terminations of rights with respect to capital assets and §1231 assets: *General Artist Corp. v. Commissioner*, 205 F.2d 360 (2d Cir. 1953) (amounts paid to a booking agent for cancellation of a contract to be the exclusive agent of a singer was ordinary income because there was no sale or exchange); *Billy Rose's Diamond Horseshoe, Inc. v. Commissioner*, 448 F.2d 549 (2d Cir. 1971) (payment by the lessee to the lessor to relieve the lessee from restoring the leased property to its original condition was ordinary income to the lessor because there was no sale or exchange); *Sirbo Holdings, Inc. v. Commissioner*, 509 F.2d 1220 (2d Cir. 1975) (holding similar to *Billy Rose's Diamond Horseshoe, Inc.*); *U.S. Freight Co. v. United States*, 190 Ct. Cl. 725 (1970) (forfeiture of a down-payment to purchase an option was not a sale or exchange; therefore the resulting loss was ordinary); *National-Standard Co. v. Commissioner*, 749 F.2d 369 (6th Cir. 1984) (taxpayer's loss resulting from a foreign currency loan repayment was ordinary because there was no sale or exchange; §988 was enacted after this case and now governs foreign currency transactions); *Stoller v. Commissioner*, 994 F.2d 855 (D.C. Cir. 1993) (losses incurred on the cancellation of forward contracts, before the enactment of §1234A, were ordinary because there was no sale or exchange); *Commissioner v. Pittson*, 252 F.2d 344 (2d Cir. 1958) (money paid to the taxpayer for cancellation of all rights under a contractual agreement to mine coal was ordinary income because it was in lieu of ordinary income which would be earned in future years, notwithstanding the character of the asset). The legislators were concerned that taxpayers could elect the character of their gain or loss by simply choosing to sell or terminate their position.

[49] 204 F.2d 673 (2d Cir. 1953). This case was cited in legislative history to §1234A.

[50] 212 F.2d 875 (3d Cir. 1954).

[51] §56(b)(1)(A)(i).

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A loss sustained by an individual taxpayer attributable to a trade or business carried on by the taxpayer is deductible against ordinary income in arriving at AGI.[52] Also, a loss incurred in a transaction entered into for profit, attributable to property held for the production of rents or royalties, is deductible in arriving at AGI.[53] However, other ordinary losses incurred are deductible only as itemized deductions — below the line.[54] Special rules apply to casualty or theft losses.[55]

To qualify the deduction as a loss incurred in a trade or business,[56] or in connection with the production of rents and royalties,[57] is not as easy as one might think. For example, when an ordinary loss is incurred from an abandonment transaction, the taxpayer must figure out — is the taxpayer abandoning her partnership interest or is the partnership abandoning a business asset? In the case of an individual taxpayer, only rarely would the equity in a pass-through entity be considered property used in a trade or business, or an asset used to produce rents and royalties. Ownership in a pass-through entity is not different from a stock investment. The entity itself may be engaged in an active trade or business or in the act of generating rents and royalties. However, the business of the entity does not reclassify the nature of the asset in the hands of the individual.[58] Although, there probably should be an exception where an active partner in a service firm is forced to abandon her partnership units.[59]

Therefore, individuals who abandon an investment that is not a security[60] can obtain an ordinary loss. However, the ordinary loss would be an investment loss reportable as a miscellaneous itemized deduction subject to the AGI limitation and added back for AMT purposes. Instead, if the entity abandons a business asset, it can flow through to the individual investor as an ordinary loss from a business, which can be deductible above the line.[61] When facing a potential ordinary investment loss, individuals should consider selling the investment to generate a capital loss that can be offset by capital gains and carried forward to future years.

Abandonment Transactions and Impact of Liabilities

In Rev. Rul. 93-80,[62] the IRS addressed two situations where a partner took the necessary steps to abandon her interest in an insolvent partnership. In one situation, the partner bore a share of partnership nonrecourse liabilities before the abandonment. The shift in liabilities caused a deemed distribution of cash under §752(b), resulting in a deemed sale or exchange. The ruling held that the abandonment resulted in a capital loss. In the second situation, the taxpayer was a limited partner who bore no economic risk of loss in partnership liabilities. Therefore, there was no deemed sale or exchange. The IRS concluded the resulting loss in the second situation was ordinary. The ruling provided no guidance on how the taxpayer should claim the loss on her tax return.

Worthlessness Is Different from Abandonment

As discussed in *Pilgrim's Pride*, worthlessness and abandonment are different concepts.[63] Worthlessness occurs without any action by the taxpayer. However, figuring out the time an asset becomes worthless to the taxpayer[64] can be difficult.[65] Abandonment, on the other hand, is the result of an intentional one-way act to no longer own or possess an asset.

The authority for an abandonment loss on the disposition of an asset, Reg. §1.165-2(a), allows a deduction when nondepreciable property is permanently discarded, or when a business or transaction is discon-

[52] §62(a)(1); Reg. §1.62-1T(c)(1).

[53] §62(a)(4); Reg. §1.62-1T(c)(5).

[54] §63(d).

[55] §67(a).

[56] §62(a)(1); Reg. §1.62-1T(c)(1).

[57] §62(a)(4); Reg. §1.62-1T(c)(5).

[58] *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *rev'g* 93 T.C. 553 (1989). The original Tax Court decision in the *Echols* case found that no abandonment had occurred, focusing only on whether or not the real estate owned by the partnership had been properly abandoned or found worthless. The Court of Appeals for the Fifth Circuit reversed the Tax Court's decision, addressing and finding an explicit abandonment of the partnership interest by the taxpayer. The Fifth Circuit placed significant emphasis on the entity theory in reversing the prior decision.

[59] Guidance in this area would be welcome.

[60] As discussed above, the abandonment of a security such as stock would result in a capital loss. Reg. §1.165-5(i).

[61] §62(a)(1).

[62] 1993-2 C.B. 239.

[63] A series of decisions concerning *Echols v. Commissioner* illuminates the relationship between worthlessness and abandonment. 93 T.C. 553 (1989), *rev'd*, 935 F.2d 703 (5th Cir. 1991), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

[64] *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991). The fact of worthlessness must be determined from the point of view of the taxpayer, even though another investor might have found the asset worthless in a prior year, or its value extending into a future year. Worthlessness requires a triggering event that led to the worthless condition of the asset. The year of such event is the year that the worthlessness deduction becomes available.

[65] Section 6511(d)(1) provides an extended (seven-year) statute of limitations on credit or refund arising from a loss due to the worthlessness of a debt or security. This additional period prevents the loss of the deduction if it is determined (as a result of audit, for instance) that worthlessness occurred in a year before the taxpayer claimed it.

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tinued. The same regulation section applies when worthlessness is the event that triggers the loss. The regulation makes clear that the deduction is allowed for the tax year in which the loss is sustained.[66]

Case law has provided a two-part test for abandonment: (1) intention on the part of the owner to abandon, and (2) an affirmative act of abandonment.[67] However, if worthlessness occurs in a year before the overt act, the loss is sustained in the year of worthlessness.[68] The Court of Appeals in *Echols*[69] explained that ''taxpayers are entitled to take loss deductions under code §165(a), not only for assets that the taxpayer has abandoned, with or without their having become worthless, but also for assets that have become worthless, with or without having been abandoned.'' The court reviews and reiterates the decision in *Rhodes v. Commissioner*,[70] finding that an overt act of abandonment is not required to establish worthlessness for a deduction under §165.[71] In other words, a deduction is allowed in the earliest year, whether from abandonment or worthlessness. A recognizable overt act of abandonment of an asset that has some value serves to fix the loss in a year before the asset's eventual worthlessness. Elements of a successful overt act of abandonment might include:

- Failed attempts to sell an asset.[72]
- Public expression of intention to abandon,[73] observable to outsiders.[74]
- Letter to the general partner or declaration at partners' meeting, expressing desire to have no further association.[75]
- The definition provided by www.merriam-webster.com is: ''to give up with the intent of never again claiming a right or interest in [property].''

Although the loss of title or possession is not required to prove intent to abandon, or to fix the date of the loss, relinquishment of title can help substantiate the act of abandonment.[76] In *Rhodes v. Commissioner*,[77] the Board of Tax Appeals recognized the taxpayer's actions of charging off of his books and refusing to make further installment payments as proof that he had abandoned his interest in a contract to buy land, even though he accepted a modest payment in the following year to assign his interest as a result of an unsolicited cash offer.

The IRS also grapples with the difficulty of identifying an exact moment of abandonment in its instructions to lenders in cases where debt is relieved because of a borrower's abandonment of secured property. The IRS states that abandonment occurs when ''the objective facts and circumstances indicate that the borrower intended to and has [sic] permanently discarded the property from use, the lender is burdened with the responsibility of reporting the abandonment, and deemed to know whatever might be discovered by a reasonable inquiry.''[78]

A partner who holds a partnership interest may claim an ordinary loss from worthlessness without having to abandon the interest.[79] This appears to provide a better result than an abandonment transaction because there is no shift in liabilities or termination of ownership. This resulting loss is ordinary. The question now becomes, where do you report the loss? In the case of a corporate partner, the reporting is straightforward: it is a loss that offsets business income. However, for an individual, the loss appears to fall below the line as a miscellaneous itemized deduction unless the partner can prove that the partnership interest itself is a business asset or produces rent or royalty income.

ESSENTIAL REPORTING FORMS

Form 1099

Form 1099-A or Form 1099-C is required in the case where debt encumbers abandoned property. The reporting requirement for Form 1099-A arises when the lender acquires the secured property in full or partial satisfaction of the debt (foreclosure), or if the facts and circumstances indicate the borrower has permanently discarded the property from use, and the property is real property, intangible property, or tangible personal property. However, debt secured by tangible personal property that is held only for personal use, or when the borrower is an exempt foreign

[66] Reg. §1.165-2(a). *See also* §165(g)(1) (if a security that is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset).

[67] *CRST, Inc. v. Commissioner*, 92 T.C. 1249 (1989), *aff'd*, 909 F.2d 1146 (8th Cir. 1990).

[68] Reg. §1.165-2(a).

[69] 950 F.2d 209 (5th Cir. 1991).

[70] 100 F.2d 966 (6th Cir. 1939).

[71] *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991).

[72] *Levine Bros. Co., Inc. v. Commissioner*, 5 B.T.A. 689 (1926).

[73] *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991).

[74] *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001).

[75] *Citron v. Commissioner*, 97 T.C. 200 (1991).

[76] *Levine Bros. Co., Inc. v. Commissioner*, 5 B.T.A. 689 (1926).

[77] 100 F.2d 966 (6th Cir. 1939).

[78] Instructions for Forms 1099-A and 1099-C.

[79] *See* n. 28, above.

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person, is excepted from this filing requirement. Note that this reporting requirement is imposed on any lender who extends the loan in connection with its trade or business, even if the lender is not in the business of lending money.[80]

If the lender is in the trade or business of lending money and has canceled or discharged the debt, Form 1099-C is filed.[81] If the reporting requirements for both Forms 1099-A and 1099-C apply, it is not necessary to submit both forms.[82]

Form 8886

Form 8886 disclosure is required for ''loss transactions.''[83] A loss transaction is a transaction that results in the taxpayer claiming a loss under §165 meeting the following threshold amounts:

- Individuals, Partnerships (with at least one noncorporate partner), S corporations: at least $2 million in any single year or $4 million in any combination of years.
- Corporations (excluding S corporations): at least $10 million in any single year or $20 million in any combination of years.

It is important to note that both ordinary and capital losses are under §165.

Rev. Proc. 2013-11[84] provides an exception for losses from the sale or exchange of an asset with a qualifying basis. It is unclear whether this exception applies to losses from a deemed sale or exchange caused by worthlessness or to losses from abandonment. Therefore, we recommend disclosure if the loss meets the threshold amounts. The qualifying basis requirement further narrows the application of this exemption to reporting. Failure to disclose properly can cause the statute of limitations not to close and can subject the taxpayer to penalties.[85]

Form 4797 and Schedule A

The IRS addresses the treatment of an abandoned or worthless partnership interest in Publication 541, Partnerships. Under *Abandoned or worthless partnership interest*, it refers a taxpayer to the Instructions to Form 4797, *Sales of Business Property*, for guidance on how to report an abandonment loss.[86] The Form 4797 instructions state: ''Deduct the loss from a qualifying abandonment of business or investment property on line 10.'' However, Form 4797 applies only to dispositions of trade or business property. The Form 4797 instructions do not clarify that a taxpayer should report losses from an abandoned investment property on Schedule A, under *Miscellaneous Deductions*.[87]

CONCLUSION

In conclusion, there is much to consider when planning for a disposition of a loss asset. The character of the property plays a critical role in determining whether to sell or abandon the asset. The resulting loss may be capital or ordinary. The ordinary loss may be an above-the-line or a below-the-line loss for individuals. Therefore, careful planning must take place before claiming an ordinary loss.

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[80] Reg. §1.6050J-1T, Q&A-2.

[81] Reg. §1.6050P-1.

[82] Reg. §1.6050P-1(e)(3).

[83] As defined in Reg. §1.6011-4(b)(5).

[84] 2013-2 I.R.B. 269.

[85] Section 6707A imposes a penalty for failure to properly disclose reportable transactions. The imposition of the penalty is not dependent on the tax treatment of the underlying transaction, i.e. whether or not the deduction is disallowed. H.R. Rep. No. 108-548 pt. 1 at 261.

[86] Pub. 541 (Rev. Jan. 2016), p. 11.

[87] Instructions are not an authority that can be relied upon to support a reported deduction. These instructions should be updated.

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