Losses on Failed Investments and Code Sec. 1234a

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The acquisition of a business can be an optimistic and risky venture. The buyer believes it is getting a good deal. The future promises profitability, and things can only go up. Nevertheless, the seller may view things quite differently and may be glad to unload its problems.

Despite the buyer’s optimism at the outset, not all acquisitions turn out well. Getting the acquisition right requires some combination of meticulous planning, flawless execution, the ability to predict the future, good timing and luck. Timing acquisitions can be incredibly difficult.

From a tax perspective, a bad acquisition can be particularly harsh. While the acquisition may be funded with hard-earned, after-tax ordinary earnings, the loss may be capital. A capital loss is subject to a variety of limitations, even for corporations that are taxed at the same rate for ordinary income and long-term capital gain.

Theft and Abandonment

Theft losses and abandonment can result in an ordinary loss, even for a capital asset. The tax consequences of investing in a Ponzi scheme can be far more favorable than investing in an honest but unprofitable business venture. While suffering a significant economic loss can be a big blow, an ordinary loss may provide consolation. Indeed, with individual rates on the rise, and with the new net investment income tax, an ordinary loss can save as much as 50 percent or more when factoring in state income tax.

Of course, the ordinary loss rules for theft losses are unlikely to help a taxpayer who suffers from an ordinary unprofitable business. If the culprit is a lack of foot traffic for a new restaurant, intense competition from a big-box retailer or a start-up burning through cash too quickly, theft losses will not help. However, with proper planning, the taxpayer may be able to claim such a loss as an ordinary abandonment loss.

Walking away and abandoning an investment or capital asset as worthless can sometimes result in an ordinary loss. The statutory
authority for an ordinary loss on abandonment is in Internal Revenue Code Section (“Code Sec.”) 165. Code Sec. 165(a) permits a deduction for any loss suffered during the year that is not compensated by insurance.

Building Character
Code Sec. 165 does not prescribe the character of the loss, but many will be ordinary, as discussed below. In particular, Code Sec. 165(c)(1) permits a loss incurred in a trade or business, while Code Sec. 165(c)(2) permits a loss incurred in a transaction entered into for profit. Neither one is subject to the harsh limitations in Code Sec. 165(h), which limits losses to those in excess of 10 percent of a taxpayer’s adjusted gross income.

Code Sec. 165 does not override the limitation on capital losses, which is preserved in Code Sec. 165(f). Moreover, under Code Sec. 165(g), worthless securities are treated as resulting in capital losses. Nevertheless, subject to these and other limitations, Code Sec. 165 provides an opportunity for taxpayers to claim an ordinary loss.

What is the dividing line between a capital loss and an ordinary loss under Code Sec. 165? The answer is deceptively simple. A sale or exchange of a capital asset with a built-in loss results in a capital loss. Conversely, abandoning a capital asset with a built-in loss without a sale or exchange is generally ordinary.

Surprisingly, determining whether a sale or exchange has taken place can be very difficult. For one thing, in addition to an actual sale or exchange, a deemed sale or exchange may also trigger a capital loss. Code Sec. 165 is clearly an area where taxpayers must tread with extreme caution!

Claiming an Ordinary Loss
Navigating the thicket of loss provisions can be challenging and the stakes can be high, as one taxpayer recently discovered in *Pilgrim’s Pride Corp.* [141 TC No. 17, Dec. 59,715 (2013).] In that case, the taxpayer (Pilgrim’s Pride) sold one of its business divisions to a buyer. To finance the acquisition, the buyer took out a short-term bridge loan.

The buyer planned to repay the bridge loan from the proceeds of a public offering. However, the buyer was unable to raise the funds through the offering 12 months later. As a result, Pilgrim’s Pride was required to purchase preferred stock from the buyer for approximately $100 million.

Things did not turn out as planned. Indeed, a few years later, the buyer stopped making dividend payments on the preferred stock. The buyer offered to redeem the stock for $20 million. Pilgrim’s Pride rejected the offer and instead surrendered all the stock to the issuer for no consideration.

Did Pilgrim’s Pride abandon the securities because it had a change of heart and wanted to help out the buyer? Perhaps it would have fared better in Tax Court had that been its motivation. But the reason was that the tax savings from claiming an ordinary loss of $100 million was significantly more than the $20 million offer plus a capital loss of $80 million.

With a tax opinion in hand, Pilgrim’s Pride turned down the $20 million in cash and instead claimed an ordinary loss from abandonment.
The fact that Pilgrim’s Pride was primarily motivated to turn down $20 million in cash due to tax considerations was surely unhelpful to their tax case. In fact, possibly fueled by the taint of tax avoidance, the Tax Court seemed to go out of its way to decide in favor of the government.

As discussed below, the Tax Court seemed to stretch to deny an ordinary loss. Perhaps the court reasoned that, if the taxpayer had prevailed, it would represent a perfect example of a taxpayer having the opportunity to achieve different tax results for transactions that are otherwise economically identical. It would also reward the taxpayer’s refusal to accept $20 million in cash for the securities by providing the taxpayer with a large tax write-off.

**Deemed Sales Under Code Sec. 1234A**

Pilgrim’s Pride claimed an ordinary loss because it contended it abandoned the securities. There was no “sale or exchange” and thus no capital loss, the company argued. Still, the Tax Court held that under Code Sec. 1234A, there was a deemed sale or exchange. The Tax Court seemed to be searching for some way to deny an ordinary loss to the taxpayer.

Indeed, at the outset of the case, neither the government nor the taxpayer thought Code Sec. 1234A applied to the transaction. Instead, the court requested both sides to brief it on the issue. Code Sec. 1234A dictates that gain or loss attributable to the cancellation, lapse, expiration or termination of a right or obligation with respect to property which is (or would be) a capital asset is treated as gain or loss from the sale of a capital asset.

The provision is somewhat obscure and was designed primarily to prevent people from claiming ordinary losses. The taxpayer argued that Code Sec. 1234A did not apply because it only applies to derivative property rights. The taxpayer interpreted the language to only apply to a right or obligation with respect to stock, not to any transaction involving the stock itself.

The legislative history indicates that Code Sec. 1234A was motivated in large part by a desire to prevent ordinary loss treatment from certain dispositions of financial contracts. One of the examples in the legislative history is the forfeiture of a down payment under a contract to purchase stock. This example seems to provide support for the taxpayer’s interpretation that Code Sec. 1234A applies to derivative rights and contracts with respect to stock and not to stock itself.

The Tax Court rejected this argument. It reasoned that stock represented a contract right that was essentially a “chose in action.” The termination of all rights with respect to rights embodied in stock resulted in a deemed sale or exchange.

The Tax Court found particularly persuasive the analogy to a redemption of a bond, which is accorded sale or exchange treatment under Code Sec. 1271(a). Just as Congress determined that a bond redemption should be treated as a deemed sale when Congress passed the predecessor to Code Sec. 1271(a), it also wanted the redemption of stock to result in a deemed sale under Code Sec. 1234A.

The Tax Court seemed to stretch the argument by analogizing to Code Sec. 1271(a). Indeed, the Supreme Court in *D. Fairbanks* [SCT, 39-1 USTC ¶9410, 306 US 436] had earlier decided that a redemption of a bond would not be treated as a sale or disposition. Therefore, Congress had to enact the predecessor to Code Sec. 1271(a) to create a deemed sale or exchange upon a redemption.

The *Fairbanks* decision and others like it seemed to stand for the principle that, in the absence of a specific statute creating a deemed sale or exchange, an abandonment would be treated as an ordinary loss. However, in ruling against Pilgrim’s Pride, the Tax Court relied on a rather obscure argument that stock was merely a bundle of rights. The Tax Court reasoned that Code Sec. 1234A applied because the transaction terminated the taxpayer’s rights with respect to the stock.

The Tax Court believed that to allow an ordinary loss on abandonment would be to permit similar economic transactions to be taxed differently. However, the Tax Court seemed to be interpreting Code Sec. 1234A far more broadly than other courts. By giving such a wide interpretation to Code Sec. 1234A, the Tax Court may be creating an opportunity for taxpayers to use Code Sec. 1234A offensively to claim capital gain treatment.

**Code Sec. 1234A Case Law**

In *J. Freda* [98 TCM 120, Dec. 57,913(M), TC Memo. 2009-191], the Tax Court held that Code Sec. 1234A did not apply to treat a legal settlement as resulting in capital gain. In that case, the
taxpayer had prevailed in a lawsuit alleging that the defendant misappropriated a trade secret. The taxpayer claimed that the settlement should be treated as capital gain.

After all, it argued, the settlement agreement terminated its contract rights in the trade secret. Nonetheless, the court determined that the taxpayer did not receive the settlement with respect to its rights to the trade secret. Instead, the settlement related to lost profits, lost opportunities, and other damages.

Indeed, the Tax Court reasoned that the taxpayer did not transfer all rights to the trade secret as part of the settlement. The decision was affirmed on appeal, although the Code Sec. 1234A argument was not addressed. [J. Freda, CA-7, 2011-2 USTC ¶50,600, 656 F3d 570, aff’d TC.]

Taxpayers have generally failed to prevail in arguing that Code Sec. 1234A should be applied to treat proceeds from legal settlements as attributable to the termination of contract rights. The case law seems to have a “heads I win, tails you lose” quality to it. Nevertheless, the broad scope of the Tax Court’s interpretation of Code Sec. 1234A certainly seems to create opportunities to argue in favor of capital gain treatment.

Sale or Exchange?

In William Flaccus Oak Leather Co. [313 US 247 (1941)], the Supreme Court held that insurance proceeds received from the loss of a factory to a fire could not be considered proceeds from a sale or exchange of a capital asset. Instead, they represented ordinary gain. The Supreme Court explained that the term “sale or exchange” should be interpreted according to its ordinary meaning unless expressly provided otherwise by statute.

The Court noted that Congress deems certain transactions to constitute a sale or exchange. For example, partial and complete liquidations, redemptions of bonds and the lapse of options are all treated as deemed sales or exchanges. However, these specific exceptions reinforce the general rule. Absent an exception, the destruction of a building in a fire that is compensated by insurance should not be deemed a sale or exchange.

Although a harsh result for the taxpayer, this holding seems to make sense. The destruction of a building by fire is not a voluntary trade or exchange on the market between two willing parties but rather an accident. It is the result of an act of God, such as a flash of lightning. Even a voluntary transaction will not necessarily satisfy the sale or exchange requirement.

In Billy Rose’s Diamond Horseshoe, Inc. [CA-2, 448 F2d 549 (1971)], the taxpayer received a settlement payment upon the termination of a lease for a theater. Under the terms of the lease, the lessee was obligated to return the theater in the same condition. When the lessee failed to do so, it paid a settlement instead.

The taxpayer took the position that the settlement payment represented proceeds from the sale or exchange of the fixtures and other theater property. However, the court held that the cancellation or release of a contract right should not be equated to the transfer of a contract right. The lessee did not acquire any property.

Instead, it was merely released from its liabilities and obligations under the lease. If there is no sale or exchange and the taxpayer suffers a loss, the loss may be ordinary even if the property is a capital asset. For example, in one case, the taxpayer qualified for an ordinary loss upon the abandonment of an Alaskan gold mining venture.

In A. J. Industries, Inc. [CA-9, 74-2 USTC ¶9710, 503 F2d 660], the asset was capital but the loss was allowed as ordinary. Similarly, the abandonment of a project to start a savings and loan also qualified for an ordinary loss in H.W. Seed. [52 TC 880, Dec. 29,719 (1969).]

This sale or exchange versus abandonment dichotomy creates friction, to be sure. Yet it also can provide an opportunity. An abandonment is not a sale or exchange.

Therefore, abandonment does not result in capital loss unless there is a deemed sale or exchange. One example of a deemed sale or exchange is a worthless security. A loss from a worthless security is deemed to result from a sale or exchange under Code Sec. 165(g).

Another example is a transfer of property to a Qualified Settlement Fund. When a defendant transfers property (rather than cash) to a Qualified Settlement Fund to settle a legal dispute, the transfer is treated as resulting in a deemed sale or exchange of the property under Reg. §1.468B-3(a)(1). Pilgrim’s Pride seemed to be relying on considerable authority that, in the absence of a statute that specifically created a deemed sale or exchange, it should be entitled to an ordinary loss.
No Net Value Proposed Regulations
The sale or exchange requirement shows up in other areas as well. For example, if a taxpayer does not receive net value in a liquidation that otherwise qualifies as tax-free under Code Sec. 332, the liquidation is not tax-free. Tax-free treatment requires that a taxpayer receive property in exchange for stock.

When the taxpayer does not receive net value, there is no exchange, and Code Sec. 332 does not apply. Instead, the liquidation triggers a loss. [Reg. §1.332-2(b).] In 2005, the IRS issued proposed regulations that would require the receipt of net value for a broad range of transactions under Code Secs. 351 and 368 to qualify as tax-free. The reasoning behind the “net value” proposed regulations is that the tax-free rules for tax-free capital contributions and corporate reorganizations require the taxpayer to receive the stock in exchange for property. If there is no net value being transferred, then there is no exchange. [Preamble to Proposed Regs. on Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11,903, 11,904 (March 10, 2005).]

Abandoning Partnership Interests
When securities become worthless, the loss is generally treated as resulting from a deemed sale or exchange under Code Sec. 165(g). Nonetheless, there is an exception for securities issued by an affiliate. A loss from worthless securities in an affiliate qualifies for an ordinary deduction. [Code Sec. 165(g)(3); Reg. §1.165-5(d)(1).]

Partnership interests may also qualify for an ordinary loss in the absence of a sale or exchange. The IRS ruled that the abandonment of partnership interest qualified for an ordinary loss. [Rev. Rul. 93-80, 1993-2 CB 239.] However, the ruling includes a trap for the unwary.

To qualify for an ordinary loss, there must not be any deemed or actual exchange. If the abandonment of a partnership interest results in a deemed distribution of cash, the partner is treated as exchanging its partnership interest for the deemed distribution. Even a de minimis actual or deemed distribution disqualifies the abandonment for ordinary loss treatment.

Under Code Sec. 752(b), any decrease in a partner’s share of liabilities is treated as a deemed distribution of cash. If a partner has any liabilities allocated to it at the time of abandonment, the abandonment results in a deemed distribution, and the resulting loss is capital. Apparently, even a peppercorn of allocated liabilities will spoil ordinary loss treatment.

In dicta, the court in Pilgrim’s Pride cast doubt on whether Rev. Rul. 93-80 remains valid. It explained that Code Sec. 1234A should apply to treat the abandonment of a partnership interest as resulting in a deemed sale or exchange. Thus, just as the taxpayer was disqualified from claiming an ordinary loss on the abandonment of preferred stock, a partner should not be eligible for ordinary loss treatment on abandoning its partnership interest.

Theft Loss
As mentioned above, another type of loss that qualifies for an ordinary loss is a theft loss. Following the unraveling of the Madoff fraud and many other smaller Ponzi schemes like it, the IRS issued Rev. Rul. 2009-9, 2009-1 CB 735, to provide guidance on theft losses. The ruling includes some taxpayer-friendly guidance and safe harbors for allowing ordinary loss treatment when the taxpayer suffers a loss due to a fraudulent scheme.

What if the theft loss takes place as part of a transaction entered into for profit or as part of a trade or business? In that event, it is not subject to the harsh limitations in Code Sec. 165(h), particularly the limitation to losses in excess of 10 percent of adjusted gross income. The theft must be the direct cause of the loss, meaning that the loss is generated by the theft of the investor’s property. An indirect theft loss, such as a decrease in the price of stock or securities on the open market after the discovery of corporate fraud, does not qualify as a theft loss.

To be precise, the taxpayer must transfer cash or property to a party that has specific intent to commit fraud or theft. The taxpayer does not need to prove that a criminal conviction took place. However, the taxpayer must establish that the recipient of the funds had criminal intent.

To qualify for a safe harbor, the “lead figure” of the scheme must have been charged in a federal or state indictment, information, or criminal complaint. The theft loss is deductible in the year of discovery. Under the safe harbor, however, the amount of loss which the taxpayer can deduct is reduced to either 75 percent or 95 percent of the total loss, depending on what attempts the taxpayer has made to recover the funds.
In fact, it can be better in many situations to forego certain attempts to recover the funds and opt for the larger tax loss. Moreover, the theft loss may even create a Net Operating Loss, which can be used to offset income in other years.

Conclusions
The court in Pilgrim’s Pride provided a very broad (and one might say unprecedented) interpretation of Code Sec. 1234A. Before the court asked for a briefing, it had not even occurred to the government that Code Sec. 1234A might apply to deny ordinary loss treatment. The Tax Court clearly seemed to disapprove of the fact that the taxpayer turned down an offer to receive $20 million for the securities.

It turned down $20 million in cash because it believed it would achieve a larger tax savings from the abandonment. And that action seemed to have a far-reaching tax impact. Nevertheless, it is difficult to discern whether the court was merely stretching the law to deny an ordinary loss, or if this case may expand the scope of Code Sec. 1234A.

In the latter event, it could presumably encompass the termination of a myriad of different contracts and rights. The expansion of the deemed sale or exchange that takes place under Code Sec. 1234A certainly contributes to the complexity of determining the tax consequences of loss transactions. Notably, in the partnership context, it is not enough for taxpayers to rest assured that abandoning a partnership interest should result in ordinary treatment as long as there is no deemed distribution of cash under Code Sec. 752(b).

Instead, taxpayers must contend with the possibility that any abandonment of a partnership interest may qualify as a deemed sale or exchange under Code Sec. 1234A. At the same time, if the court is correct that virtually any abandonment of a financial instrument results in a deemed sale or exchange, this seems to cast doubt on the “net value” proposed regulations.

Under those proposed regulations, the Treasury determined that, if a taxpayer does not receive property with a net value in an otherwise tax-free transaction, there is no “exchange” for tax purposes. Therefore, tax-free treatment does not apply because tax-free treatment is predicated on an exchange. However, under the Pilgrim’s Pride court’s interpretation, the rules now seem different.

If a taxpayer gives up its rights to stock in a liquidation under Code Sec. 332, or if a taxpayer gives up its rights to property as part of a contribution to a controlled corporation under Code Sec. 351, this should result in a deemed exchange under Code Sec. 1234A. Up until now, taxpayers have generally not fared well when relying on Code Sec. 1234A to try to achieve capital gain treatment.

If the Tax Court’s interpretation in Pilgrim’s Pride prevails, taxpayers may have considerably more latitude to claim capital gain treatment. In any case, when attempting to claim an ordinary loss from abandonment, or capital gain treatment for a termination of contract rights under Code Sec. 1234A, taxpayers must exercise extreme caution.