Take Pride in Ordinary Losses After *Pilgrim's Pride*

By Robert W. Wood


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In this article, Wood discusses *Pilgrim's Pride* and the abandonment of capital assets resulting in ordinary losses.

Acquisitions can be risky, and from a tax perspective, a bad acquisition can seem particularly harsh. The acquisition may be funded with after-tax ordinary earnings. If it goes badly, however, the loss may well be capital.

Capital losses are subject to limitations that can be painful. Even C corporations that are taxed at the same rates for ordinary income and long-term capital gain do not like capital losses. Nonetheless, theft losses and abandonment can result in ordinary losses, and that can produce some strange incentives. Taxes and economics, after all, can be quite different.

Alluringly, abandoning an investment or capital asset as worthless can sometimes result in an ordinary loss. It sounds pretty simple. The statutory authority for an ordinary loss on abandonment is in section 165. It permits a deduction for any loss suffered during the year that is not compensated by insurance.

Section 165 does not dictate the character of the loss. But section 165(c)(1) permits taxpayers to deduct a loss incurred in a trade or business. Section 165(c)(2) permits taxpayers to deduct a loss incurred in a transaction entered into for profit.

Section 165 does not override the limitation on capital losses, and worthless securities result in capital losses. Nevertheless, subject to limitations, section 165 can provide ordinary loss opportunities. A sale or exchange of a capital asset results in a capital loss, while abandoning a capital asset without a sale or exchange is generally ordinary.

That might seem to set the table nicely with easy ways to maximize the tax benefit on your facts. Surprisingly, determining whether a sale or exchange has taken place can be difficult. Moreover, sometimes you can be saddled with ''deemed sale'' treatment you did not want.

Pride of the Pilgrims

In *Pilgrim's Pride Corp. v. Commissioner*,[1] the taxpayer (Pilgrim's Pride) sold one of its business divisions. 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, it was unable to raise the funds through the offering 12 months later.

Thus, Pilgrim's Pride had to purchase preferred stock from the buyer for about $100 million. Eventually, the buyer stopped making dividend payments and offered to redeem the stock for $20 million.

Pilgrim's Pride rejected the offer and instead surrendered all the stock to the issuer for nothing. Why would the company turn down $20 million in cash and prefer a complete bust? Because the amount of tax savings from claiming an ordinary loss of $100 million was worth it. That is, the claimed ordinary loss on the $100 million was worth significantly more than $20 million in cash plus a capital loss of $80 million. Pilgrim's Pride even commissioned a tax opinion so that it could be satisfied that it made the right choice. Thus, with tax opinion in hand, Pilgrim's Pride turned down $20 million in cash and claimed an ordinary loss from abandonment.

The IRS challenged the deduction, arguing that Pilgrim's Pride's $98.6 million loss was capital in nature. In Tax Court, Pilgrim's Pride argued that even if the stock was a capital asset, there was no

[1] 141 T.C. No. 17 (2013).

sale or exchange. There was nothing to make the transaction capital, so the deduction should be upheld, it argued.

Not surprisingly, the IRS disagreed. It argued that section 1234A required the $98.6 million loss to be treated as a capital loss. The Tax Court concluded that when Pilgrim's Pride walked away from its $98.6 million investment, it terminated all its rights. The stock was a capital asset, the termination was covered by section 1234A, and the loss was capital.

Fifth Circuit Rescue

The Court of Appeals for the Fifth Circuit reversed the Tax Court and concluded that section 1234A did not apply to the abandonment of the stock.[2] That made Pilgrim's Pride's loss ordinary under section 165. In reaching its conclusion, the Fifth Circuit stated that section 1234A applies only to the termination of rights or an obligation to acquire a capital asset.

The court stated that this provision does not apply to the termination of ownership of a capital asset the taxpayer already owns. In fact, the Fifth Circuit concluded that if Congress intended to make the abandonment of a capital asset a capital loss, it would have stated that rule more clearly in the tax code. For example, Congress could have stated that abandoning a capital asset results in a capital loss. The court noted that the IRS did that, in part by amending the section 165 regulations to provide that abandoning stock results in a capital loss.

In *Pilgrim's Pride*, however, the court of appeals concluded that the IRS had provided no evidence that forfeiting a capital asset, such as stock or a partnership interest, is akin to forfeiting the right to acquire a capital asset. According to the court, only forfeiting the right to acquire a capital asset is subject to section 1234A.

Tax Motivated

The taxpayer in *Pilgrim's Pride* was clearly tax motivated, and some have noted that that in itself is an important feature of the case. It seems strange that a $20 million cash deal is less attractive than a $0 deal, after taxes. To some extent, the taint of that behavior may have influenced the Tax Court's decision.

The Tax Court clearly disapproved of the taxpayer turning down an offer to receive $20 million for the securities. It turned down $20 million in cash because it believed that it would achieve larger tax savings from the abandonment. And that action seemed to have a far-reaching tax impact.

Equally interestingly, these actions did not bother the court of appeals one bit. Yet it is also worth looking again at the Tax Court decision that was reversed because the Tax Court in *Pilgrim's Pride* seemed to interpret section 1234A more broadly than other courts.

Sale or Exchange?

In *Freda v. Commissioner*,[3] the Tax Court held that section 1234A did not apply to treat a legal settlement as resulting in capital gain. The taxpayer in *Freda* had prevailed in an earlier lawsuit, alleging that the defendant misappropriated a trade secret. The taxpayer argued that the settlement from that lawsuit was capital gain because the settlement agreement terminated its contract rights in the trade secret.

However, the court said the settlement related to lost profits, lost opportunities, and other damages. The Tax Court reasoned that the taxpayer did not transfer all rights to the trade secret as part of the settlement. The *Freda* decision was affirmed on appeal, although the section 1234A argument was not addressed.[4]

In *Helvering v. William Flaccus Oak Leather Co.*,[5] 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 otherwise expressly provided by statute.

The Court noted that Congress deems specific transactions to constitute a sale or exchange. For example, partial and complete liquidations, redemptions of bonds, and lapses of options are all treated as deemed sales or exchanges. But these specific exceptions reinforce the general rule.

Absent an exception, if a building is destroyed by a fire and insurance compensates for the loss, that 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. Rather, it is an accident — the result of an act of God, like a flash of lightning.

Voluntary Transactions

Even a voluntary transaction will not necessarily satisfy the sale or exchange requirement. A good example of this is *Billy Rose's Diamond Horseshoe Inc.*

[2] *Pilgrim's Pride*, No. 14-60295 (5th Cir. 2015).

[3] T.C. Memo. 2009-191.

[4] *Freda v. Commissioner*, 656 F.3d 570 (7th Cir. 2011).

[5] 313 U.S. 247 (1941).

v. United States.[6] In that case, the taxpayer received a settlement payment on the termination of a lease for a theater.

Under the lease terms, 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's position was that the settlement payment represented proceeds from the sale or exchange of the fixtures and other theater property. But 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 *A.J. Industries Inc. v. United States*,[7] the taxpayer qualified for an ordinary loss on the abandonment of an Alaskan gold mining venture; the asset was capital, but the loss was allowed as ordinary. Similarly, the abandonment of a project to start a savings and loan qualified for an ordinary loss in *Seed v. Commissioner*.[8]

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, it should not result in capital loss treatment 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 section 165(g).

No Net Value?

The sale or exchange requirement surfaces in other areas. For example, if a taxpayer does not receive net value in a liquidation that otherwise qualifies as tax free under section 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 section 332 does not apply. Instead, the liquidation triggers a loss.[9] In 2005 the IRS issued proposed regulations that would require the receipt of net value for a broad range of transactions under sections 351 and 368 to qualify as tax free.

There is valid reasoning behind the net value proposed regulations. 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, there is no exchange.[10]

Partnership Interests

When securities become worthless, the loss is generally treated as resulting from a deemed sale or exchange under section 165(g). However, there is an exception for securities issued by an affiliate. A loss from worthless securities in an affiliate qualifies for an ordinary deduction.[11]

Another financial instrument that may qualify for an ordinary loss in the absence of a sale or exchange is a partnership interest. The IRS ruled that the abandonment of a partnership interest qualified for an ordinary loss.[12] Nevertheless, the ruling includes a trap for the unwary.

For a transaction to qualify for ordinary loss treatment, 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.

Notably, under section 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. The unfortunate result is that the loss is capital.

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

The Fifth Circuit's decision in *Pilgrim's Pride* gave the taxpayer a nice ordinary deduction and eliminated the considerable black cloud cast over Rev. Rul. 93-80. Thus, abandonments of partnership interests are back to the ordinary loss treatment taxpayers have come to expect.

Theft Losses

Another type of loss qualifying for ordinary loss treatment is a theft loss. There has been considerable interest in theft losses following the unraveling

[6] 448 F.2d 549 (2d Cir. 1971).
[7] 503 F.2d 660 (9th Cir. 1974).
[8] 52 T.C. 880 (1969).
[9] *See* reg. section 1.332-2(b).

[10] *See* preamble to proposed regulations, 70 F.R. 11,903, 11,904 (Mar. 10, 2005).
[11] *See* section 165(g)(3); and reg. section 1.165-5(d)(1).
[12] *See* Rev. Rul. 93-80, 1993-2 C.B. 239.

of the Madoff fraud and similar, smaller schemes. As a result, the IRS issued Rev. Rul. 2009-9[13] to provide guidance on theft losses.[14] That ruling provides some taxpayer-friendly guidance and safe harbors. 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 section 165(h), particularly the limitation to losses exceeding 10 percent of adjusted gross income.

A loss that results from the decrease in price of stock or securities on the open market does not qualify as a theft loss. Instead, the taxpayer must have transferred cash or property to a party that had 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 by a federal or state indictment, information, or criminal complaint. The theft loss is deductible in the year of discovery. Moreover, the theft loss may create a net operating loss. That can help ease the pain of the theft loss for years to come.

Lasting Pride

Following the Tax Court's decision in *Pilgrim's Pride*, there has been some concern that the section 1234A sleeping dog might be awakened. Section 1234A was enacted not to allow for capital gain treatment, but to deny ordinary loss treatment. It was targeted to treat losses as capital that taxpayers were likely to claim as ordinary.

Yes, section 1234A could be expanded. Yet the Fifth Circuit seems to treat section 1234A as an oddity that occasionally imports capital gain or loss treatment. On the gain point, the provision is not limited to capital losses. That is probably giving some taxpayers ideas. If not, shouldn't it?

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[13]2009-14 IRB 735.

[14]*See also* Rev. Proc. 2009-20, 2009-14 IRB 749.