



ATTENTION

## Final Regulations Deny Ordinary Loss for Stock Abandonment

*Abandonment of property is a method of recognizing an ordinary loss, rather than a capital loss that requires the “sale or exchange” of property. Recently the Internal Revenue Service (“IRS”) finalized a regulation that limits the use of this method when it comes to the tax treatment of losses from abandoned “securities” (the “New Regulation”).<sup>1</sup> In this context “securities” generally include stock in a corporation and debt instruments.<sup>2</sup> For investors planning to abandon securities to create an ordinary loss, the New Regulation forecloses this possibility. Additionally, although the New Regulation is not retroactive, the preamble to the New Regulation leaves open the possibility that the IRS will scrutinize prior attempts to claim an ordinary loss.<sup>3</sup>*

. . .

The New Regulation is drafted so as to narrowly cure a problem the IRS identified relating to taxpayers claiming an ordinary loss based on an alleged definitional gap between two categories of capital losses: “sales or exchanges”<sup>4</sup> and “worthlessness.”<sup>5</sup> Specifically, some taxpayers claimed that these definitions did not include stock abandonment, thereby permitting an ordinary loss for such disposition.

As discussed below, this definitional gap is not relevant to the abandonment of other property and therefore the New Regulation does not impact the abandonment of other property, such as interests in partnerships (or limited liability companies treated as partnerships for federal income tax purposes (an “LLC”)). As a result, the abandonment of an equity interest in a corporation or partnership (or LLC) may have drastically different economic consequences.

# CLIENT ALERT

Ordinary losses have two significant advantages to capital losses. First, ordinary losses can offset both capital gains and ordinary income. Generally, capital losses can only offset capital gains.<sup>6</sup> If the taxpayer does not have sufficient capital gains in a given year the capital losses may be of no value. Second, capital losses incurred by corporations have a limited carryback period (generally 3 years) and limited carryover period (generally 5 years), while the combined carryback and carryover period of ordinary losses is much longer (2 years and 20 years, respectively).<sup>7</sup>

Reading these two limitations together, capital losses in excess of capital gains for a given year have no value in that year, and if a corporate taxpayer has no net capital gains in the prior three years and is unable to generate capital gains sufficient to exceed such capital losses within five years, such capital losses become completely useless. Given the recent stock market declines, this could be significant to investors.

The Revenue Act of 1936 defines “capital losses” simply as losses arising from the “sale or exchange” of capital assets.<sup>8</sup> In 1938, Congress identified

“peculiar and anomalous results” relating to taxpayers getting an ordinary loss or a capital loss on securities based on the manner of disposition.<sup>9</sup>

To correct this perceived problem, Congress enacted a new category of capital losses due to worthlessness of securities. The New Regulation does not create yet another new category of disposition for abandonment, rather it considers abandonment to be an indication of worthlessness.

In the preamble to the New Regulation, the IRS analogizes the issue concerning abandonment with the perceived problem in 1938: worthlessness leading to an ordinary loss, while sale or exchange of a security results in a capital loss.<sup>10</sup>

Now the IRS thinks it “peculiar and anomalous” for a taxpayer to get an ordinary loss upon the abandonment of a security when the sale or worthlessness of the same security would result in a capital loss.<sup>11</sup> The IRS resolves this anomaly with the New Regulation and further states in the Preamble that it believes that the act of abandonment establishes worthlessness.<sup>12</sup>

While the New Regulation indeed closes the definitional gap so that any disposition of securities is treated as a capital loss, no other type of capital asset is subject to this treatment. Section 1222 generally defines a capital loss as the “loss from the sale or exchange of a capital asset,” which, for instance, has been held not to include losses due to abandonment of partnership interests.<sup>13</sup>

Moreover, as the New Regulation purports to be defining the statutory term “worthless” to include abandoned stock, there is no danger of this reading expanding to include other capital assets without Congress changing the statute. Therefore, the New Regulation should not give pause to investors that have abandoned, or plan to abandon, partnership or LLC interests.

Nevertheless, private equity managers, hedge fund managers and other investors should continue to comply with the other rules that may limit their ability to claim an ordinary loss on the abandonment of a partnership interest (e.g., whether the transaction meets the requirements for abandonment, or whether there is a business purpose for the partnership).

Further, in assessing the value of capital losses in financial statements, these investors should keep in mind that corporations with significant capital losses now have fewer tools at their disposal for utilizing these losses and that some or all of those losses may evaporate if they cannot be utilized within the three-year carryback and five-year carryover periods.<sup>14</sup>

Lastly, investors should get comfortable with the fact that the abandonment of one type of equity interest (stock) will have different tax consequences than the abandonment of another type of equity interest (partnership or LLC interests).

## New York

Seven Times Square  
New York, NY 10036  
+1.212.209.4800  
+1.212.209.4801 [fax]

## Boston

One Financial Center  
Boston, MA 02111  
+1.617.856.8200  
+1.617.856.8201 [fax]

## Washington, DC

601 Thirteenth Street NW,  
Suite 600  
Washington, DC 20005  
+1.202.347.2222  
+1.202.347.4242 [fax]

## Hartford

City Place I  
185 Asylum Street  
Hartford, CT 06103  
+1.860.509.6500  
+1.860.509.6501 [fax]

## Providence

121 South Main Street  
Providence, RI 02903  
+1.401.276.2600  
+1.401.276.2601 [fax]

## London

8 Clifford Street  
London, W1S 2LQ  
United Kingdom  
+44.20.7851.6000  
+44.20.7851.6100 [fax]

## Dublin

Alexandra House  
The Sweepstakes  
Ballsbridge, Dublin 4  
Ireland  
+353.1.664.1738  
+353.1.664.1838 [fax]

[www.brownrudnick.com](http://www.brownrudnick.com)

Our 200 attorneys provide assistance across key areas of the law, including tax law, finance, corporate and securities, bankruptcy and restructuring, government law and strategies, complex litigation and arbitration, climate and energy, intellectual property, and real estate.



**1** Treas. Reg. § 1.165-5 (effective March 13, 2008). References herein to “§” or “Section” are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

**2** Treas. Reg. § 1.165-5(a)(3). This definition of a debt instrument would generally include most publicly traded debt.

**3** Abandonment of Stock and Other Securities, 72 Fed. Reg. 41,468, 41,470 (July 30, 2007) (the “Preamble”).

**4** § 1222(2), (4).

**5** § 165(g).

**6** Individual taxpayers can use up to \$3,000 annually of capital losses to offset ordinary income.

**7** Individual taxpayers may carryover capital losses indefinitely.

**8** Revenue Act of 1936, Pt. II, § 23(j), 49 Stat. 1648 (June 22, 1936).

**9** H. Rep. No. 1860, 75th Cong., 3d Sess., at 18-19 (1938).

**10** Preamble at 41,469.

**11** *Id.*

**12** *Id.* See also, Rev. Rul. 2004-58, 2004-24 IRB 1043 (in the context of intellectual property, abandonment is proof of worthlessness).

**13** See, e.g., Citron v. Commissioner, 97 T.C. 200 (1991); Zeeman v. U.S., 275 F. Supp. 235 (1967).

**14** It should be noted that the New Regulation may be applied retroactively, as the IRS views it as an interpretation and not an alteration of the law.

For further information, please contact your Brown Rudnick attorney or one of the following attorneys:

## Patrick M. Cox

+1.212.209.4949  
[pcox@brownrudnick.com](mailto:pcox@brownrudnick.com)

## Fred L. Levy

+1.202.536.1725  
[flevy@brownrudnick.com](mailto:flevy@brownrudnick.com)

*Gwendolen D. Long contributed to this alert.*