Worthless Partnership Interests

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Mergers and acquisitions are cyclical. In the aftermath of the dot-com bust, merger and acquisition activity dwindled to a mere trickle of what it had been in the hey-day of the Internet boom. Today, it seems the mergers and acquisitions faucet has been fully turned back on. This upswing in mergers and acquisitions can probably be attributed to a variety of reasons, including falling interest rates, favorable law changes, and a return of market confidence.

Of course, many mergers and acquisitions don't happen for those reasons at all. In what might be seen as more traditional mergers and acquisitions, the genesis of the combination is simply cost efficiencies. Yet, rarely do we consider the downside of mergers and acquisitions. What happens when the cost efficiencies do not materialize, or notwithstanding the parties' best intentions, interest rates spike or laws change? Sometimes, such unforeseen hurdles result in the merger or acquisition—or any investment for that matter—not performing as expected.

Soured investments often lead to consideration of tax benefits. Normally, tax benefits can only be achieved upon a realization event, meaning that a taxpayer has to sell his soured investment. Mere fluctuations in value (no matter how great the swing) usually do not allow a taxpayer to claim tax benefits.

One exception to this realization rule concerns investments that become completely worthless. When an investment becomes completely worthless, taxpayers may be able to claim tax benefits without a more traditional realization event, assuming other requirements are met. Many M&A TAX REPORT readers probably assume that taxpayers can always claim a deduction when their investments become worthless. However, claiming a deduction based on a worthless investment is complicated, and there is a long history of questions concerning such deductions.

Worthless History?

Congress enacted Section 165 as part of the 1954 Code, allowing taxpayers to claim a deduction when their investments lost all their value. Congress left the details of implementing Code Sec. 165 to Treasury. This has proven troublesome, both for the government and for taxpayers. The IRS has instituted myriad rules to determine when a deduction is allowed. These rules focus on both objective events and on subjective factors, making compliance difficult. Needless to say, they have caused frequent battles, and numerous court decisions.

Recently, in Chief Counsel Advice (CCA) 200637032 [Sept. 2, 2005], the IRS published a legal ruling hoping to stave off yet another trip to court over this nettlesome issue. In this ruling, the IRS set forth guidance to determine whether an individual ("Ira Individual") was entitled to claim a Code Sec. 165 deduction for the worthlessness or abandonment of his interest in a partnership ("Services").

Unfortunately, the facts of the CCA are not well developed, so it does not reach any definitive conclusions. However, it still has value to taxpayers, providing broad and generalized advice in an area filled with uncertainty.

The Loan

Services was a professional firm organized as a limited liability partnership. Ira Individual joined Services as its "National Director." Under the terms of the offer letter from Services to Ira as well as Services' partnership agreement, Ira did not appear to have been responsible for any of the net losses or liabilities of Services. Ira was only required to provide a contribution to Services in the form of a subordinated loan funded through a subsidiary of Services. Ira signed a promissory note in favor of the subsidiary for that amount.

Before working a full year for Services, Ira resigned. Ira requested repayment of the subordinated loan under a provision of Services' partnership agreement that provided that Services would return a partner's paid-in capital within 60 days of a partner's resignation. Services did not make payment, and Ira continued to demand payment at least until Year 2, and possibly through Year 3. In fact, as of the date the CCA was issued, Services had still not made any payments to Ira.

According to the CCA, Ira did not appear to have relinquished his legal right to be repaid under the original note. Indeed, correspondence between Services and Ira in Year 2 indicates that while Services rejected Ira's demand for immediate payment (asserting that the loan was subordinated to other claims and that Ira had to agree to arbitration), Services did not dispute that the amount was an obligation of Services.

The Filings

It appears that Ira may have had a partnership interest in Services. Indeed, Ira received a Schedule K-1 from Services in Year 1 which identified Ira as a general partner of Services. The K-1 also indicated that Ira contributed capital to Services during the year. However, this does not jibe with other facts mentioned in the CCA, namely that Ira lent funds to Services, and did not contribute funds to Services.

In contrast, the manner in which Ira reported this transaction is telling to what Ira thought had transpired. On Ira's Year 1 return, he claimed an ordinary loss on Form 4797 (*Sale of Business Property*) for the subordinated loan. He identified this claimed loss as "Worthlessness of Partnership Interest."

During Year 1, Services discontinued revenue-producing activities. However, Services did not file for bankruptcy, nor did it so file in later years. Subsequent events indicated that Services may still have held assets available to satisfy its creditors' claims, including a return of Ira's subordinated loan. In Year 4, Services agreed to settle a class action lawsuit. The settlement was comprised of a current payment and a possibility of additional payments based on a percentage of settlement payments that may be made by Services in other pending cases or to its partners.

Timing Is Everything

Code Sec. 165(a) allows a deduction for losses sustained during the tax year and not compensated for by insurance or otherwise. A loss deduction is permitted only for a tax year in which the loss is sustained, as evidenced by closed and completed transactions, and as fixed by identifiable events occurring in that year. [Reg. §1.165-1(d)(1).] A loss deduction is typically ordinary in nature, but a loss from the sale or exchange of a capital asset is a capital loss. [Code Sec. 165(f).]

Rev. Rul. 93-80, 1993-2 CB 239, provides that a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. If there is an actual or deemed distribution to the partner, or if the transaction is otherwise in substance a sale or exchange, the partner's loss is capital (except as provided in Code Sec. 751(b)).

Abandonment of an asset for purposes of Code Sec. 165 requires (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. [*A.J. Industries, Inc.*, CA-9, 74-2 USTC ¶9710, 503 F2d 660, 670 (1974); Rev. Rul. 93-80; Rev. Rul. 2004-58, 2004-1 CB 1043.] Manifesting your intent is important. For example, in *J.C. Echols*, CA-5, 91-2 USTC ¶50,360, 935 F2d 703, 706–08 (1991), the court found both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership.

A deduction for worthlessness under Code Sec. 165 is allowable only if there is a closed and completed transaction fixed by identifiable events establishing that the property is worthless in the year for which the deduction is claimed. Reg. §1.165-1(b) and (d)(1). Although a taxpayer is not required to be an "incorrigible optimist," a mere diminution in the value of an asset is not sufficient to establish worthlessness. [*S.S. White Dental Manufacturing Co.,* SCt, 1 USTC ¶235, 274 US 398, 403, 47 SCt 598 (1927); *J.V. Proesel,* 77 TC 992, 1006, Dec. 38,393 (1981).] As in the case of abandonment, both subjective and objective factors are taken into account. [*See L. Boehm,* SCt, 45-2 USTC ¶9448, 326 US 287, 292–93 66 SCt 120 (1945); *Echols*, *supra,* 935 F2d, at 706–08.]

The Chief Counsel noted that both abandonment and worthlessness are ultimately factual determinations. It continued, noting that not all the facts had been developed in this case so far. However, based on the facts established, there was no indication that Ira's rights in the subordinated loan were abandoned or became worthless in Year 1. In fact, the Chief Counsel ruled that Ira had not met the burden of establishing that the subordinated loan was abandoned or had become worthless in *any* year. Ouch.

As a subjective matter, Ira expended significant funds in payment to Ira's attorney in an effort to collect the loan. This effort continued at least into Year 2, and there was some evidence that Ira was *still* seeking payment of the loan as late as Year 3. Although Services disagreed with Ira's attorney regarding subordination to other claims and whether Ira was required to arbitrate, Services acknowledged the existence of the obligation. Thus, Ira's appraisal of the situation—as indicated by his actions—was inconsistent with a finding of abandonment or worthlessness.

As an objective matter, Ira had not established an identifiable event that would demonstrate that a loss had been sustained. There was no overt act indicating that Ira had abandoned his right to his funds. Ira pointed to a criminal case that had been instituted against Services in Year 1, but this was not sufficient to establish worthlessness. Although Services ceased to operate as a professional firm and had primarily engaged in winding up its affairs, it did not declare bankruptcy and, as late as Year 4, had assets with which to settle a class action suit.

Moreover, the settlement provided for additional payments to the extent Services entered into other settlements, or was able to distribute remaining assets to its partners after all claims were satisfied. This suggests that Services may still have had assets with which to pay claims (such as Ira's), even if Ira's claim was subordinated to general creditors' claims.

Conclusion

Ultimately, the Chief Counsel stated that Ira had not presented facts sufficient to establish the fact, amount, timing or character of a loss with respect to his interest in Services in Year 1. In short, Ira didn't receive even a single positive word in his case to claim a deduction. In fact, about all Ira got in the CCA was ambiguity, in that CCA 200637032 has a rather undiscerning focus on his particular interest in Services.

In places, the CCA suggests Ira Individual was a creditor. In other places, it suggests he was a partner. Overall, the CCA analyzes Ira's interest as a worthless partnership interest. Indeed, the IRS analyzes the deduction as Ira abandoning his partnership interest in Services and/or claiming his Services interest as worthless.

Yet, the facts suggest Ira Individual was simultaneously trying to recoup his investment on, and claim a deduction for, a subordinated loan. The CCA provides little insight into how the IRS makes this leap between analytical spheres. Perhaps the IRS's focus was solely on the taxpayer's reporting posture here, ignoring the underlying facts. This makes me wonder if we are looking at our old friend: tax reporting creating a trap for the unwary. In any event, this CCA should give practitioners pause, and cause them to be careful when advising on claiming deductions for worthless investments.