Take Pride in Ordinary Loss Deductions After *Pilgrim's Pride*

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The acquisition of a business can be risky. If the business does not pan out, the loss can be painful from a cash flow perspective. Yet from a tax perspective, a bad acquisition can seem particularly harsh. The acquisition may be funded with after-tax ordinary earnings.

If it goes bad, however, the loss may well be capital. Capital losses are subject to a variety of limitations, even for corporations that are taxed at the same rates for ordinary income and long-term capital gain. Nonetheless, theft losses and abandonment can result in ordinary losses.

Alluringly, walking away and 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 Internal Revenue Code Section ("Code Sec.") 165, permitting a deduction for any loss suffered during the year that is not compensated by insurance.

Code Sec. 165 does not prescribe the *character* of the loss. But Code Sec. 165(c)(1) permits a loss incurred in a trade or business, and Code Sec. 165(c)(2) permits a loss incurred in a transaction entered into for profit. Code Sec. 165 does not override the limitation on capital losses, and worthless securities result in capital losses.

Nevertheless, subject to limitations, Code Sec. 165 can provide ordinary loss opportunities. Just remember that 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. This might seem to set the table nicely for seemingly simple steps to maximize the tax benefit on your facts.

Surprisingly, though, 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. The simple can become complex, as it did for Pilgrim's Pride Corp.

Pride of the Pilgrims

In *Pilgrim's Pride Corp.* [141 TC No. 17, Dec. 59,715 (2013)], the taxpayer 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, the buyer was unable to raise the funds through the offering 12 months later. As a result, Pilgrim's Pride had to purchase preferred stock from the buyer for approximately $100 million. Eventually, the buyer stopped making dividend payments and offered to redeem the stock for $20 million.

Surprisingly, 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 tax savings from claiming an ordinary loss of $100 million were 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 it could feel secure it made the right choice. Thus, with tax opinion in hand, Pilgrim's Pride turned down the $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 sale or exchange. There was nothing to make the transaction capital, so the deduction should be upheld.

Not surprisingly, the IRS disagreed. It argued that Code Sec. 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 of its rights. The stock was a capital asset, the termination was covered by Code Sec. 1234A and the loss was capital.

Fifth Circuit Rescue

The Court of Appeals for the Fifth Circuit reversed the Tax Court and concluded that Code Sec. 1234A did not apply to the abandonment of the stock. That made Pilgrims Pride's loss ordinary under Code Sec. 165. In reaching its conclusion, the Fifth Circuit stated that Code Sec. 1234A applies only to the termination of rights or 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, there would have been a more clear statement of this rule in the Code. For example, Congress could have stated that abandoning a capital asset results in a capital loss.

The court noted that the IRS did this in part by amending the Code Sec. 165 regulations to provide that abandoning stock has that effect. In this situation, though, 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 the latter is subject to Code Sec. 1234A.

Tax-Motivated

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

The Tax Court clearly disapproved 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.

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. For the Tax Court in *Pilgrim's Pride* seemed to interpret Code Sec. 1234A more broadly than other courts.

Sale or Exchange?

In *J.A. 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. The taxpayer in *Freda* had prevailed in a lawsuit alleging that the defendant misappropriated a trade secret. The taxpayer argued that the settlement was capital gain, as 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 Code Sec. 1234A argument was not addressed. [*J.A. Freda*, CA-7, 2011-2 USTC ¶50,600.]

In *William Flaccus Oak Leather Co.* [SCt, 41-1 USTC ¶9427, 313 US 247, 61 SCt 878], 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. But 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. 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 is *Billy Rose's Diamond Horseshoe, Inc.* [CA-2, 71-2 USTC ¶9622, 448 F2d 549]. There, 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. v. United States* [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* [Dec. 29,719, 52 TC 880 (1969)].

This sale or exchange vs. 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 Code Sec. 165(g).

No Net Value?

The sale or exchange requirement also surfaces in other areas. 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. [*See* 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.

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, then there is no exchange. [*See* Preamble to Proposed Regulations on Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11,903, 11,904 (Mar. 10, 2005).]

Partnership Interests

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

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 partnership interest qualified for an ordinary loss. [*See* Rev. Rul. 93-80, 1993-2 CB 239] However, the ruling includes a trap for the unwary.

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 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. 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 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, the Tax Court thought that a partner should not be eligible for ordinary loss treatment on abandoning its partnership interest.

The Fifth Circuit decision in *Pilgrim's Pride* not only gave the taxpayer a nice ordinary deduction, the decision also eliminated this 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 this one following the unraveling of the Madoff fraud and many other smaller schemes like it. As a result, the IRS issued Rev. Rul. 2009-9 [2009-1 CB 735] to provide guidance on theft losses.

This 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 Code Sec. 165(h), particularly the limitation to losses in excess of 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 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.

Nonetheless, 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 was wide concern that the sleeping dog that Code Sec. 1234A has become would be awakened with a vengeance. Code Sec. 1234 was enacted not to allow for capital gain treatment, but the reverse. That is, it was designed to treat some losses as capital that taxpayers were likely to want to claim as ordinary.

There still may be vestiges of that fear that Code Sec. 1234A could be expanded. Yet the Fifth Circuit has put Code Sec. 1234A back in its place as an occasional oddity that imports capital gain or loss treatment. On the gain point, it is worth noting, though, that by its terms, it is not limited to capital losses. That is probably giving some taxpayers ideas. If not, shouldn't it?