

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel, CC:SB:2:WAS:2

from: Reviewer, CC:PSI:2

subject:

This Chief Counsel Advice responds to your request for assistance dated May 27, 2005.
This advice may not be used or cited as precedent.

LEGEND

X =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

D1 =

D2 =

D3 =

a =

b =

c =

d =

ISSUE

In what taxable year is A, an individual, entitled to claim a § 165 deduction for the worthlessness or abandonment of A's interest in X, a partnership?

CONCLUSION

A has not established that the partnership interest became worthless or was abandoned in A's Year 1 or Year 2 taxable year, or in any subsequent taxable year.

FACTS

A joined X, a state registered limited liability partnership, with the title of "National Director" on D1. Under the terms of the offer letter from X to A and the partnership agreement of X, A does not appear to have been responsible for any of the net losses or liabilities of X.

A was required under the terms of the offer letter to provide a contribution to X in the form of a "subordinated loan" to X. The original amount of the "subordinated loan" as set forth in the offer letter was \$ a, which was later adjusted (under circumstances not set forth in the materials furnished to this office) to \$ b. The "subordinated loan" in the amount of \$ b was funded through a subsidiary of X. A signed a promissory note in favor of the subsidiary in that amount.

A resigned from X in a letter dated D2 of Year 1, which resignation was accepted by X effective that date. A requested repayment of the "subordinated loan" under a provision of the partnership agreement providing that X would return a partner's paid-in capital within 60 days of a partner's resignation. A has not received any payments from X with regard to the "subordinated loan." A continued to demand payment on the "subordinated loan," at least until Year 2, and possibly through Year 3, and does not appear to have relinquished the legal right to be repaid under the original note. Correspondence between X and A in Year 2 indicates that while X rejected A's demand for immediate payment (asserting that the "loan" was subordinated to other claims and that A had to agree to arbitration), X did not dispute that the amount was an obligation of X.

A received a Schedule K-1, Partner's Share of Income, Credits, Deductions, etc., from X for its fiscal year ending D3 of Year 1. The Schedule K-1 identifies A as a "general

partner” and indicates that A contributed \$ b in capital to X during the year. With A’s Year 1 Form 1040, U.S. Individual Income Tax Return, A attached Form 4797, Sales of Business Property, claiming an ordinary loss in the amount of \$ c, representing the “subordinated loan” amount of \$ b with additional legal fees and miscellaneous expenses connected with the “subordinated loan.” This claimed loss is identified as “Worthlessness of Partnership Interest, [X].”

During Year 1, X was . X discontinued revenue-producing activities . X has never filed for bankruptcy. Subsequent events indicate that X may still hold assets available to satisfy claims. In Year 4, X agreed to settle a class action lawsuit for at least \$ d, with the possibility of additional payments based on a percentage of settlement payments that may be made by X in other pending cases or to its partners.

LAW AND ANALYSIS

Section 165(a) of the Internal Revenue Code allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise. A loss deduction is permitted under § 165 only for a taxable year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events occurring in that year. Section 1.165-1(d)(1) of the Income Tax Regulations. A loss from the sale or exchange of a capital asset is a capital loss. § 165(f).

Rev. Rul. 93-80, 1993-2 C.B. 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 § 751(b)).

Abandonment of an asset for purposes of § 165 requires (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Rev. Rul. 93-80; Rev. Rul. 2004-58, 2004-1 C.B. 1043. See also Echols v. Commissioner, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding 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), reh’g denied, 950 F.2d 209 (5th Cir. 1991).

A deduction for worthlessness under § 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. Treas. Reg. § 1.165-1(b) and (d)(1). Although the taxpayer is not required to be an “incorrigible optimist,” a mere diminution in the value of an asset is not sufficient to establish worthlessness. United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 403 (1927); Proesel v. Commissioner, 77 T.C. 992, 1006 (1981). As in the case of abandonment, both

subjective and objective factors are taken into account. See Boehm v. United States, 326 U.S. 287, 292-293 (1945); Echols, 935 F.2d at 706-708.

Both abandonment and worthlessness are ultimately factual determinations, and not all the facts have been developed in this case. However, based on the facts established so far, there is no indication that A's rights in the "subordinated loan" were abandoned or became worthless in Year 1; in fact, A has not met the burden of establishing that the "subordinated loan" was abandoned or has become worthless in any year.

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

As an objective matter, A has not established an identifiable event that would demonstrate that a loss has been sustained. There is no overt act indicating that A has abandoned A's right to A's paid-in capital. The criminal case against X and the related events that occurred in Year 1 do not establish worthlessness. Although X ceased to operate as a professional firm and is primarily engaged in winding up its affairs, it has never to our knowledge declared bankruptcy and, as late as Year 4, had at least \$ d in assets with which to settle a class action suit. Moreover, the settlement provides for additional payments to the extent X enters into other settlements, or is able to distribute remaining assets to its partners after all claims are satisfied. This suggests that X may still have assets with which to pay claims such as that of A, even if A's claim is subordinated to the general creditors' claims.

As yet, A has not presented facts sufficient to establish the fact, amount, timing, or character of a loss with respect to A's interest in X.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Brad Poston of Branch 2 of this office at if you have any further questions.