February 20, 2014

Property Abandonment Results in Capital Loss: 'Pilgrim's Pride'

By: Elliot Pisem and David E. Kahen

A loss may be recognized for tax purposes through an abandonment of property, including a "security," such as shares of stock in a corporation or a bond or debenture issued by a corporation or governmental entity, intangible property other than a security, and tangible property. In general, the amount of the loss will be the owner's adjusted basis in the property immediately before the disposition. In the case of a security, an abandonment will be considered to have occurred if the owner "permanently surrender[s] and relinquish[es] all rights in the security and receive[s] no consideration in exchange for the security."[1]

It has long been thought that an abandonment may in many cases give rise to an ordinary deduction, rather than a capital loss, which arises upon a "sale or exchange" of a capital asset. The difference in character may be critical in determining the extent of any tax benefit resulting from the abandonment. For example, a capital loss may be used, generally, to offset capital gains only. By contrast, the use of ordinary losses is not so limited, and further savings may result from the rate differential for individuals between long-term capital gains and other income.

Elliot Pisem *and* ***David E. Kahen*** *are partners in the law firm of Roberts & Holland LLP.*

In a recent decision relating to the abandonment of a security, the Tax Court held that the resulting loss must be treated as a loss from the sale or exchange of a capital asset (and hence as a capital loss) pursuant to Internal Revenue Code (IRC) section 1234A, if the abandoned property had been held by the taxpayer as a capital asset.[2] This surprising decision has significant implications for the tax treatment of losses arising on the abandonment of all sorts of property, whether or not constituting "securities."

Facts in 'Pilgrim's Pride'

Pilgrim's Pride Corporation (PPC) was the successor to Gold Kist Inc. (Co-op).[3] In connection with Co-op's sale of a division to Southern States Cooperative, Inc. (Southern), Co-op obligated itself to purchase, for $98.6 million, a package of (i) preferred stock of Southern and (ii) other financial instruments issued by Southern States Capital Trust I (Trust), a Delaware statutory trust established by Southern (collectively the "securities").[4] This purchase was effected in 1999.

Roughly five years later, and in connection with plans to merge Co-op into a for-profit business corporation, the stock of which would become publicly traded, Co-op sought to dispose of all of the Southern and Trust securities, and Southern offered to acquire them for $20 million. That sale would have resulted in a large, and largely unusable, capital loss, and Co-op's board of directors concluded that an abandonment of the securities for no consideration would result in an ordinary loss and a greater overall benefit to Co-op.

Accordingly, in order to realize a loss with an ordinary character, Co-op "voluntarily and irrevocably" surrendered the securities to Southern and the Trust in June 2004 for no consideration. It recorded a loss for financial statement purposes equal to $38.8 million, the then carrying value of the securities on its books, and reported a $98.6 million ordinary loss on its tax returns for the tax year ended in June 2004. In connection with the abandonment, an opinion was obtained from a law firm regarding the allowability of the ordinary loss deduction.

In 2009, the IRS issued a statutory notice of deficiency to PPC as successor in interest to Co-op. The asserted tax deficiency reflected a determination that the loss of Co-op on the abandonment of the securities was a capital loss rather that an ordinary loss; the IRS also asserted an accuracy-related penalty under IRC section 6662.

Because PPC was in bankruptcy proceedings at the time of issuance of the statutory notice, it could not challenge the notice of deficiency immediately. A plan of reorganization under chapter 11 of the Bankruptcy Code became effective with respect to PPC in late 2009, and PPC then filed a petition for review of the deficiency with the Tax Court. The government conceded the accuracy-related penalty, and the only issue remaining before the court was the character of the abandonment loss as capital or ordinary.

Analysis

It was undisputed that the abandoned securities were capital assets of Co-op. Pursuant to IRC section 165(f), losses from the "sale or exchange" of capital assets are subject to the rules of IRC sections 1211 and 1212; as noted above, such capital losses are generally allowed only to the extent of capital gains. However, if a capital asset is abandoned, and the taxpayer receives no consideration for the abandoned property, the disposition does not, under case law discussed in *Pilgrim's Pride*, constitute a sale or exchange. Therefore, the disposition will result in an ordinary loss, rather than a capital loss, absent a specific provision of the IRC that treats the disposition as though it were a sale or exchange. The crux of the case, then, was whether there was such a provision that applied in this situation.

The nature of the arguments initially made by the government in support of capital loss treatment is not made clear by the decision, but it seems likely that the government referred at least in part to IRC section 165(g), under which a loss from the *worthlessness*—as distinguished from the abandonment—of a security that is a capital asset is treated as a loss from the sale or exchange of a capital asset in the year in which the security became worthless.[5] After opening and reply briefs were filed, the court on its own initiative asked the parties to address whether IRC section 1234A required the abandonment before the court to be deemed a capital loss, and the focus of the discussion in the opinion was on whether that provision was applicable.

IRC section 1234A provides that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset."

As originally enacted in 1981, section 1234A did not generally apply to contractual positions relating to stock. Indeed, it is clear from the provision's legislative history (briefly discussed in the opinion) that Congress intended it to address the classification of gains and losses with respect to offsetting contractual positions (straddles) in actively traded personal property, and in particular to prevent tax avoidance transactions that would result in ordinary losses being derived from dispositions of certain capital assets. Section 1234A was amended in 1997, however, to expand its scope from covering only rights and options relating to certain types of actively traded personal property, such as commodities futures, to other property. Legislative history relating to this change indicated that section 1234A should now function to prevent taxpayers from having, in substance, an election to recognize gains as capital gains and losses as ordinary losses.

PPC's primary argument was that the phrase "right or obligation . . . with respect to property" in section 1234A indicated that the provision, even as amended in 1997, was intended to apply to dispositions of contractual and derivative rights with respect to property, such as futures contracts and options, but not to dispositions of the property itself.

The Tax Court disagreed with the petitioner's reading of the provision. Based on its view of ordinary usage of the phrase "with respect to," as defined in a dictionary, and on its interpretation in reported decisions addressing other issues, the court concluded that the phrase "termination of . . . a right . . . with respect to property" includes a termination of all rights inherent in the ownership of property through abandonment of the property, as well as a termination of rights arising under contracts relating to such property. The court found nothing in the legislative history relating to the original enactment of section 1234A in 1981 or its expansion in 1997 to support PPC's argument that section 1234A was intended to apply only with respect to dispositions of derivative contract rights.

PPC also argued that the Regulations' (prospective) amendment in 2008[6] to provide that losses from the abandonments of securities would thereafter generally be treated as capital losses under section 165(g) indicated that Treasury did not believe that section 1234A applied to the abandonment of a security. The court, although not citing any evidence that Treasury had section 1234A in mind as the underpinning for the amended regulation, dismissed this argument as well. In the view of the court, the result reached in the amended regulation was consistent with section 1234A as it was being interpreted by the government in the proceedings at hand.[7]

Finally, PPC asserted that the application of section 1234A in this context would be inconsistent with Rev. Rul. 93-80 (1993-2 C.B. 239), relating to losses recognized upon the abandonment of a partnership interest. That published ruling holds that, if no partnership liabilities are allocated to the abandoning partner, and the abandonment of the partnership interest accordingly does not result in any "deemed distribution" to the partner under IRC section 752 by reason of relief from liabilities, the loss from abandonment of the interest is ordinary because there is no sale or exchange.

The court did not attempt to reconcile Rev. Rul. 93-80 with its reading of section 1234A, but simply noted that the ruling was issued four years before the amendment to section 1234A that made that provision potentially applicable to abandonments of partnership interests, and that the IRS was under no obligation to withdraw such "obsolete" guidance immediately upon enactment of a conflicting statutory provision (or, apparently, at any time within the succeeding seventeen years).

The court concluded that PPC was not entitled to an ordinary deduction upon the abandonment of the securities, because section 1234A treated the resulting recognized loss as a loss from a sale or exchange; and, therefore, that PPC was entitled only to a capital loss by reason of the abandonment.

Observations

The Tax Court's application of section 1234A to the abandonment context described in *Pilgrim's Pride* was a surprise to many practitioners.

Taking into account the amendment of regulations under IRC section 165 in 2008 to treat losses from the abandonment of securities as losses subject to the worthless securities rules of section 165(g), the Tax Court's conclusion here may not have much practical impact in the context of a potential abandonment of securities. However, the decision will compel taxpayers and their advisors to reconsider long-held views regarding the likely tax consequences of abandonment of capital assets that are not securities as defined in section 165, such as certain partnership interests and interests in real property.

Taking into account the magnitude of the potential impact of section 1234A on tax liabilities of affected taxpayers who abandon property, as well as the lack of any clear indication at the time of the 1997 amendment to section 1234A that Congress intended to change the treatment of abandonments of property as to capital assets generally, there seems a good chance of further litigation regarding this issue.

---

1 Reg. § 1.165-5(i)(1).

2 *Pilgrim's Pride Corporation v. Commissioner*, 141 T.C. No. 17 (2013).

3 Co-op was a nonexempt cooperative taxed subject to the provisions of IRC sections 1381-1383, under which it was subject to the ordinary corporate income tax imposed by IRC section 11, with certain modifications.

4 It is not entirely clear from the Tax Court's opinion whether the financial instruments issued by the Trust constituted stock or debt for tax purposes, but the opinion does state that all the financial instruments issued by Southern and by the Trust were "securities" as defined in IRC § 165(g)(2).

5 The statute contains an exception for securities of affiliated corporations not relevant here. As noted above, Southern had offered to purchase the securities for $20 million, so it would not appear, at least at a superficial level, that they could be considered "worthless." In this regard, Treasury Reg. § 1.165-5(i) was amended in 2008, after the year in issue before the court, to provide, in substance, that a security that is abandoned will be considered to be worthless for purposes of section 165(g) and therefore to result in a capital loss, apparently regardless of whether the security is in fact objectively worthless. The rationale for the amendment appears to have been that abandonment indicates the security is worthless to the owner, who should not be able to obtain a better tax result by accelerating an abandonment. Although the amendment purported to be a "clarification" of prior law, it was not by its terms retroactive, and its Preamble indicated that no inference should be drawn from the amendment as to the character of a loss realized prior to the effective date of the amendment. In any event, the Tax Court did not rely on the amendment to the Regulation in deciding the case.

6 See note 6, above.

7 PPC also made the technical argument that, if section 1234A had been the basis for concluding that an abandonment loss with respect to a security was a capital loss, that result would apply even if the abandoned security was that of an affiliated corporation, and that section 1234A would then be in conflict with Reg. section 1.165-5(i)(1), which makes clear that securities of an affiliated corporation as described in section 165(g)(3) are not subject to the deemed capital loss result otherwise imposed by section 1.165-5(i). The court found this argument not persuasive in light of the circumstance that section 165(g)(3) expressly provides that affiliated corporation securities as described in section 165(g)(3) shall not be treated as capital assets.