Criteria for Claiming a Worthless Security Loss Deduction

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Many taxpayers are familiar with the Internal Revenue Code Section 165 worthless stock deduction. Taxpayers often call on valuation analysts to analyze and to document the worthlessness of the stock of a private company, corporate subsidiary, or some other common stock equity interest. The Section 165 loss deduction also applies to the worthlessness of a partnership interest, limited liability membership interest, or similar equity interest. Many taxpayers may not be aware that the taxpayer typically does not need to actually abandon the worthless security interest in order to claim the loss deduction. This discussion summarizes the requirements applied by the Internal Revenue Service and by the courts that allow taxpayers to claim the worthless security loss deduction (particularly when the worthless business ownership interest is not abandoned).

Introduction

Taxpayers often apply Internal Revenue Code Section 165(a) to claim an income tax deduction for an uncompensated loss sustained during the tax year. An uncompensated loss occurs when the taxpayer does not receive insurance proceeds, a reimbursement, or any other compensation related to the loss.

The tax character of the uncompensated loss can be an ordinary income deduction or a capital loss, depending on the facts and circumstances of the loss event.

Regulation Section 1.165-1(b) provides that in order for the loss to be allowable as an income tax deduction, the loss must be:

1. evidenced by a closed and completed transaction,
2. fixed by identifiable events, and
3. actually sustained during that tax year.

In order to satisfy the Regulation 1.165-1(b) requirements for claiming a loss deduction, the taxpayer must typically walk away from—or otherwise abandon—the property that suffered the loss.

Another taxpayer application of Section 165(a) is what is typically called the worthless stock deduction. This description is often used because the taxpayer is claiming a tax deduction related to the worthlessness of the stock of a private company or of a similar ownership interest.

Valuation analysts are often called on by the taxpayer to help prove that the equity ownership interest—usually the stock of the private company (or the stock of a corporate company)—is worthless.

As this discussion will illustrate, the Section 165(a) "worthless stock" deduction is not limited to the stock of a corporation. The Section 165(a) deduction is also available with regard to the worthlessness of a partnership interest, a limited liability

company ("LLC") membership interest, or a similar equity interest.

Regardless of the type of equity interest, the Section 165(a) deduction becomes available when the security ownership interest becomes worthless.

This discussion describes the criteria that taxpayers and the Internal Revenue Service ("Service") consider to determine worthlessness. In particular, this discussion explains that the actual abandonment of the equity ownership interest is not a requirement for the taxpayer to claim a Section 165(a) worthless security tax deduction.

Valuation analysts are also called on to prove—and to document—the worthlessness of a partnership interest, a limited liability membership interest, or any similar equity ownership interest.

The *MCM Investment Management, LLC*, Decision

A taxpayer can prove that it is entitled to a Section 165(a) loss deduction for the worthlessness of a partnership interest without abandoning the business interest. In the fairly recent judicial decision in *MCM Investment Management, LLC*, T.C. Memo 2019-158, the Tax Court agreed with this taxpayer position and allowed the Section 165(a) loss deduction for a worthless partnership interest.

This *MCM Investment* judicial decision provides practical guidance both for taxpayers and for tax advisers with regard to the legal requirements in order to sustain a tax deduction for business ownership interest worthlessness.

This judicial decision also provides practical guidance for valuation analysts with regard to the analysis and the documentation of the equity ownership interest worthlessness.

This *MCM Investment* Tax Court decision supports the tax position taken by the taxpayer: that the actual abandonment of the partnership interest (or other equity ownership interest) is not required in order to claim a Section 165(a) loss deduction.

The *Echols* Decision and the Abandonment Dispute

Historically, the Service has taken the position that an actual abandonment is a required condition for an equity ownership interest worthlessness deduction. The Service's historical position was that:

1. worthlessness equated to abandonment and
2. only worthless securities would qualify for the Section 165(a) loss deduction.

The courts did not always accept the Service's very limited interpretation of Section 165(a).[1]

The question of a business ownership interest abandonment was definitively addressed by the Court of Appeals in its decision in *Echols*.[2] In the *Echols* decision, the Fifth Circuit reversed a Tax Court decision and rejected the Service's position with regard to the abandonment requirement.

The Court of Appeals concluded that a taxpayer married couple could claim a Section 165(a) loss deduction with regard to a real estate partnership interest ownership interest. The couple had claimed the loss deduction under Section 165(a) based on their conclusion of the worthlessness of the partnership interest.

The taxpayer couple claimed that the equity interest was worthless even though the partnership had not abandoned an unimproved tract of land, the partnership's only asset.

In the *Echols* decision, the Appeals Court noted that the worthlessness determination of a security ownership interest is based on a combination of both objective criteria and subjective criteria.

With regard to the objective criteria, a property that subjectively has a substantial value cannot be considered worthless for loss tax deduction purposes. With regard to the subjective criteria, this consideration typically relates to the question of when the property actually became worthless.

With regard to the worthless security, the taxpayer is expected to exercise judgment in the determination as to when the security interest became worthless. Such taxpayer judgment implies that there is not an absolute objective test as to when a subject security became worthless. That is, another taxpayer (exercising its own judgment) may conclude that a subject security became worthless in an earlier tax year or in a later tax year.

However, the taxpayer's subjective determination of when a subject security became worthless should be supported by credible evidence and analysis documenting when the security actually became worthless. That is, the taxpayer's judgmental selection of the tax year in which the security became worthless should be supported by objective evidence.

The Service never acquiesced to the above-mentioned Fifth Circuit *Echols* decision. The

Service decision not to acquiesce is documented in 1993 FSA Lexis 353 (August 31, 1993).

Nonetheless, just a few months after the FSA was issued, the Service issued Revenue Ruling 93-80. Revenue Ruling described whether a taxpayer loss incurred with regard to the abandonment or the worthlessness of a partnership interest would be considered an ordinary loss or a capital loss. The determination of the character of the loss (ordinary versus capital) is an important consideration of this ruling.

However, Revenue Ruling 93-80 also implies that a worthless stock deduction may be available without the actual abandonment of the security ownership interest—in this case, the underlying partnership interest.

As mentioned above, the Service did not acquiesce to the *Echols* decision. Nonetheless, Revenue Ruling 93-80 keeps alive the question of whether the Service would accept a taxpayer tax deduction claim for a worthless security deduction (for a partnership interest) when the taxpayer has not abandoned the security ownership interest.

MCM Investment Management, LLC

The *MCM Investment* decision provides important guidance with respect to the Tax Court's consideration of both (1) the subjective determination of worthlessness and (2) the objective determination of worthlessness.

This 2019 Tax Court decision involved a "parent" partnership and a "subsidiary" partnership. The taxpayer and parent partnership was MCM Investment Management, LLC ("MCM"). MCM owned a controlling interest in McMillan Companies LLC ("McMillan").

McMillan operated in the home building and residential remodeling segment of the construction industry. In 2007, the subprime mortgage crisis began and residential real estate values generally decreased. The McMillan business operations became unprofitable, and the amount of the company liabilities exceeded the value of the company assets.

The tax year at issue in *MCM Investment* was 2009. By 2009, an internal McMillan analysis indicated that an orderly liquidation of company assets would generate more cash to pay off the $70 million of senior debt than a plan of ongoing business operations. Of course, this five-year orderly liquidation plan resulted in no residual value to pay either the McMillan controlling interest owner or any other company equity owners.

MCM claimed an approximately $41 million worthless security loss deduction on its 2009 income tax return. This loss deduction was based on the taxpayer's determination that its partnership equity interest in McMillan had become worthless during that tax year.

That taxpayer determination was based on two factors. First, McMillan began the process of liquidating its business operations in July 2009. Second, the McMillan cash flow projections (prepared during 2009) indicated that there would be insufficient cash flow to pay off all of the company senior debt—and no cash flow available for any of the company equity holders.

Upon audit, the Service agreed with the taxpayer that the character of the loss would be ordinary income. However, during the audit, the issue of liability relief was not addressed.

The dispute that arose during the audit was: When did the investment in McMillan become worthless? That is, what was the correct year in which taxpayer MCM should recognize the worthless security loss deduction?

In *MCM Investment*, the Tax Court had to decide whether the taxpayer MCM met all of the requirements for the Section 165(a) loss deduction in 2009. MCM did not abandon its partnership interest in McMillan in 2009.

Therefore, the court had to determine if the taxpayer was entitled to the worthless security deduction in 2009. In other words, the court had to decide if the MCM equity interest in McMillan became worthless in that tax year.

The Taxpayer's Subjective Determination of Securities Worthlessness

In *MCM Investment*, the Tax Court applied the two-part test from the *Echols* decision.

First, the Tax Court analyzed whether taxpayer MCM subjectively concluded that the McMillan equity ownership interest was worthless in 2009.

Based on the evidence presented at the trial, the Tax Court decided that MCM did subjectively conclude that the McMillan partnership interest was worthless for two reasons.

The first reason the court decided that MCM subjectively concluded that McMillan was worthless was the taxpayer's filing of its 2009 partnership

income tax return. That 2009 tax return claimed a worthlessness loss deduction.

The second reason the court decided that MCM subjectively concluded that McMillan was worthless was the fact witness testimony of the MCM managers and partners. The MCM managers and partners credibly testified about the devastating impact that the financial crisis had on the residential real estate market.

In addition, the court was persuaded by the McMillan financial projections that demonstrated the company's inability:

1. to pay off its senior lender in full or
2. to have any assets remaining for the MCM partners and other equity owners.

Finally, the court was persuaded by the McMillan plan to gradually wind down its business operations over a five-year period—a plan that was designed to maximize the amount of cash flow available to pay the company's creditors.

The Taxpayer's Objective Determination of Securities Worthlessness

Second, the Tax Court analyzed whether the objective evidence confirmed the MCM subjective determination that the McMillan equity interest became worthless in 2009. In concluding if this objective determination test was met in *MCM Investment*, the Tax Court relied on the principles for objectively determining the worthlessness of private corporation stock.

While applied many times over the years, those "worthless stock" determination principles were first applied in the 1938 Board of Tax Appeals decision in *Morton*.[3]

In the *MCM Investment* decision, the Tax Court specifically referred to the following language from the *Morton* decision:

> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has a liquidating value. If its assets are less than its labilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and cannot be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.
>
> There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders. In such cases, the stock, obviously, has not liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can presently be said to have no potential value. Where both these factors are established, the occurrence in a later year of an "identifiable event" in the corporation's life, such as liquidation or receivership, will not, therefore, determine the worthlessness of the stock, for already "its value had become finally extinct."

In the *MCM Investment* case, the court decided that the McMillan financial projections were both (1) conservative and (2) based on market condition assumptions.

The McMillan financial projections indicated that an immediate company liquidation would result in the senior creditor receiving only about 40 percent of its loan balance. This scenario would also result in no residual assets or cash being available for distribution either (1) to MCM or (2) to the preferred equity holders.

In contrast, the McMillan gradual liquidation of company operations resulted in a higher percentage payoff of the senior creditor debt (and still no residual payment either to MCM or the preferred equity holders). That financial projection scenario represented the highest and best use of the McMillan assets.

The Tax Court also commented on the balance sheet test for business enterprise solvency or insolvency. The court noted that balance sheet insolvency was not necessarily required when preferred equity interests (including corporation preferred stock or partnership preferred interests) are involved with the subject debtor entity.

That is, a subordinate entity equity interest may become worthless if the entity cannot satisfy the preferred equity holder's preferential claim in

liquidation. This principle was articulated in the *Mahler* decision.[4]

In *MCM Investment*, the Tax Court concluded that the combination of the McMillan debt and the impact of the financial crisis on the residential real estate market objectively established that McMillan had no liquidation value. The court concluded that McMillan objectively had no liquidation value, either in 2009 or in the foreseeable future.

Facts and Circumstances Impact This Judicial Decision

Taxpayer MCM was successful in claiming a worthless security loss deduction related to its equity investment in McMillan. The Tax Court allowed the tax deduction based on its assessment of:

1. the impact of the financial crisis on the residential real estate market and
2. the McMillan contemporaneously prepared financial projections documenting the company's worthlessness.

The Tax Court also mentioned the lack of a McMillan liquidation value (for both the preferred equity interests and the nonpreferred equity interests) as evidence of the worthlessness of the MCM equity interest. Specifically, the Tax Court noted the evidence that McMillan objectively had no liquidation value in 2009 or in the foreseeable future.

The Tax Court concluded that taxpayer MCM passed both (1) the subjective determination of the worthlessness test and (2) the objective determination of the worthlessness test. Therefore, the Tax Court upheld the taxpayer's worthless security loss deduction for the MCM equity investment in McMillan.

Summary and Conclusion

Taxpayers more frequently apply the provisions of Section 165(a) to claim a worthless security loss deduction for the stock of a private company or for the stock of a corporation's subsidiary.

Although it is typically referred to as the "worthless stock deduction," Section 165(a) is not restricted to the worthlessness of private company stock or of subsidiary corporation stock. Section 165(a) may also be applied to claim a loss deduction related to a partnership interest, an LLC membership interest or any other equity ownership interest.

The regulations related to Section 165 provide regulatory guidance with regard to the requirements to claim a Section 165(a) worthless security loss deduction.

In addition, the courts have applied a two-test procedure with regard to allowing such an income tax deduction:

1. the taxpayer's subjective determination of worthlessness and
2. the taxpayer's objective determination of worthlessness.

In the *MCM Investment Management, LLC*, decision, the Tax Court provided guidance to taxpayers—and to their tax advisers—with regard to the justification of a Section 165(a) worthlessness loss deduction. In particular, the *MCM Investment* decision is important because it supports the principle that the abandonment of a partnership ownership interest is not a requirement for claiming the Section 165(a) worthlessness deduction.

The *MCM Investment* decision also provides guidance with regard to the valuation analysis of—and the documentation of—the worthlessness of the subject equity interest.

The *MCM Investment* decision also illustrates the importance of how the specific facts and circumstances of a case may influence the court's decision. In the *MCM Investment* case, the McMillan contemporaneously prepared analyses (including the preparation of credible and supportable financial projections) convinced the Tax Court that taxpayer MCM had passed both the subjective determination test and the objective determination test.

Notes:

1. See Zeeman, 175 F. Supp. 235 (S.D. NY, 1967) affirmed on this issue and remanded in part on other issues, 395 F.2d 861 (2d Cir. 1968); 146 B.R. 464 (Bankr. D. Colo. 1991); Tejon Ranch Co., T.C. Memo 1985-207; and In re: Kreidles.
2. Echols v. Commissioner of Internal Revenue, 935 F.2d 703 (5th Cir. 1991).
3. Morton v. Commissioner of Internal Revenue, 38 B.T.A. 1270, 1278-1279 (1938), aff'd 112 F.2d 320 (7th Cir. 1940).
4. Mahler v. Commissioner of Internal Revenue, 119 F.2d 869 (2d Cir. 1941).

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