Wall Street Concepts

Briefing

Tax-Loss Recognition of Worthless Securities

- *Taxpayers can only write off worthless securities in the year they become worthless*
- *A worthless security loss must be evidenced by*
  - *A closed and completed transaction,*
  - *Fixed by an identifiable event, and*
  - *Actually sustained during the taxable year.*
- *Brokers can facilitate a taxpayer's loss recognition by purchasing or enabling abandonment of the worthless securities*
- *Failure to take the proper steps when writing off a worthless security can possibly lead to a disallowed loss and the need to amend another year's tax return.*

March, 2017 (updated)

Empowering the Financial World

FIS

Contents

Tax-Loss Recognition of Worthless Securities 1

Issue 1

Summary 1

Discussion 2

Abandonment 3

Conclusion 4

Additional Resources 5

References and Citations 5

Tax-Loss Recognition of Worthless Securities

ISSUE

Taxpayers have a need to take advantage of investment losses arising from a worthless security in a timely and proper fashion. The Internal Revenue Code (the "Code") provides specific rules regarding the treatment of worthless securities. However, despite these regulations it seems as though the determination of when a security becomes worthless is subjective and more of an art than science.[1] Without being able to present an adequate compliant case for a worthless security write-off, the IRS may disallow the capital loss. Thus taxpayers need to know with confidence when they are holding a worthless security and what to do about it.

SUMMARY

- A worthless security tax loss can only be taken in the year the security becomes worthless[2]
- A security is worthless for loss recognition purposes when it ceases to have any liquidating value and it lacks any potential value[3]
- A worthless security loss must be evidenced by
  - A closed and completed transaction,
  - Fixed by an identifiable event, and
  - Actually sustained during the taxable year[4]
- Taxpayers should document the basis for their worthless security determination
- A taxpayer's abandonment of a security represents a closed and completed transaction and is indicia of future worthlessness to the taxpayer
- A taxpayer is only allowed to take an abandoned security loss if all rights in the security have been permanently surrendered and relinquished for no consideration[5]
- There is an extended look-back period of seven years to amend tax returns for worthless security loss recognition[6]
- Brokers often facilitate a customer's disposition of worthless securities by engaging in a principal transaction to purchase or otherwise acquire the security
- All losses from worthless securities for individual taxpayers are capital losses[7]

---

[1] "Worthlessness is determined by an objective rather than a subjective standard, although subjective considerations may play a part." Boehm v. Commissioner, 326 U.S. 287, 292 (1945)

[2] §1.165-1(d)

[3] Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938)

[4] §1.165-1(b)

[5] IRB 2008-16 T.D. 9386 Abandonment of Stock and Other Securities

[6] IRC Section 6511(d)(1)

[7] IRC Section 165(g)(1)

From a customer service point of view brokers need to facilitate a client's ability to recognize a capital loss on worthless securities that are held by the client. This is particularly appropriate when the client has purchased the security through the broker and perhaps even in reliance upon information or a recommendation from the broker. However, the broker who provides tax information that is specific to a situation such as whether or not a security has become worthless by IRS standards is running the risk of offering tax advice. Brokers are not in the business of giving such advice. However, in this competitive environment of trying to attract a greater amount of customer assets, providing information about the tax rules to be applied when determining worthlessness or establishing a worthless security sale facilitation service can positively differentiate a firm from its competitors. Firms should consider setting up such buying programs for clients to sell their worthless securities and/or provide an overview of considerations a customer should weigh if they believe they have a worthless security.

DISCUSSION

Taxpayers often ask their broker what they should do in order to recognize a loss from a security that has stopped trading or is only quoted in the pink sheets for fractions of a penny. The answer to this question depends upon the specific facts of what has happened to the corporation involved. Section 165 of the Code allows a loss deduction for a capital asset up to its amount of basis. To be allowable the loss must be evidenced by

- A closed and completed transaction,
- Fixed by an identifiable event, and
- Actually sustained during the taxable year.

Code section 165(g) and § 1.165–5 specifically address losses from securities. The character of these losses is treated as though they arose from a sale or exchange of the security. Thus a security that meets the worthless security requirements will create a capital loss (short- or long-term) and not an ordinary loss. The date of disposal (for duration purposes) is the last day of the year in which the security became wholly worthless.

The determination of whether and when a security has permanently lost its value is fact based. A security "may not be considered worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time."[8] The court in the Morton v. Commissioner case established a two tiered test for value:

- The security must not have any current liquidating value, and
- The security must lack the potential for any future value

The security of a company with liabilities greater than assets may have no current value, and a security for which there is absolutely no buyer may also be currently worthless. However, such companies may still be in business or have assets and an ongoing corporate existence. Such circumstances could give rise to some future value and as such they would not meet the worthless test. To establish that there is no future value the courts have said that "there are two ways of showing lack of potential value, either liabilities so exceed the assets that there is no hope for recovery or by identifiable events demonstrating the worthlessness of the stock."[9]

[8] Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938)

[9] IRS Field Service Advice No. 200226004

When applying the worthless test a taxpayer may rely upon one or more identifiable events to establish no future value. Such events include:

- The sale of all corporate assets,
- The surrender of the corporate charter,
- The cessation of business,
- The point when credit negotiations to salvage a company are terminated, or
- The liquidation of the company.

Ultimately using this approach calls for judgment. If the company is really finished, and there is no possible future salvation, then the taxpayer should select the last identifiable event that enabled this determination and it is in that year the loss is deductible. Note that courts have held that until all payments have been disbursed upon a corporate dissolution there is still value in the company. So if everything is dissolved in year one but some amount of money will be paid to stockholders in year two from closing all accounts, the year of loss recognition for tax purposes is year two.

Abandonment

As case law evolved around what constitutes final worthlessness of a security, the concept of abandonment gained prominence as a determining factor in that assessment. In fact, section 165 losses have been referred to as 'abandonment losses' to reflect that some act is required that evidences a taxpayer's intent to permanently discard or discontinue use. A closed and completed transaction.

Since tax law only permits taking a worthless security loss in the year the security becomes wholly worthless, the IRS issued regulations in 2008 which established taxpayer "abandonment" of a security in the year of abandonment if all rights in the security are permanently surrendered and relinquished at that time for no consideration. Treasury Decision 9386, Abandonment of Stock or Other Securities, provides guidance on the availability and character of a loss deduction under section 165 of the Code for losses sustained from abandoned stock or other securities. T.D. 9386 introduced new § 1.165–5 (i) "Abandonment of securities." This established the guidelines for a taxpayer to abandon a security. That section reads as follows:

> Abandonment of securities—(1) In general. For purposes of section 165 and this section, a security that becomes wholly worthless includes a security described in paragraph (a) of this section that is abandoned and otherwise satisfies the requirements for a deductible loss under section 165… To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. For purposes of this section, all the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

The formalized abandonment as specified in subsection 1.165-5(i) enables a taxpayer to satisfy the second part of the two part test – that the security lack any future value. Given the speculative nature of what the future holds, by permitting a taxpayer to couple one or more of the identifiable events which are deemed to reflect a lack of future value with the surrender of all rights in the security, permanently and relinquished for no consideration, the IRS has created a greater level of certainty for taxpayers to determine worthlessness.

CONCLUSION

Financial firms can offer various forms of support for their clients with worthless securities. Some firms offer to buy shares for a nominal amount and others have a program of enabling a taxpayer to abandon the securities by turning ownership over to the firm for no consideration. Whether or not your firm provides such services, it should offer guidance for a taxpayer who may find herself holding a security she thinks may be worthless. Such guidance should include some or all of the following concepts.

- If a loss is claimed too soon, the IRS may disallow it
- If the loss is claimed too late, the IRS may disallow it
- It's better to claim a loss too soon rather than too late[10]
- Worthless stocks in tax-free accounts (IRA) are not eligible for write-off
- If possible, a taxpayer should sell the security even if the cost of sale is greater than proceeds received, as long as the loss benefit to be recognized justifies the sale
- If sale is not possible, the taxpayer should gather documentation that can support the following
    - The security was worthless in the year of the write-off
    - The security had some form of value in the preceding year
    - An identifiable event (bankruptcy, surrender of charter, cessation of business, etc.) occurred along with the abandonment of the security
- It is the taxpayer's burden, upon audit, not the IRS's to establish that there's no current liquidating value, as well as no potential value[11]
- If possible, obtaining a statement confirming worthlessness from a broker, bankruptcy court or the representative of the now defunct company that issued the shares is a prudent part of documenting the loss
- When looking at a company in bankruptcy a taxpayer should keep in mind a chapter 7 event forces a company to shut down completely and thus at some point the shares will most likely be worthless
- A chapter 11 event is a reorganization and the company will seek to emerge as an operating entity. Whether the shares outstanding currently will become worthless is a matter determined in the ultimate outcome of the reorganization, but throughout the event the possibility of the shares having some future value exists
- A loss is claimed on Form 8949 and Schedule D with zero proceeds, a sale date at year end and the description "worthless"
- Taxpayers have a seven year window to amend a return to claim a worthless security loss
- A worthless security loss is an asset and a taxpayer should use it as quickly as possible to offset capital gains

[10] Young v. Commissioner of Internal Revenue, 123 F. 2d 597 (2d Cir. 1941) Mr. Justice Augustus Hand concluded the Court's opinion as follows, "In cases like this the taxpayer is at times in a very difficult position in determining in what year to claim a loss. The only safe practice, we think, is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is any reasonable chance of its being applicable to the income for those years".

[11] Figgie International, Inc. v. Commissioner, 807 F. 2d 59, 62 (6th Cir. 1986)

Whatever path a firm takes to assist its clients in disposing of worthless securities in a timely and proper fashion, it should advise its client to make certain they have documented their actions and rationale for determining the security was worthless. Having adequate documentation can strengthen the taxpayer's case as it is always the taxpayer's burden to establish worthlessness. And maintaining appropriate documentation may facilitate a redetermination of worthlessness to another year if the IRS disallows the initial claim.

Additional Resources

REFERENCES AND CITATIONS

- IRC Section 165(g)(1)
- IRC Section 6511(d)(1)
- §1.165-1(d)
- §1.165-1(b)
- IRB 2008-16 T.D. 9386 Abandonment of Stock and Other Securities
- IRS Field Service Advice No. 200226004
- Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938)
- Young v. Commissioner of Internal Revenue, 123 F. 2d 597 (2d Cir. 1941)
- Boehm v. Commissioner, 326 U.S. 287, 292 (1945)
- Figgie International, Inc. v. Commissioner, 807 F. 2d 59, 62 (6th Cir. 1986)

For additional information on this topic, please contact:

Martin J. Bentsen, Esq.
Senior Manager, Wall Street Concepts Solutions, FIS
646.445.1067 martin.bentsen@fisglobal.com