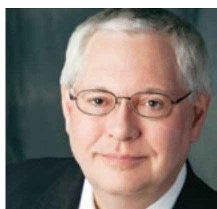
SUBJECTIVE DETERMINATION AND OBJECTIVE DETERMINATION FOR CLAIMING A WORTHLESS SECURITY LOSS DEDUCTION



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Tax counsel often advise taxpayers to apply Internal Revenue Code (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 receives 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.

Treasury Regulation 1.165-1(b) provides that in order for the loss to be allowable as a tax deduction, the loss must be: (i) evidenced by a closed and completed transaction; (ii) fixed by identifiable events; and (iii) actually sustained during that tax year. In order to satisfy the Regulation 1.165-1(b) requirements for claiming a loss deduction, typically the taxpayer must walk away from or otherwise abandon the property that suffered the loss.

Another taxpayer application of Code section 165(a) is what is typically called the "worthless stock" deduction. This term is often used because the taxpayer is claiming a tax deduction related to the worthlessness of the stock of a private company or a similar ownership interest. For example, a parent corporation may claim a loss deduction related to the worthlessness of the common stock of a subsidiary corporation.

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 security ownership interest, the section 165(a) deduction becomes available when the ownership interest becomes worthless.

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

THE ECHOLS DECISION AND THE ABANDONMENT DISPUTE

Historically, the IRS maintained the position that an actual abandonment is a required condition for a security ownership interest worthlessness deduction. The IRS's historical position was that: (i) worthlessness equated to abandonment; and (ii) only worthless securities would qualify for the loss deduction. However, the courts did not always accept this very limited interpretation of section 165(a).[1]

The question of a business ownership interest abandonment was definitively addressed by the Fifth Circuit in *Echols v. Commissioner*.[2]

In *Echols*, the Court of Appeals concluded that a married couple could claim a section 165(a) loss deduction with regard to a real estate partnership ownership interest. The taxpayers claimed that the equity interest was worthless even though the partnership had not abandoned an unimproved tract of land, the partnership's only asset. The 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 still has a substantial market value cannot be considered worthless for loss tax deduction purposes. The subjective criteria typically relate to the question of when the property actually became worthless. The taxpayer is expected to exercise judgment in the determination of when the security interest became worthless. Such taxpayer judgment implies that there is not an absolute objective test as to when the subject security becomes worthless. That is, another taxpayer (exercising his own judgment) may conclude that the subject security became worthless in an earlier tax year or in a later tax year.

However, the taxpayer's subjective determination of when the subject security became worthless should be supported by credible evidence and analysis indicating that—and when—the security 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 IRS never acquiesced to the *Echols* decision, documented in 1993 FSA Lexis 353 (August 31, 1993). Nonetheless, just a few months after the FSA was issued, the IRS issued Revenue Ruling 93-80.

Revenue Ruling 93-80 described whether a taxpayer loss incurred with regard to the abandonment or the worthlessness of a partnership interest would be considered as an ordinary loss or as a capital loss. However, it also implies that a worthless stock deduction may be available without the actual abandonment of the security interest—in this case, the underlying partnership interest.

Revenue Ruling 93-80 leaves open the question of whether the IRS would accept a taxpayer tax deduction claim for a worthless security deduction (for a partnership interest) when the taxpayer has not abandoned the partnership interest.

MCM INVESTMENT MANAGEMENT, LLC

A taxpayer can prove that it is entitled to a section 165(a) loss deduction for worthlessness of a partnership interest without abandoning the business interest. In the 2019 decision *MCM Investment Management, LLC. v. Commissioner,* the Tax Court agreed with the taxpayer and allowed the section 165(a) loss deduction for a worthless partnership interest.[3]

MCM Investment provides practical guidance both for tax counsel and taxpayers with regard to the legal requirements to sustain a tax deduction for the security ownership interest worthlessness. This judicial decision also provides practical guidance for tax counsel and valuation or financial analysts with regard to the documentation of the security ownership interest worthlessness. *MCM Investment* supports the position that an actual abandonment of the partnership interest (or any other ownership interest) is not required in order to claim a section 165(a) loss deduction.

The case involved a parent partnership and a subsidiary partnership. The taxpayer/parent partnership was MCM Investment Management, LLC (MCM). MCM owned a controlling interest in subsidiary McMillan Companies LLC (McMillan).

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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's liabilities exceeded the value of the company's assets.

The tax year at issue in *MCM Investment* was 2009. By 2009, an internal McMillan analysis indicated that an orderly liquidation of the company assets would generate more cash to pay off the $70 million of senior debt than would 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 during 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's senior debt—and there would be no residual cash flow available for any of the company's equity holders.

Upon audit, the IRS 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?

Because MCM did not abandon its partnership interest in McMillan in 2009, the Tax Court had to determine if MCM was entitled to the worthless security deduction in 2009. To determine whether the MCM equity interest became worthless in 2009, the Tax Court applied the two-part test described in the *Echols* decision.

Subjective determination of securities worthlessness

First, the Tax Court analyzed whether MCM subjectively concluded that the McMillan security 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: (i) MCM's 2009 income tax return claimed a worthlessness loss deduction; and (ii) fact witness testimony of the MCM managers and partners described the devastating impact that the financial crisis had on the residential real estate market.

In addition, the Tax Court was persuaded by the McMillan financial projections that demonstrated the company's inability to pay off its senior lender in full or to have any assets remaining for either the MCM partners or any other equity owners. Finally, the court was persuaded by the McMillan plan to gradually wind down its business operations over a five-year period in order to maximize the amount of cash flow available to pay the company's creditors.

Objective determination of securities worthlessness

Second, the Tax Court analyzed whether the objective evidence confirmed the MCM subjective determination that the McMillan security interest was worthless in 2009. In concluding if this objective determination test was met, 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 v. Commissioner*.[4]

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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 liabilities 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 whether the liabilities of a corporation are so greatly in excess of its asset 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 no liquidating value, and since the limits of the corporation's future and 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 conservative and based on market condition assumptions. The 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 available for distribution either to MCM or to the preferred equity holders.

In contrast, the McMillan plan of gradual liquidation of company operations resulted in a higher percentage payoff to the senior creditor (but still no residual payment to either 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 *Mahler v. Commissioner.*[5]

In *MCM Investment*, the Tax Court concluded that the combination of the amount 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, 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 deduction based on its assessment of: (i) the impact of the financial crisis on the residential real estate market; and (ii) the 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 court noted the evidence

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that McMillan objectively had no liquidation value in 2009 or in the foreseeable future.

The Tax Court concluded that taxpayer MCM passed both the subjective determination of the worthlessness test and 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.

CONCLUSION

Tax counsel may often advise taxpayers to apply the provisions of Code section 165(a) to claim a worthless security loss deduction for the stock of a private company or the stock of a corporation's subsidiary.

For example, parent corporations often claim the section 165(a) loss deduction with regard to the worthless stock of a corporation's subsidiary. However, although it is commonly referred to as the "worthless stock deduction," section 165(a) is not restricted to the worthlessness of 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 guidance to tax counsel and taxpayers 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 a tax deduction: (i) the taxpayer's subjective determination of worthlessness; and (ii) the taxpayer's objective determination of worthlessness.

In the *MCM Investment* decision, the Tax Court provided further guidance to tax counsel and taxpayers with regard to the justification of 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 to taxpayers and to valuation or financial analysts with regard to the analysis and documentation of the worthlessness of the security ownership interest. The 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 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 v. U.S., 175 F. Supp 235 (S.D.N.Y. 1967), affirmed on this issue and remanded in part on other issues, 395 F.2d 861 (2d Cir. 1968); In re: Kreidle, 146 B.R. 464 (Bankr. D. Colo. 1991); Tejon Ranch Co., T.C. Memo 1985-207.

2 Echols v. Commissioner of Internal Revenue, 935 F.2d 703 (5th Cir. 1991).

3 T.C. Memo 2019-158.

4 Morton v. Commissioner of Internal Revenue, 38 B.T.A. 1270, 1278-1279 (1938), aff'd 112 F.2d 320 (7th Cir. 1940).

5 Mahler v. Commissioner of Internal Revenue, 119 F.2d 869 (2d Cir. 1941).

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