

Chapter 14

Losses

p.835

§165(a) provides the general rule that a tax deduction is available (1) for any loss sustained during the taxable year and (2) not compensated for by insurance.

§165(b) specifies the deduction for the loss is the adjusted basis (& not the FMV of the property).

§165(c) provides limitations for individuals for losses (1) in trade or business, (2) in transactions entered into for profit, and (3) casualty losses (previously discussed).

When does a loss occur?

Consider the concept of a “realization” event as being necessary (e.g., §1001) for determining gain or loss from disposition of an asset.

Reg. §1.165-1(d) refers to the deduction as available for the taxable year “in which the loss is sustained” and that the loss is evidenced by “closed and completed transactions” and “as fixed by identifiable events occurring in such taxable year.”

S.S. White Dental Mfg. Co. p. 835

U.S. taxpayer owned stock of a German corp. (subsidiary) and had loaned funds to the corp.

German Govt. (during wartime) seized the German corp. properties in 1918 (but properties when restored in 1920 were worthless).

Did a “closed transaction” occur in 1918 when the property was seized? Holding: (1) stock and (2) accounts receivable were worthless & a loss deduction was available for that year.

But, what about potential for future recovery?

Securities Losses

p. 838

How realize the loss? Sell the asset to realize the loss.

What if no sale – how prove the timing of the worthlessness of the property item (and, therefore, the timing of the deduction)?

See Code §6511(d) provides seven (not three) year period of limitation with respect to bad debts and worthless securities.

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Ponzi scheme victims

Loss to A from embezzlement in a transaction entered into for profit:

1) Theft loss or capital loss under Code §165?

Held: Theft loss – from depriving A of money by criminal acts. Theft for §165 purposes.

2) Deduction limits: Theft loss on investment account is deductible under §165(c)(2) and not subject to §165(h) limitations. And, not subject to §67 and §68 limits on deductions.

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3) Year of deduction: §165(e) specifies loss sustained for year loss is discovered; except must wait until reimbursement claim resolved. Deduction in year of theft discovery if no claim for reimbursement. Later events: Excess recovery causes gross income inclusion; inadequate recovery enables deduction.

4) Amount of deduction: Theft loss is tax basis of the property lost, less any reimbursement.

How determine this tax basis? P.843 Continued

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continued

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5) Net operating loss availability? Code

§172(d)(4)(C) specifies §165(c)(2) or (3) losses are treated as business deductions. Thus, carryback three (not two) years (§172(b)(1)(E)) and carryforward for 20 years (§172(b)(1)(A)).

6) Claim of right applicability? §1341

applicable when subsequent reversal of an item is included in gross income. Theft loss does not qualify for §1341 recomputation.

7) Mitigation under §§1311-1314? No, since no inconsistency.

Related Parties Transactions

p.847

McWilliams v. Commr.: Taxpayer sold stock in his account and wife's account bought same stock at same time. Objective was to establish losses for tax purposes. Spouses filed separate tax returns. Sales/purchase transactions were made through the NYSE.

Under §267 IRS disallowed loss deductions as being from “sales or exchanges” between related parties. Held: §267 limit applies.

Any time limit for the application of §267?

Section 267 Concepts

p. 850

§267(a)(1) specifies no deduction available for any loss from the sale or exchange of property “directly or indirectly” between related parties.

Who are “related parties.” See Code §267(b) for definition of “relationships.” Siblings?

Objective of this provision: limit losses when an identity of economic interests exists.

Basis of replacement property: §267(d) – gain is recognized only to extent exceeding prior loss; loss computation – use buyer’s basis. Cf, §1015.

§1091 – “Wash Loss” Rules - Loss Disallowed

T sells stock (or securities) and T buys same stock (or securities) within thirty days; no loss deduction is allowed. §1091(a).

Code §1091(d) provides that stock repurchased takes the basis of the security sold; therefore, the loss deduction is postponed until a bona fide disposition is made.

How avoid applicability of this rule? E.g., sell ten year bonds and buy five year bonds? Sell Ford stock and buy GM stock?

Problem 3, p. 850

a) A owns stock with 100 basis; sells at 90; buys (within 15 days) at 85. Allowable loss: none; tax basis for the purchased stock is: 95.

b) B owns stock with 100 basis; buys at 90; then (within 15 days) sells shares at 85.

(i) Sale of old shares? Loss is disallowed and basis is 105; or, (ii) sale of new shares: no limit on the loss deduction? Which shares are sold?

c) Purchase at 90 and then prompt sale at 85: Loss deduction is available, cf., §1091 language?

Problem 8, p. 852

Spousal Transfers

Impact of Code §1041 concerning transfers of loss property between spouses (usually for §1041 purposes in the divorce context)?

Code § 267(g) exempts these transfers between spouses or incident to a divorce from §267 applicability.

Straddles & Code §1092

p.852

What is a “straddle”? I.e., offsetting positions with respect to personal property. §1092(c).

A straddle results in a “substantial diminution in risk” when holding several positions.

A current loss deduction is allowed only to the extent loss exceeds the unrecognized gain. §1092(a)(1).

Capital Losses

Code §1211

p.853

Code §1211 limits deduction of capital losses:

(1) For corporations, to the extent of any capital gains; and,

(2) for individuals, to the extent of capital gains, plus \$3,000 per year (against ordinary income).

Purpose of this provision: No “cherrypicking” of losses to use to offset ordinary income.

Cf., §183 hobby loss limitation provision limiting loss deduction to hobby income.

O.L. Burnett

p. 854

Ordinary loss?

Taxpayer sustained 18x loss on sale of securities (attributable to the conduct of a business?).

IRS says T not carrying on a trading business and, thus, limited to \$2,000 (now \$3,000) loss.

Note: Property is a capital asset unless either (1) inventory or (2) held for sale to customers in the ordinary course of trade or business.

See Code §1221(a)(1).

Remember: Yeager case (p.600) re §163(d).

Section 1231 Assets

P.856

§1221(a)(2) excludes depreciable business property and business realty from the definition of a “capital asset.”

§1231 provides that upon the sale of these §1221(a)(2) assets: (1) capital gains treatment is available for gains, and (2) ordinary loss treatment applies if property is sold for a loss.

Requires the netting of §1231 gains and losses.

§1231(c) was enacted to limit the cyclical realization of §1231 gains and §1231 losses.

Involuntary Conversions

P.857

Assume: (1) Involuntary conversion of business property and capital assets, and

(2) no reinvestment of insurance proceeds.

To postpone gain recognition Code §1033 mandates reinvestment to extent of proceeds.

Does the receipt of insurance proceeds result from a “sale or exchange” of property?

See Code §1231(a)(3)(A)(ii) & (B) re involuntary gain as a capital gain and involuntary loss as deductible against ordinary income.

Involuntary Conversions of Vacation Home P.858

This involuntary conversion is not eligible for §1231 capital gain treatment (if gain, e.g., from insurance proceeds), since the asset not held as a §162 or §212 asset.

However: See §165(h)(2) (B) re providing equivalent treatment to §1231 re personal casualty gains in excess of personal capital losses. Cf., §165(h)(2) (A) re net capital loss (as ordinary) to extent exceeding 10% of AGI.

(Business?) Bad Debts

Whipple v. Commr. P.859

§166(a) enables a deduction for worthless debts; but, §166(d) specifies short-term capital loss treatment for nonbusiness bad debts.

Taxpayer loaned funds to the corporation he controlled & the debt became worthless.

Claimed business bad debt deduction status.

IRS, Tax Court & 5th Cir. say nonbusiness debt.

Held: Not here engaged in a trade or business (of lending?) to the corporations. Loans were made to preserve his investments.

Tax Treatment of Personal Debts

p.865

Problem 3:

- a) **Loan to a relative becomes a bad debt – Deduction available? Or a gift? Must prove: (1) a real debt and (2) debt became worthless.**
- b) **Loan made to car purchaser becomes bad – If real debt - should have a bad debt deduction.**
- c) **Should any deduction be available? Cf., casualty loss deduction - §165. Personal loan to a deadbeat relative - same as a casualty loss?**

Worthless Debt Issues

P. 865

- 1) **Partially worthless debt - §166(a)(2) - provides a deduction for partially worthless bad debts. When available? When proof and charging off for financial (GAAP) purposes.**
- 2) **Bad debt reserves – GAAP accounting requires a bad debt reserve; not (ordinarily) possible for FIT purposes. However, tax reserve is available for small banks - §585.**
- 3) **Loan guarantees – guarantor's loss as a nonbusiness bad debt (Putnam case, Sup. Ct).**

Employee or Investor

Generes case

P.867

Can employee status change a loan made to the employer into a business loan (to protect one's status/business as an employee)?

Here: Large loans to the corporation; but, small compensation amount (particularly after-tax); and, larger investment in the company's stock.

Could not determine that the dominant motivation for the loans was a business purpose and, therefore, no business bad debt deduction.

See jury charge scenario, p. 867-868.

How Achieve Business Expense Deductions?

P. 868. Particularly for start-ups:

Use an unincorporated entity to enable tax losses to currently flow through to the owners – e.g., use a limited partnership or a limited liability company (LLC).