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The best of a bad investment

A recent tax case out of the Fifth Circuit approved a taxpayer's strategy to make the best of a bad investment. According to the facts of *Pilgrim's Pride v Commissioner*, the taxpayer purchased preferred stock from two corporations (Issuers) for a total of $98.6 million in 1999. By 2004, the stock had declined significantly in value and the Issuers offered to buy back the stock for $20 million. The taxpayer determined that the best course of action was to abandon the stock for no consideration because a $98.6 million ordinary abandonment loss would generate tax savings more valuable than the $20 million offered by the Issuers. Accordingly, the taxpayer surrendered the stock to the Issuers, terminating its ownership rights with respect to the Issuers. The taxpayer then claimed an ordinary loss of $98.6 million. The Internal Revenue Service (IRS) disagreed with the character of the loss, arguing that the abandonment should be treated as a sale or exchange, resulting in a capital loss (subject to limitation), rather than an ordinary loss.

The US Treasury regulations generally allow a deduction for losses sustained in the taxable year, including losses from the abandonment of property. However, an abandonment loss is not allowed with respect to losses sustained upon the sale or exchange of property. The Internal Revenue Code includes a provision (IRC §1234A) that deems certain transactions to be sales or exchanges for tax purposes. At issue in *Pilgrim's Pride* was whether this provision applied to the abandonment of stock that is held as a capital asset.

In 2013, the US Tax Court agreed with the IRS, rejecting the taxpayer's argument that this provision only applied to derivative or contractual rights and did not apply to property rights inherent in ownership. However, the Fifth Circuit reversed the Tax Court's ruling, finding that IRC §1234A 'applies to the termination of rights or obligations with respect to capital assets (eg derivative or contractual rights to buy or sell capital assets) [but] does not apply to the termination of ownership of the capital asset itself'. The IRS attempted to argue that when a capital asset is abandoned, IRC §1234A applied because the inherent rights with respect to the abandoned asset were also being abandoned. The court disagreed, noting that 'Congress does not legislate in logic puzzles'.

The Fifth Circuit's decision appears to give taxpayers more leeway in considering whether abandoning an asset and reaping a tax benefit is more beneficial than recouping a partial recovery.

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