

# Fifth Circuit Reverses Tax Court on Character of Abandonment Loss

In a pro-taxpayer decision, the Fifth Circuit Court of Appeals has reversed the U.S. Tax Court's holding that the abandonment of a capital asset gives rise to a capital loss. [Pilgrim's Pride Corp. v. Comm'r](#)<sup>1</sup> involves a taxpayer's abandonment of securities to the issuer of the securities and its subsequent deduction of an ordinary loss for such abandonment.

Tax losses are characterized as either ordinary or capital. Capital losses typically arise when there is (i) a sale or exchange for consideration of (ii) a capital asset. But where a taxpayer abandons a capital asset, the requisite "sale or exchange" and "consideration" are missing and thus, an ordinary loss may result. An abandonment is an affirmative action taken to relinquish all rights and obligations associated with ownership of the subject property, without consideration. By contrast, if securities held by a taxpayer become worthless, the resulting loss automatically is characterized as a capital loss.<sup>2</sup>

In the facts of this case, which occurred in 2004, before the regulations under section 165(g)<sup>3</sup> were expanded, Pilgrim's Pride (the "Taxpayer") abandoned securities for no consideration, effectuating its abandonment by sending the issuer and transfer agent letters stating that it "irrevocably abandons, relinquishes, and surrenders all of its rights, title and interest" in the securities. For the Taxpayer, the after-tax value of a \$98 million ordinary loss claimed on its 2004 tax return was greater than the redemption value offered by the issuer's board (\$20 million). Importantly, the securities were not worthless as the issuer was willing to pay to redeem them. Initially, the IRS disagreed with the Taxpayer on grounds that the act of abandonment rendered the stock worthless to the Taxpayer and therefore, the loss should be capital. When both parties landed in front of the U.S. Tax Court, the court took an uncommon step by asking the parties to consider whether section 1234A should apply.

Enacted in 1981 in response to a character mismatch involving certain straddle transactions, section 1234A requires capital treatment for any gain or loss "attributable to the cancellation, lapse, expiration, or other termination of – (1) a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer." As originally drafted, section 1234A only covered rights or obligations with respect to actively traded personal property (such as commodities). In 1997, Congress expanded the section's reach to include rights or obligations with respect to all types of property that are (or on acquisition) would be capital assets. This amendment opened the door for the Tax Court to consider the application of section 1234A to the Taxpayer's loss.

The IRS argued that section 1234A applied to the Taxpayer's abandonment of the securities. Specifically, the IRS argued that abandonment of the securities involved the termination of certain rights and obligations inherent in the securities and thus section 1234A applied. In other words, while the IRS agreed that section 1234A did not apply *directly* to the abandonment of a capital asset itself, in respect of the Taxpayer's capital asset – that is, securities in another corporation – section 1234A did apply *indirectly* because abandonment involved the termination of certain

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<sup>1</sup> Pilgrim's Pride v. Comm'r, 5th Cir., No. 14-60295, 2/25/15

<sup>2</sup> Internal Revenue Code section 165(g) explains, "if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall . . . be treated as a loss from the sale or exchange . . . of a capital asset." Securities include shares of stock in a corporation and debt issued by a corporation in registered form. Section 165(g)(2). In 2008, Treasury expanded the regulations issued under section 165(g) to treat abandoned securities as being worthless *per se*; accordingly, after 2008, the abandonment of securities will give rise to a capital loss. Treas. Reg. § 1.165-5(i).

<sup>3</sup> Unless otherwise specified, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code") and all "Treas. Reg. §," "Temp. Treas. Reg. §," and "Prop. Treas. Reg. §" are references are to the Final, Temporary, and Proposed Treasury Regulations promulgated thereunder, respectively, as of the date of this memorandum.

rights and obligations inherent in the securities. For instance, a shareholder's abandonment of stock would terminate its rights as a shareholder in the management, profits, and assets of the underlying corporation.

The Fifth Circuit disagreed with the Tax Court and refused to apply section 1234A to the abandonment of a capital asset itself, regardless of any resulting termination of inherent rights. The Fifth Circuit noted that had Congress intended for the abandonment of a capital asset to give rise to a capital loss, there were far easier ways of doing so and a strained interpretation of section 1234A to include rights inherent in the ownership of a capital asset would render other Code sections and authority superfluous. Effectively, the Fifth Circuit's decision limits the application of section 1234A to the termination of derivative or contractual rights with respect to capital assets.

Pilgrim's Pride may seem of little consequence to taxpayers holding securities today. As noted above, the regulations now treat losses from the abandonment of securities as worthless securities losses under section 165(g), causing the losses to be capital.<sup>4</sup> Nevertheless, Pilgrim's Pride may be of importance to other capital assets that are abandoned by taxpayers, and in particular, partnership interests.<sup>5</sup> Like stock, partnership interests contain inherent rights in the management, profits, and assets of the partnership. Also like stock, partnership interests generally are capital assets. Had the IRS been successful in persuading the Fifth Circuit that section 1234A applied, the abandonment of a partnership interest to the issuer arguably would have been subject to capital loss treatment. For now, it appears that taxpayers may still claim an ordinary loss for the abandonment of partnerships interests in certain situations, provided there is no relief from partnership liabilities.

## Contacts

If you have any questions or would like to discuss potential implications, please contact us.

### Frank Strong

Managing Principal  
Washington National Tax Office  
Deloitte Tax LLP  
+1 202 220 2069  
[fstrong@deloitte.com](mailto:fstrong@deloitte.com)

### Helen Yanchisin

Director  
Washington National Tax Office  
Deloitte Tax LLP  
+1 202 378 5266  
[hyanchisin@deloitte.com](mailto:hyanchisin@deloitte.com)

### David Benz

Principal  
Deloitte Tax LLP  
+1 213 996 4986  
[dbenz@deloitte.com](mailto:dbenz@deloitte.com)

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<sup>4</sup> Some commenters have suggested that the conclusion in Pilgrim's Pride may mean that the government's position in Treas. Reg. § 1.165-5(i), which provides that an abandonment *per se* equals worthlessness, is contrary to case law on the issue and therefore may be subject to challenge.

<sup>5</sup> For over 20 years, the IRS's own position of the abandonment of partnership interests has been that an ordinary loss results so long as the abandoning partner is not being relieved of any underlying partnership debt. See Rev. Rul. 93-80; see also Echols v. Comm'r, 935 F.2d 703, 707 (5th Cir. 1991); Citron v. Comm'r, 97 T.C. 200, 215 (1991).

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