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Memorandum

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To:

Senior Program Analyst
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(Small Business/Self-Employed)

From:

Senior Attorney ()
(Small Business/Self-Employed)

Subject: Worthlessness of partnership interests in and loans to

ISSUES

1. Whether (" ") partners are entitled to take an ordinary loss deduction under I.R.C. § 165 for the purported worthlessness of their partnership interests in the firm, or a bad debt deduction under I.R.C. § 166(a) for the purported worthlessness of subordinated notes issued by the firm, as of , on Schedule E of their tax returns.
2. Whether partners are entitled to take a capital loss deduction under either § 165(f), § 166(d) or to treat the loss as § 1231 loss for the purported worthlessness of their partnership interests in the firm as of .
3. Whether partners may reduce their net earnings from self-employment for the tax year by the amount of their claimed ordinary loss deduction under § 165 for the purported worthlessness of their partnership interests in the firm as of .

CONCLUSIONS

1.

[REDACTED]

In fact, the evidence obtained thus far, including an appraisal of a partner's interest in [REDACTED], demonstrates that the partnership interests and/or the subordinated loans had value as of [REDACTED]. Additionally, the partners have not established that the subordinated loans and partnership interests were abandoned or became worthless in any year.

2.

[REDACTED]

A loss claimed to result from the worthlessness or abandonment of a partnership interest may be treated as a sale or exchange under I.R.C. 741(a) and thus a capital loss, if the taxpayer is relieved of partnership liabilities. The partners have not demonstrated that such a loss was realized. The partners continued to receive Forms K-1

The evidence shows that the partnership still considered them partners and, therefore, they would not be entitled to a capital loss deduction for the sale or exchange of their partnership interest. Similarly they have not demonstrated that their partnership interests were involuntarily converted. [REDACTED]

[REDACTED]

3. The disposition of a partnership capital interest, whether by sale or exchange, abandonment, or determination as a worthless security is a disposition of property, and as such, is specifically excluded from the computation of net earnings from self-employment. I.R.C. § 1402(a)(3); Treas. Reg. § 1.1402(a)-6(a)(3). Therefore, whether or not partners are entitled to a deduction in 2002, ordinary or capital, with respect to their partnership interest, they should not reduce earnings from self-employment by the amount of the claimed loss.

FACTS

partners of claimed on their federal income tax return an ordinary loss deduction under I.R.C. § 165 for the worthlessness as of , of either their partnership interests or subordinated loans to the firm. Some partners described the loss as worthlessness and/or abandonment. The deductions were claimed on Schedule E, which deductions reduced the partners' self-employment income and, thus, their self-employment tax.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

partners claimed the worthlessness partnership or loan deduction on Schedule E, Part II, as a non-passive loss, thereby reducing their net earnings from self-employment.

partners received a Form K-1 for the
fiscal year

Furthermore, other partners claimed a capital loss for the worthlessness of their partnership interests or subordinated loans either on Schedule D or on Form 4797.

apparent rationale for claiming the deduction

The deductions were taken because

partners were issued a series of subordinated, nonnegotiable interest-bearing promissory notes payable over a five-year period, evidencing a n obligation to repay the balance of the paid-in-capital left in the partnership.
suspended all principal and interest payments
with respect to such notes.

Appraised Value of a Partnership Interest as of

An appraisal
partner's interest as of
had approximately

obtained by a partner that valued the
, stated that, as of that date
of cash on hand. The partnership also

had revenue from renting _____, from _____ payments from _____, and from earnings on its cash on hand.

The appraisal noted that, as of _____, the Partnership was solvent with significant liquid assets.

The appraisal also noted that the Forms K-1 issued to partners with respect to the period from _____, “reflected significant income and positive cash flow” to the partnership. However, the appraisal stated a belief a partner “cannot expect the full return of his capital account.”

The appraisal also noted the following positive factors indicating that a partner’s interest had _____ value as of _____:

1. The continued revenue generating operations at _____;
2. Continuing revenue from _____;
3. Substantial amounts of cash and receivables held by _____, suggesting that it is in a liquid position;
4. The absence as of _____;
5. _____;
6. The apparent settling of most, if not all, its significant lease obligations; and
7. That _____ has not filed for bankruptcy protection and appears to have no intention of doing so.

LAW

Worthlessness and abandonment deduction for partnership interests and subordinated loans

Section 165(a) of the Internal Revenue Code allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise. A loss deduction is permitted under § 165 only for a taxable year in which the loss is sustained, as evidenced by closed and completed transactions and as fixed by identifiable events occurring in that year. Treas. Reg. § 1.165-1(d)(1). A loss from the sale or exchange of a capital asset is a capital loss. § 165(f). Pursuant to I.R.C. § 165(b), the amount of loss shall be determined based on the person's adjusted basis as provided in § 1011 for determining the loss from the sale or other disposition of property. Although § 165(g) provides a capital loss deduction for worthless securities that are capital assets, there is no similar specific provision for the worthlessness of a partnership interest.

Rev. Rul. 93-80, 1993-2 C.B. 239, provides that a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. If there is an actual or deemed distribution to the partner, or if the transaction is otherwise in substance a sale or exchange, the partner's loss is capital (except as provided in § 751(b)). I.R.C. § 741.

Abandonment of an asset for purposes of § 165 requires (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Rev. Rul. 93-80, 1993-2 C.B. 239; Rev. Rul. 2004-58, 2004-1 C.B. 1043. See also Echols v. Commissioner, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), reh'g denied, 950 F.2d 209 (5th Cir. 1991).

A deduction for worthlessness under § 165 is allowable only if there is a closed and completed transaction fixed by identifiable events establishing that the property is worthless in the year for which the deduction is claimed. Treas. Reg. § 1.165-1(b) and (d)(1). Although the taxpayer is not required to be an "incorrigible optimist," a mere diminution in the value of an asset is not sufficient to establish worthlessness. United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 403 (1927); Proesel v. Commissioner, 77 T.C. 992, 1006 (1981). As in the case of abandonment, both subjective and objective factors are

taken into account. See Boehm v. United States, 326 U.S. 287, 292-293 (1945); Echols, 935 F.2d at 706-08.

Sale or exchange of a partnership interest

As stated above, loss on the sale or exchange of a partnership interest is considered loss from the sale or exchange of a capital asset, except as provided in § 751(b). I.R.C. § 741. For taxpayers other than corporations, capital losses are allowed only to the extent of capital gains, plus the lesser of \$3,000 or the excess of such losses over such gains. I.R.C. § 1211(b).

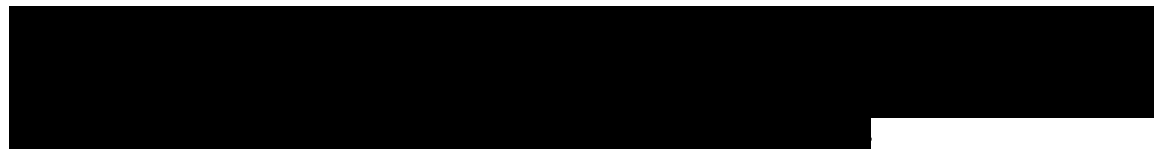
Self-employment tax calculation

I.R.C. § 1402 provides that the distributive share of income or loss from a partnership for a general partner is considered in the computation of net earnings from self-employment. The disposition of a partnership capital interest, whether by sale or exchange, abandonment, or determination as a worthless security is a disposition of property, and as such, is specifically excluded from the computation of net earnings from self-employment. I.R.C. § 1402(a)(3); Treas. Reg. § 1.1402(a)-6(a)(3). Therefore, whether or not partners are entitled to a deduction, ordinary or capital, with respect to their partnership interest, they should not reduce earnings from self-employment by the amount of the claimed loss.

Analysis

Issue 1

Based on the facts established so far, there is no indication that the partners' partnership interests and rights in the subordinated loans issued in lieu of returning their capital accounts were abandoned or became worthless in . Additionally, the partners have not established that the subordinated loans and partnership interests were abandoned or became worthless in any year.



As an objective matter, the partners have not established an identifiable event that would demonstrate that a loss has been sustained. There is no overt act indicating that the partners have abandoned their right to the amounts due under the subordinated loans for the repayment of their paid-in capital accounts.

do not establish worthlessness. Although

declared bankruptcy. , it has never to our knowledge

As yet, the partners have not presented facts sufficient to establish the fact, amount, timing, or character of a loss with respect to their interests

To the contrary, the appraisal obtained by one partner provided several reasons why a partner's partnership interest should still have

The appraisal explicitly stated that, as of was solvent and had approximately of cash on hand and income from earnings on the cash. was also generating revenue from renting and was receiving payments from .

the appraiser thought it significant that

Additionally, the Forms K-1 issued to partners for the period ended , showed "significant income and positive cash flow."

Although the appraiser stated that a partner "cannot expect the full return of his capital account" (emphasis added), this statement indicates that partners' partnership interests likely decreased in value, but that the partners could expect a return of at least a portion of their capital accounts. A mere diminution in the value of an asset is not sufficient to establish worthlessness. United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 403 (1927); Proesel v. Commissioner, 77 T.C. 992, 1006 (1981).

If the partnership interests and subordinated loans were truly worthless as of , the partners would not have continued their collection efforts against after that date. All of the factors above lead to the conclusion that the subordinated loans and/or partnership interests were not worthless as of .

Issue 2

Although any loss on the sale or exchange of their partnership interests should be capital under § 741, unless there were unrealized receivables and inventory, like the analysis above for Issue 1 relating to the worthlessness or abandonment of the partnerships interests and/or subordinated loans, the partners

have not established that there was a sale or exchange of their partnership interests. [REDACTED]

Although the partners [REDACTED] all continued to receive Forms K-1 for the period [REDACTED]. Most of them also received a Form K-1 for [REDACTED]. Therefore, although some partners who claimed a loss of their partnership interest on either Schedule D or Form 4797, the evidence provided by [REDACTED], the Forms K-1, shows that the partnership still considered them partners.

Issue 3

As stated above, most of the [REDACTED] partners that reported their worthlessness loss deduction for either their partnership interest or subordinated loan did so on Schedule E, which reduced their self-employment income and, thus, their self-employment tax. However, their self-employment tax liability should have been based only on their distributive share of earnings or loss from [REDACTED], any other partnerships of which they were partners for the [REDACTED] tax year, and any other trade or business income. The disposition of a partnership capital interest, whether by sale or exchange, abandonment, or determination as a worthless security is a disposition of property, and as such, is specifically excluded from the computation of net earnings from self-employment. I.R.C. § 1402(a)(3); Treas. Reg. § 1.1402(a)-6(a)(3). Therefore, whether or not partners are entitled to a deduction in [REDACTED], ordinary or capital, with respect to their partnership interest, they should not reduce earnings from self-employment by the amount of the claimed loss. Therefore, the amount of their worthlessness deduction should not have been netted with their distributive shares of income and loss from [REDACTED], other partnerships, or other trades or businesses.

CONCLUSION

[REDACTED]