Revenue Rulings, Revenue Ruling 93-80,, Internal Revenue Service, (Nov. 10, 1993)

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Revenue Ruling 93-80, I.R.B. 1993-38,5, November, 10, 1993

Clarifying and superseding: Rev. Rul. 70-355

Revoking: Rev. Rul. 76-189

[Code Secs. 165, 731 and 741]

Partnerships: Abandonment of worthless interest: Losses.–

The IRS ruled that a loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. In certain cases where there is an actual or deemed sale or exchange, the partner's loss may be capital. Rev. Rul. 70-355 is clarified and superseded. Rev. Rul. 76-189 is revoked. BACK REFERENCES: 93FED ¶9804.33, 93FED ¶9805.047, 93FED ¶25,622.087 and 93FED ¶25,742.02.

ISSUE

Is a loss incurred on the abandonment or worthlessness of a partnership interest a capital or an ordinary loss?

FACTS

Situation 1. PRS is a general partnership in which *A, B*, and *C* were equal partners. During 1993, *PRS* became insolvent, and *C* abandoned *C*'s partnership interest. *C* took all steps necessary to effect a proper abandonment, including written notification to *PRS. PRS*'s partnership agreement was amended to indicate that *C* was no longer a partner. At the time *C* abandoned the partnership interest, *PRS*'s only liabilities were nonrecourse liabilities of 120 *x* dollars, shared equally by *A, B*, and *C. C* had a remaining adjusted basis in the partnership interest of 180 *x* dollars. *C* did not receive any money or property on leaving the partnership.

Situation 2. LP is a limited partnership in which *D* and *E* were general partners and *F* was one of the limited partners. During 1993, *LP* became insolvent, and *F* abandoned *F*'s limited partnership interest. *F* took all steps necessary to effect a proper abandonment, including written notification to *LP. LP*'s partnership agreement was amended to indicate that *F* was no longer a partner. At the time *F* abandoned the partnership interest, *F* had a remaining adjusted basis of 200 *x* dollars in the partnership interest. *F* did not bear the economic risk of loss for any of the partnership liabilities and was not entitled to include a share of the partnership liabilities in the basis of *F*'s partnership interest. *F* did not receive any money or property on leaving the partnership.

LAW

Section 165(a) of the Internal Revenue Code allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(b) provides that the basis for determining the amount of a deduction for any loss is the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property. Section 1.165-1(b) of the Income Tax Regulations provides that a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

Section 165(f) of the Code provides that losses from sales or exchanges of capital assets are allowed only to the extent allowed in sections 1211 or 1212. Under section 1.165-2 of the regulations, however, absent a sale or exchange a loss that results from the abandonment or worthlessness of nondepreciable property is an ordinary loss even if the abandoned or worthless asset is a capital asset (such as a partnership interest).

To establish the abandonment of an asset, a taxpayer must show an intent to abandon the asset, and must overtly act to abandon the asset. *CRST, Inc. v. Commissioner*, 92 T.C. 1249 (1989), *aff'd*, 909 F.2d 1146

(8th Cir. 1990); *Dezendorf v. Commissioner*, T.C.M. 1961-280, *aff'd*, 312 F.2d 95 (5th Cir. 1963). An asset is worthless when it in fact has no value. *Laport v. Commissioner*, 671 F.2d 1028 (7th Cir. 1982); *Boehm v. Commissioner*, 326 U.S. 287 (1945).

Section 731(a) of the Code provides that in the case of a distribution by a partnership to a partner, loss is recognized by the partner only upon distribution in liquidation of the interest in a partnership, and only where no property other than money, unrealized receivables, and inventory is distributed to that partner. Loss is recognized by the partner to the extent the adjusted basis of the partner's partnership interest exceeds the money distributed and the basis to the distributee partner in any unrealized receivables and inventory items distributed. Any loss recognized under section 731(a) is considered a loss from the sale or exchange of the partnership interest of the distributee partner.

Section 741 of the Code provides that in the case of a sale or exchange of a partnership interest, gain or loss is recognized to the transferor partner. The gain or loss is considered gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to inventory items that have appreciated substantially in value and unrealized receivables).

Section 752(b) of the Code provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities, is considered a distribution of money to the partner by the partnership.

In Rev. Rul. 70-355, 1970-2 C.B. 51, a taxpayer paid cash for an interest as a limited partner in a partnership, and the taxpayer's capital account was credited with an amount less than the cash paid. The partnership agreement provided that losses would first be allocated against each partner's capital account and any balance would be shared only by the general partners. In a subsequent taxable year, the partnership sustained a loss in its business operations, entered into bankruptcy, and dissolved. The taxpayer's distributive share of the partnership loss for the taxable year reduced the taxpayer's capital account to zero. In addition, the taxpayer's adjusted basis in the partnership interest, which was greater than the taxpayer's capital account, was reduced by the taxpayer's distributive share of the loss. However, the taxpayer's adjusted basis in the partnership interest was not reduced to zero. The taxpayer did not receive any cash or other consideration in liquidation of the taxpayer's partnership interest.

Rev. Rul. 70-355 concludes that the taxpayer's loss is deductible as an ordinary loss under section 165(a) of the Code. The taxpayer's loss was composed of the taxpayer's distributive share of the partnership loss equal to the taxpayer's capital account and the balance of the taxpayer's adjusted basis in the partnership interest.

In Rev. Rul. 76-189, 1976-1 C.B. 181, *D* purchased a one-third interest in the *ABC* partnership from taxpayer *A. ABC* sustained a net loss from its business operations for the taxable year and terminated at the end of that taxable year. At termination, *ABC* had no remaining assets or liabilities. *D*'s distributive share of the partnership loss did not reduce *D*'s basis in *D*'s partnership interest to zero.

Rev. Rul. 76-189 concludes that *D* has an ordinary loss deduction for *D*'s distributive share of the partnership loss under section 702(a) of the Code and a capital loss deduction for any remaining adjusted basis in *D*'s partnership interest under section 731(a) on the date the partnership terminated. This was so even though there was no actual or deemed distribution from the partnership.

ANALYSIS

The abandonment or worthlessness of a partnership interest may give rise to a loss deductible under section 165(a) of the Code. Whether a loss from the abandonment or worthlessness of a partnership interest is capital or ordinary depends on whether or not the loss results from the sale or exchange of a capital asset.

Sections 731 and 741 of the Code apply to any transaction in which the partner receives an actual distribution of money or property from the partnership. These provisions likewise apply to any transaction in which a partner is deemed to receive a distribution from the partnership (*e.g.*, section 752(b)). Thus, whether there is an actual distribution or a deemed distribution, the transaction is treated as a sale or exchange of the partnership interest, and any loss resulting from the transaction is capital (except as provided in section 751(b)). Such a transaction is not treated for tax purposes as involving a loss from the abandonment or worthlessness of a partnership interest regardless of the amount of the consideration actually received or deemed received in the exchange.

Any decrease in a partner's share of partnership liabilities is deemed to be a distribution of money to the partner under section 752(b). The section 752(b) deemed distribution triggers the distribution on liquidation rule of section 731(a) for recognition of loss. For purposes of determining whether or not section 752(b) applies to create a deemed distribution upon abandonment or worthlessness, liability shifts that take place in anticipation of such event are treated as occurring at the time of the abandonment or worthlessness under general tax principles. *See also*section 1.731-1(a)(2) of the regulations providing that the liquidation of a partner's interest in a partnership may take place by means of a series of distributions.

A loss from the abandonment or worthlessness of a partnership interest will be ordinary if there is neither an actual nor a deemed distribution to the partner under the principles described above. Even a *de minimis* actual or deemed distribution makes the entire loss a capital loss. *Citron v. Commissioner*, 97 T.C. 200, 216 n.14 (1991). In addition, the loss will be ordinary only if the transaction is not otherwise in substance a sale or exchange. For example, a partner's receipt of consideration from another partner (or a party related thereto) may, depending upon the facts and circumstances, establish that a purported abandonment or worthlessness of a partnership interest is in substance a sale or exchange.

Partner *D* in Rev. Rul. 76-189 satisfied all of the requirements for ordinary loss treatment. Partner *D* did not receive any actual distributions, and *D* was not deemed to receive any distributions under section 752(b) of the Code as a result of liability shifts. Nevertheless, Rev. Rul. 76-189 denied *D* ordinary loss treatment because the Service concluded that for partnership terminations section 731 applied as if an actual distribution had taken place. The Service will no longer follow Rev. Rul. 76-189.

The taxpayer in Rev. Rul. 70-355 also satisfied all of the requirements for ordinary loss treatment. Unlike Rev. Rul. 76-189, however, Rev. Rul. 70-355 concludes that the taxpayer's loss is ordinary without discussing the relevance of partnership liabilities in determining whether a partner has an ordinary loss under section 165(a) of the Code upon the abandonment or worthlessness of a partnership interest. Further, some taxpayers have interpreted the partnership's bankruptcy as an essential fact in Rev. Rul. 70-355. Thus, although the conclusion in Rev. Rul. 70-355 is consistent with the conclusion in this revenue ruling, to avoid further confusion, Rev. Rul. 70-355 is clarified and superseded.

In *Situation 1*, when *C* abandons the interest in *PRS*, which has liabilities in which *C* shares, a deemed distribution of 40 *x* dollars is made to *C* under section 752(b) of the Code. The deemed distribution reduces the basis of *C*'s interest to 140 *x* dollars (180 *x* - 40 *x* = 140 *x*). Because there is a deemed distribution to *C*, section 731(a) applies and any loss allowed is capital. Thus, *C*'s entire 140 *x* dollars loss from abandoning the *PRS* interest is a capital loss even though the deemed distribution under section 752(b) is only 40 *x* dollars. The results would be the same if *C*'s interest in *PRS* were found to be worthless. Because *C* shares in the liabilities of *PRS*, a deemed distribution is made to *C* on a finding of worthlessness, section 731 applies, and any loss allowed is capital.

In *Situation 2, F* permanently abandons *F*'s interest in *LP.*Section 731 of the Code does not apply because *F* did not receive any actual or deemed distribution from the partnership. *F* received nothing in exchange for *F*'s interest in *LP.* Accordingly, *F* realizes an ordinary loss of 200 *x* dollars for the adjusted basis of *F*'s partnership interest, which may be deducted under section 165(a) as an ordinary loss subject to all other applicable rules of the Code. The results would be the same if *F*'s partnership interest in *LP* had become worthless.

HOLDING

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 section 751(b)).

EFFECTS ON OTHER REVENUE RULINGS

Rev. Rul. 70-355 is clarified and superseded. Rev. Rul. 76-189 is revoked.

PROSPECTIVE APPLICATION

Pursuant to the authority granted in section 7805(b) of the Code, taxpayers may rely upon Rev. Rul. 76-189, for closed and completed transactions occurring before November 10, 1993, the date of release of this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Deane M. Burke of the office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Deane M. Burke on (202) 622-3080 (not a toll-free call).