

PUBLICATION

Can You Deduct Losses from Failed Investments?

May 26, 2010

In the current economic climate, many investors have suffered losses on investments and from uncollectible debts. The deductibility of such losses depends on the nature of the investment, whether the investment is a capital asset, whether the investment is totally worthless, the nature of the investor (e.g. individual, corporation or other artificial entity). It is important to keep in mind the distinction between a bad debt and a loss. The deductibility of losses is governed by IRC§165, while the deductibility of bad debts is governed by IRC§166.

The first question to be answered is whether the investment is a "security," which IRC§165(g) defines as including:

1. Shares of stock of a corporation;
2. The right to subscribe for, or receive, shares of stock of a corporation; or
3. A bond, debenture, note or other evidence of indebtedness to pay a fixed and determinable sum of money, which instrument has been issued with interest coupons or in registered form by a domestic or foreign corporation or any government or political subdivision thereof.

An interest in a partnership or limited liability company is not a security.

The first two elements of this definition should not present any problems in interpretation. With respect to the third, interest coupons have been virtually obsolete since 1982 when Congress imposed severe impediments to issuing bearer bonds. "Registered form" means that ownership can be transferred only on the books of the issuer or on the books of a transfer agent appointed by the issuer. Thus, a negotiable promissory note which may be transferred to a holder in due course without any participation by the obligor is not a "security" in the context of IRC §165(g) even though it may be a security for other purposes of the Internal Revenue Code.

No deduction is permitted for partial worthlessness of a security. The security must be entirely worthless as evidenced by various factors. Such factors may include filing of Chapter 7 bankruptcy, the fact that the liabilities greatly exceed the assets of the corporation and that the corporation has no intrinsic worth.

In addition, the taxpayer must establish that the security had value at the beginning of the taxable year and lost its value during the year.

Alternatively, if the investor cannot establish to the satisfaction of the Service that an investment is wholly worthless and cannot sell the security in an arms length transaction, the investor may abandon the security. The regulations require that in order to abandon a security, the investor must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. All facts and circumstances determine whether a transaction is properly characterized as an abandonment or other type of transaction.

An individual may deduct a loss for a worthless security only if the loss is (1) incurred in a trade or business, (2) incurred in a transaction entered into for profit, or (3) incurred as a result of casualty or theft.

Losses from worthless securities are usually a loss from the sale or exchange of a capital asset and allowed to the extent of the rules applicable to capital losses. Losses from the following may be claimed as ordinary losses:

4. Securities held by banks;
5. Stock of an affiliated corporation;
6. Securities held by a regulated Small Business Investment Corporation;
7. Stock of a Small Business Investment Corporation; and
8. Section 1244 Stock.

When IRC §165 does not apply because the investment is not a security, IRC§166, dealing specifically with bad debts, may permit a deduction.

Unlike IRC §165, which does not permit deductions unless the investment is wholly worthless, IRC §166 permits a deduction for partially worthless debts when the Internal Revenue Service is satisfied that a debt is recoverable only in part.

A loss, whether from partial or full worthlessness of a debt acquired in the course of a trade or business, is deductible in computing ordinary income. That is not the case for a nonbusiness bad debt. A nonbusiness bad debt is any debt other than (1) a debt created or acquired in connection with a trade or business of the taxpayer, or (2) a debt the loss from the worthlessness of which is incurred in connection with the taxpayer's trade or business.

Where a nonbusiness bad debt becomes worthless within the taxable year, the loss is classified as a short term capital loss and the availability of a deduction is determined under the rules for capital losses.

No investor makes an investment intending to lose money, but investors should be prepared to prove to the IRS that every effort was made to recover the money invested.