

**May 2004**

## **Loss and Income Tax**

There is a wonderful quote by the very, very humorous Senator Robert J. Dole, who said, "Contrary to reports that I took the loss badly, I slept like a baby-every two hours I woke up and cried." While Senator Dole was speaking about losing his bid for the Republican presidential nomination on August 14, 1988, his comment about losses is pertinent. Losses hurt, very much. Fortunately, tax law provides some benefit for economic losses (not for presidential losses). Sometimes a significant benefit is available, sometimes a smaller benefit. If, for example, you sell a stock for a loss, you will report this on Schedule D and you will generate a capital loss. As tax law stands now, the maximum capital loss deductible per year is \$3,000, with the balance of the loss carried over, to be made available in future years, subject to the restriction in that year. (The \$3,000 cap has been around for a long time, but legislation could change it.) Example: If you sell stock X for \$2,000 in 2004 and the stock had a cost of \$10,000, you have a loss of \$8,000, of which \$3,000 is useable in 2004 and can offset ordinary income. However, the balance of the loss of \$5,000 will be available in 2005 (and may again be capped at \$3,000), with the balance of \$2,000 available-finally-in 2006.

### **Exception to the \$3,000 cap**

Since the capital loss is capped at a useable loss of only \$3,000, some taxpayers have looked for ways to write off more of their loss currently. If the stock qualifies as stock in a small corporation, under Internal Revenue Code Section 1244, up to \$100,000 of the loss is deductible in the year the loss takes place. If you ever consider forming a small business, please speak to the office about this important Code Section. In the example above, a loss of \$8,000 of Section 1244 stock would produce a fully deductible loss of \$8,000, fully available in the year of the loss, not limited to \$3,000.

### **Does corporate accounting fraud constitute theft?**

With the recent news about accounting fraud and other illegal misconduct by the officers or directors of the corporation that issued the stock, some taxpayers believe that they can deduct the decline in market value of their stock as a theft loss and take a full deduction in the current year. This is not accurate. The IRS recently issued Notice 2004-27 to dispute this notion.

Internal Revenue Code Section 165 does allow deductions for losses and the IRS addresses this important section. It provides that no deduction shall be allowed solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to another similar cause. However, a deduction is allowed under sub-section 165(a) if the stock is worthless and has no recognizable value. A decline in the value of stock owned by the taxpayer is not allowed as a deduction until the taxable year in which the loss is actually sustained as a result of the sale or exchange of the stock or the stock becomes wholly worthless. If a stock does become worthless, the \$3,000 cap still applies. If the stock in the example above became worthless in 2004, the loss would be \$10,000, but only \$3,000 could be used in 2004 with the carryover of \$7,000 available in subsequent years.

### **Stock losses are capital losses.**

If a theft takes place, a current loss is allowed, without any restriction of \$3,000/year. However, subsection 165(f) provides that losses from sales or exchanges of capital assets shall be allowed only to the \$3,000 a year maximum. Stock held for investment is specifically defined in the code as a capital asset and thus the amount that individual taxpayers may deduct for losses from sales or exchanges of

stock is subject to the rules for sales or exchanges of capital assets, including the rules for carrying forward to subsequent years the amount of any excess capital loss.

### **Stock losses are not theft losses.**

Some tax professionals raise the argument that corporate officer fraud leads to a conclusion that a theft loss should be allowed. The IRS says: NO! In cases involving stock purchased on the open market, the courts have consistently disallowed theft loss deductions relating to a decline in the value of the stock, even when that loss was attributable to corporate officers misrepresenting the financial condition of the corporation, and even when the officers were indicted for securities fraud or other criminal violations. In the case of *Paine v. Commissioner*, the taxpayers claimed a theft loss deduction for a decline in value of stock stemming from misrepresentations of the financial status of the corporation by corporate officials. The court noted that the taxpayers did not purchase the stock from the corporate officers who made the misrepresentations, but on the open market. In the 6th circuit case *MTS International Inc. v. Commissioner*, an individual taxpayer sold at a loss, stock that was acquired on a public stock exchange and argued that the substantial decline in value was due to criminal conduct by the corporation's officers. The Sixth Circuit concluded that the loss was not a theft loss. These decisions have been affirmed by other court cases and also by revenue ruling.

This is not to say that a theft loss is never allowed. There are situations where a theft loss is properly allowed. There are also situations where the loss is a capital loss. There are nuances involved in determining the timing of a worthless security. And Section 1244, mentioned earlier, has its technicalities. The office encourages you to be an active participant in our country's vibrant capitalism, but also encourages you to speak with the office about the tax ramifications of these investments. Hopefully, with help from the office you will sleep like an adult, not cry like a baby!

## **Uncertainty**

Much in tax law is clear. Much in tax law is unclear. Much is open to interpretation. And sometimes the simplest rules are subject to interpretation. This newsletter monthly explores both the law and the topic of flexibility, when pertinent. In a recent court case, *Allyson C. Briggs v. Commissioner*, T.C. Summary Opinion 2004-22, which you can find at <http://www.ustaxcourt.gov>, Ms. Briggs litigated an issue which resulted in an additional tax assessment by the IRS on her 1999 1040 in the amount of \$523. She represented herself and did a great job.

The issue is simple. Allyson filed her own tax return, even though her parents claimed her as a dependent. This filing situation is not unusual with students, who have sufficient income to require filing but who are still supported by their parents. As such, her tax return included all of her income, reduced by her standard deduction, but not reduced by her exemption amount, since the exemption amount was claimed on her parents' return. When such an individual files a tax return, the standard deduction he or she is entitled to is limited to the greater of \$750 (for 2003-less in 1999) or the amount of earned income, plus \$250, not to exceed \$4,750 (for 2003). Clearly, the higher standard deduction results in less taxable income, and a lower income tax liability. Remember that \$523 in tax was at stake. As tax court cases go, this was a small amount of tax, but to Allyson it was a great deal of money. And remember, the goal of filing a tax return is to complete the return properly and utilize all available benefits in the law you are entitled to legally.

### **Facts of the case**

She had wages of (rounding the figures) \$4,000, interest income of \$8,000, a Schedule C Business Loss of (\$4,000), and a capital loss of (\$3,000) for a total income of \$5,000. Using 2003 figures, what is the standard deduction? The IRS argued that the standard deduction should be \$750, since, the IRS stated, the earned income, upon which the standard deduction is based, is the NET of wage income of \$4,000 reduced by the Schedule C Business Loss of (\$4,000) for net earned income of zero. The greater of \$750 or the amount of earned income (\$0) plus \$250 is \$750. Ms. Briggs argued that her earned income was the wage income of \$4,000 which is not reduced, for purposes of the definition of earned income, by the Schedule C loss, so her standard deduction should be \$4,250, the earned income of \$4,000 from wages

plus \$250. If her standard deduction is \$4,250, then her taxable income is \$5,000 minus \$4,250 for a taxable income of \$750. If the IRS were correct, her taxable income would have been \$5,000 minus \$750 for a taxable income of \$4,250. She WON. The decision in the case hinged on the definition of earned income. Internal Revenue Code Section 63, which provides this special definition of the standard deduction, does not clearly define the term "earned income". Code Sections 32 and 911 both use the term "earned income", but the definitions in these two code sections are not consistent. The decision concluded that the Schedule C loss is not a reduction to wage income, for purposes of determining the limited standard deduction.

### **Can you benefit from this decision?**

If, in following the worksheet to determine the lower standard deduction, you included the Schedule C loss, you should consider filing an amended return, Form 1040X.

The tax law is neither simple nor always clear. The office appreciates assisting you with continued navigation of the tax law.

## **Worthless Stock**

The first article in this newsletter dealt with the topic of tax losses in general. This article addresses more specifically the problems involved in deducting the loss when stock is deemed worthless. The dot-com days are over but perhaps some of you are still holding onto those dot-com shares and hoping for a comeback. You may not want to wait much longer. According to IRS Publication 550 "Investment Income and Expense," worthless securities may result in a deductible loss.

### **What is a worthless security?**

Even if your securities (e.g., stocks, bonds, debentures, notes, etc.) have crashed significantly, down to pennies, you do not have a worthless security because it technically still has value. Even if the company has claimed bankruptcy, gone to receivership, stopped trading its shares or been inactive, it does not mean that its shares are worthless. More has to happen.

### **How to prove a security is worthless?**

There are instances when proving the security is worthless can be straightforward: The company issues a formal notification like a Form 1099-DIV which reflects a liquidating distribution. However this is not necessarily the norm. Often you will have to ascertain if the security is worthless. Since this process takes time, the IRS allows you to use hindsight. You can take up to seven years to make the determination, but the loss must be recognized in the year the stock was deemed to be worthless. For example, if a stock is deemed to have been worthless in Year 2003, you have until April 15, 2010 to amend your taxes for 2003 and claim the loss.

Although the IRS provides guidelines for determining when a security is worthless, the resulting conclusion is still subjective. It is not surprising that many deductions claimed on "worthless" securities have been denied by the IRS and contested in court.

In general, a loss can be claimed if there is no liquidating value in the stock and no foreseeable operation for the company. If you can prove that the company is insolvent and has ceased its operation or has sold most of its assets, you have a good chance of showing that the stock is worthless.

### **How to create a loss?**

As stated above, determining if a security is worthless takes time. One way to avoid the research of proving a security worthless and create an assured loss deduction is to sell the shares to your broker. Make sure they are actually sold and not simply transferred to your broker. A transfer with no consideration will jeopardize the deduction of your loss.

Another method to claim a loss deduction on a seemingly worthless security is to sell the security to a non-related party. This person can be anyone except your spouse, siblings [either whole or half-blood], ancestors, or lineal descendants. Thus your in-law or cousin could buy your shares for pennies. You will have to arrange with your broker to sign over the certificates to the new owner and create a bill of sale to demonstrate the shares were actually sold.

Assume you have sold your worthless stock to Cousin Lucky. Suddenly the company recovers and its shares skyrocket in value. You have at least kept the appreciation within your extended family and assured yourself a loss deduction. Selling your securities to your broker or a third party provides some instant rewards. It enables you to claim your loss without an IRS challenge. You can avoid the analysis and review of the company's financial statements to determine if its securities are worthless or not. This sale both saves you the time and assures you the loss.

### **Capital vs. ordinary loss**

In general, claims of worthless stock generate a capital loss. Whether the loss is short term or long term depends on when you purchased the shares. The "sale date" of your shares is deemed to be the last day of the taxable year in which they are deemed worthless.

Example. On December 10, 2002 you buy shares of Worthy Co. for \$5,000. On May 15, 2003, you receive a notification that the shares are worthless. In Year 2003 you can claim a long-term capital loss of \$5,000 (subject to the \$3,000 cap) even though you had held the shares less than 12 months. The term of the loss is determined by the length of time between the date of purchase and the deemed date of sale (the end of the taxable year), not the date the shares are determined worthless, i.e. May 15th.

If you need help determining whether or not a security is worthless, please contact Krebs Advisory Group. Remember that a determination that a security is worthless can ultimately be challenged by the IRS, but proper evaluation and planning can help insure your deduction.

Very Truly Yours,

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