

Abandonment and Worthlessness

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IRC § 165

- ▶ A deduction is allowed for losses sustained during the tax year and not compensated for by insurance or otherwise (§ 165(a)).
- ▶ Generally allows taxpayers to deduct, as an ordinary loss, the adjusted basis of those oil and gas interests that have been abandoned or have become worthless during the tax year.

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Requirements – Treas. Reg. § 1.165-1(b)

- ▶ To be deductible under Section 165(a), loss generally must be:
 - Evidenced by closed and completed transaction;
 - Fixed by identifiable events; and
 - Actually sustained during the taxable year.

Worthless deduction

- ▶ Worthlessness and abandonment are separate and distinct grounds for a loss deduction. *Echols v. Comm'r*, 950 F.2d 209 (5th Cir. 1991).
- ▶ A deduction for worthlessness is allowable only if there is:
 - (1) a closed and completed transaction,
 - (2) fixed by identifiable events establishing that the property is worthless in the taxable year the deduction is claimed. Rev. Rul. 2004-58, 2004-1 C.B. 1043.
- ▶ The test for worthlessness is a combination of (1) the taxpayer's subjective determination of worthlessness and (2) objective evidence supporting its determination. *Echols*, 950 F.2d at 213.

Abandonment loss– Treas. Reg. § 1.165–2(a)

- ▶ The regulation generally allows a loss deduction for nondepreciable property arising from the sudden termination of the property's usefulness in a business or transaction for profit where (1) the business or transaction is discontinued or (2) the property is permanently discarded from use.
- ▶ For this purpose, the taxable year that the loss is sustained is not necessarily the taxable year that the overt act of abandonment or loss of title to the property occurs.

Abandonment loss

- ▶ To deduct an abandonment loss under §165(a), the taxpayer must show:
 - (1) an intent on the part of the owner 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)
- ▶ Nonuse alone is insufficient to establish abandonment. *Beus v. Comm'r*, 261 F.2d 176, 180 (9th Cir. 1958).

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