

Standard
Federal Tax: Deductions for Losses; 1972 Federal Tax Report, c. 1964
Report

DEDUCTIONS FOR LOSSES

[§ 1505]

LOSSES

Sec. 165 [1954 Code]. (a) **GENERAL RULE.**—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) **AMOUNT OF DEDUCTION.**—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) **LIMITATION ON LOSSES OF INDIVIDUALS.**—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds \$100. For purposes of the \$100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) **WAGERING LOSSES.**—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) **THEFT LOSSES.**—For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) **CAPITAL LOSSES.**—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) **WORTHLESS SECURITIES.**—

(1) **GENERAL RULE.**—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) **SECURITY DEFINED.**—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) **SECURITIES IN AFFILIATED CORPORATION.**—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) stock possessing at least 80 percent of the voting power of all classes of its stock and at least 80 percent of each class of its nonvoting stock is owned directly by the taxpayer, and

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(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom. As used in subparagraph (A), the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(h) DISASTER LOSSES.—Notwithstanding the provisions of subsection (a), any loss

(1) attributable to a disaster which occurs during the period after the close of the taxable year and on or before the last day of the 6th calendar month beginning after the close of the taxable year, and

(2) occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1970.

at the election of the taxpayer, may be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred. Such deduction shall not be in excess of so much of the loss as would have been deductible in the taxable year in which the casualty occurred. If an election is made under this subsection, the casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed.

(i) CERTAIN PROPERTY CONFISCATED BY THE GOVERNMENT OF CUBA.—

(1) TREATMENT AS SUBSECTION (c)(3) LOSS.—For purposes of this chapter, in the case of an individual who was a citizen of the United States, or a resident alien, on December 31, 1958, any loss of property which—

(A) was sustained by reason of the expropriation, intervention, seizure, or similar taking of the property, before January 1, 1964, by the government of Cuba, any political subdivision thereof, or any agency or instrumentality of the foregoing, and

(B) was not a loss described in paragraph (1) of subsection (c), shall be treated as a loss to which paragraph (3) of subsection (c) applies. In the case of tangible property, the preceding sentence shall not apply unless the property was held by the taxpayer, and was located in Cuba, on one or more days in the period beginning on December 31, 1958, and ending on May 16, 1959.

(2) SPECIAL RULES.—

(A) For purposes of subsection (a), any loss described in paragraph (1) shall be treated as having been sustained on October 14, 1960, unless it is established that the loss was sustained on some other day.

(B) For purposes of subsection (a), the fair market value of property held by the taxpayer on one or more days during the period beginning on December 31, 1958, and ending on May 16, 1959, to which paragraph (1) applies, on the day on which the loss of such property was sustained, shall be its fair market value on the first day in such period on which the property was held by the taxpayer.

(C) For purposes of section 172, a loss described in paragraph (1) shall not be treated as an expropriation loss within the meaning of section 172(b).

(D) For purposes of section 6601, the amount of any tax imposed by this title shall not be reduced by virtue of this subsection for any period prior to February 26, 1964.

(j) CROSS REFERENCES.—

(1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g)(2)(C) applies, if issued by a political party or similar organization, see section 271.

(3) For special rule for losses on stock in a small business investment company, see section 1242.

(4) For special rule for losses of a small business investment company, see section 1243.

(5) For special rule for losses on small business stock, see section 1244.

.01 Amended by P. L. 92-336, P. L. 91-687, P. L. 91-677, P. L. 91-606, P. L. 88-348, P. L. 88-272, P. L. 87-426 and P. L. 85-866. For details, see the Code Volume.

Committee Report on P. L. 91-677

I. Summary

.03 The bill as passed by the House amends the provisions of the tax laws relating to the deduction of Cuban expropriation losses of individuals to permit the carryback and carryover of losses of an individual resulting from the Cuban expropriation of investment property. Under present law, Cuban expropriation losses of an individual may generally be carried forward if they are attributable to property used in his trade or business, or carried back and forward if they are attributable to property held by him for personal use.

The bill as passed by the House also modifies the requirement under this provision of present law that the expropriated property must have been held by the taxpayer in Cuba on December 31, 1958. Under the modified requirement the property must have been held at some time during the period from December 31, 1958, through May 16, 1959. The modified requirement applies to personal-use property under present law, as well as to investment property under the bill. A trade or business expropriation loss, however, may be deducted when sustained without regard to these time limitations.

Claims for refund arising under the provisions of the bill may be filed between the date of enactment of the bill and July 1, 1971, even though they would otherwise be barred by the statute of limitations.

The committee accepted the House-passed provision without change. In addition, it added an amendment to the bill to increase the net operating loss carryover period for Cuban expropriation losses from 10 to 15 years.

The Treasury Department has indicated that it does not oppose the enactment of this bill, as amended.

II. Reasons for Bill

Losses on investment property and time of loss

Under present law (sec. 172), net operating losses may be carried back 3 years and carried forward 5 years to offset income of the taxpayer. Net operating losses arising from expropriation by a foreign government may not

be carried back, but they may be carried forward 10 years. However, in the case of individuals, these provisions are fully applicable, in effect, only to losses incurred in the taxpayer's trade or business.

A special rule (sec. 165(l)) is provided for losses resulting from expropriation by the Cuban Government of property of an individual held for personal use, such as his residence. If the individual was a citizen or resident of the United States on December 31, 1958, any Cuban expropriation loss sustained before January 1, 1964, which was not a trade or business loss or an investment loss is treated as a casualty loss and therefore may be carried back 3 years and carried forward 5 years. (The special rule specifically provides that it may not be carried forward 10 years as a foreign expropriation loss.) If the property is tangible property, it must have been held by the taxpayer and located in Cuba on December 31, 1958.

An individual's losses on investment property (that is, property held for the production of income not in connection with a trade or business) may not be carried back or carried over under the regular net operating loss provision (sec. 172) except to the extent the individual has investment income. However, investment losses normally are capital losses, since they arise from the sale or exchange of capital assets, and as such they may be carried back or carried over under the capital loss carryback and carryover provisions (sec. 1212).

On the other hand, foreign expropriation losses of investment property are treated as ordinary losses and not as capital losses, since they are not considered as resulting from a sale or exchange. As a result there is no carryback or carryover of such losses except to the extent the taxpayer has investment income.

The committee agrees with the House that it is anomalous that unused Cuban expropriation losses of business property and personal-use property may be carried to other taxable years (under sec. 172) but unused Cuban expropriation losses of investment property cannot. There appears to be no reason why, if carrybacks and carryovers are to be allowed for expropriation losses of personal-use property, that they should not be allowed for expropriation losses of investment property, a class of property more closely related to business property, with respect to which losses have traditionally been accorded carryback and carryover treatment.

¶ 1505.03—Continued

The committee is also concerned with the situation of a taxpayer who acquired property after December 31, 1958, but before the Cuban Government initiated its widespread policy of expropriation. This problem applies both to personal-use property under present law and investment property under the bill. (A trade or business expropriation loss already is eligible for the 10-year expropriation loss carryover even if the property was acquired after December 31, 1958).

15-year loss carryover for trade or business losses

In 1964, Congress permitted taxpayers to substitute, on an elective basis, a 10-year carryover period for the usual 3-year carryback and 5-year carryover period. This was done because it was recognized that foreign expropriations, particularly the then recent Cuban expropriations, often represent larger than normal losses for which the usual 8-year carryback-carryover period was inadequate. It has come to the attention of the committee that because of the magnitude of the losses sustained as a result of Cuban expropriations, some taxpayers—particularly small businesses not generating large annual incomes—have been unable to offset their expropriation losses against their income in the 10-year carryover period. Because of this the committee believes that it is appropriate to extend the carryover period further in the case of Cuban expropriation losses.

III. Explanation of Bill

Loss on investment property and time of loss

The bill generally provides that Cuban expropriation losses of individuals with respect to investment property are to be treated in the same way as Cuban expropriation losses of individuals with respect to personal use property under present law—that is, as casualty losses which may be carried back and carried over under the net operating loss provisions.

As in the case of expropriations of personal-use property, an investment property loss is to be treated as having been sustained on October 14, 1960, unless it is established that it was sustained on some other day, and the normal 3-year carryback and 5-year carryover rule is to apply (rather than the 10-year carryover rule applicable to foreign expropriation losses incurred in a trade or business).

The bill provides that for purposes of determining whether investment property qualifies for casualty loss treatment, the property must have been held by the taxpayer in Cuba on one or more days during the period beginning on December 31, 1958, and ending on May 16, 1959. The bill also changes the provision of present law, which requires personal-use property to be held by the taxpayer in Cuba on December 31, 1958, in order to qualify for casualty loss treatment. The amendment permits personal use property to qualify if it was held on one or more days during the period beginning on December 31, 1958, and ending on May 16, 1959. For example, if a taxpayer acquired a residence in Cuba in February 1959, he could qualify for casualty loss treatment with respect to a later expropriation of the residence.

For purposes of determining fair market value of personal-use property or investment property which receives casualty loss treatment, the bill

provides that the fair market value is to be determined on the first day in the period beginning on December 31, 1958, and ending on May 16, 1959, on which the property was held by the taxpayer.

The bill also provides that, notwithstanding any law or rule of law, refund or credit of any overpayment attributable to the amendments made by the bill, may be made or allowed if a claim for refund or credit is filed after the date of enactment of the bill [January 12, 1971] and before January 1, 1971 [July 1, 1971]. This provision permits a taxpayer to file a claim for refund or credit for otherwise closed years (1) with respect to expropriated investment property, and (2) with respect to personal-use property acquired and held in Cuba after December 31, 1958, and on or before May 16, 1959, since casualty loss treatment is not available for expropriations of such property under present law. No interest is to be allowed on these refunds or credits for any period before January 1, 1972.

15-year carryover for trade or business losses

Under an amendment added by the committee, the net operating loss carryover period for Cuban expropriation losses is increased from 10 to 15 years. The carryover period for expropriation losses other than those incurred in Cuba remains at 10 years. Both the 10-year period for expropriations generally and the new 15-year Cuban expropriation loss carryover are available only for losses incurred in a trade or business.

For purposes of the provision added by the committee a net operating loss for a taxable year is considered to be attributable first to any Cuban expropriation losses for the taxable year up to the amount of these losses, then to other foreign expropriation losses up to the amount of these losses. In other words, income for a year is first offset by ordinary losses and deductions, then by non-Cuban expropriation losses, and finally by Cuban expropriation losses. A similar result is achieved when a net operating loss is carried over and partially absorbed in a taxable year. In this case, the amount of the carryover attributable to ordinary net operating losses is considered to be absorbed first, the amount attributable to foreign expropriation losses other than Cuban expropriation losses is considered to be absorbed next, and the amount attributable to Cuban expropriation losses is considered to be absorbed last. These rules have the effect of preserving as carryovers those losses to which the longest carryover period applies.

The amendments made by provision of the bill are to apply with respect to foreign expropriation losses sustained in taxable years ending after December 31, 1958.—Senate Committee Report.

Committee Report on P. L. 91-687

I. Summary

.04 H. R. 19369, in general, reduces from 95 percent to 80 percent the amount of stock a parent corporation must own in a subsidiary corporation in order to claim an ordinary loss deduction for the stock it holds in the subsidiary corporation if this stock becomes worthless. The same percentage ownership requirement presently applies where a parent corporation desires to file a consolidated income tax return with a subsidiary.

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This bill is unanimously reported by your committee and its enactment is not opposed by the Treasury Department.

II. Reasons for Bill

Under present law, a corporation whose stock or securities in a subsidiary company become worthless is allowed an ordinary loss deduction, rather than the capital loss treatment generally provided for worthless securities. However, a company is considered a subsidiary company for this purpose only if the parent corporation owns at least 95 percent of each class of the subsidiary's stock. Despite this treatment under the worthless stock provision, in determining when a parent company may file a consolidated income tax return with its subsidiary, present law provides a substantially lower percentage ownership test. For this purpose, a company is considered a subsidiary company if the parent corporation owns 80 percent, rather than 95 percent, of the subsidiary's voting power and each class of the subsidiary's nonvoting stock.

When the ordinary loss treatment for securities of a subsidiary company which become worthless was originally enacted in 1942, Congress indicated it was providing this treatment since (at that time) a consolidated income tax return could be filed by a parent and its subsidiary companies where the parent had a 95-percent ownership interest in the subsidiaries. In these cases the concept was that the companies were considered closely enough related, in effect, to treat them as one operating business. In the case of consolidated return treatment, the losses of one may be offset against the income of the other. In the case where the securities of the subsidiary company become worthless, following the same concept, the loss, in effect, is regarded as a loss of part of the business of the parent corporation rather than as a loss on an investment.

The Internal Revenue Code of 1954 reduced the required ownership which must exist for companies to file consolidated returns from 95 percent to 80 percent. A similar change, however, was not made in the ownership requirement which applies in the case of the ordinary loss deduction allowed for worthless securities

of a subsidiary company. Since an 80-percent control interest is considered an appropriate degree of relation for purposes of treating two or more corporations as one business under the consolidated return provisions of the tax law, the committee believes it also is appropriate to reduce the required ownership for ordinary loss treatment of worthless stock and securities of a subsidiary company from 95 percent to 80 percent. Accordingly, the bill generally conforms the ownership requirement under the worthless securities provision to that which applies in the case of consolidated returns.

III. Explanation of Bill

The bill amends the provision in the tax laws (sec. 165(g)(3)) allowing a corporation ordinary loss treatment for its holdings of stock or securities of a subsidiary company which become worthless, by substituting an 80-percent ownership requirement for the present 95-percent requirement. As a result, ordinary loss treatment is to be available to a parent company for its holdings of securities in a subsidiary which become worthless if the parent company directly owns at least 80 percent of the voting power of all classes of the subsidiary's stock and at least 80 percent of each class of the subsidiary's nonvoting stock. For purposes of this ownership test, nonvoting stock which is limited and preferred as to dividends is not taken into account.

The amendments made by this bill are to apply to taxable years beginning on or after January 1, 1970.—House Committee Report.

.05 The Conference Committee Report on P. L. 88-348 are at 1964-2 CB 594.

.07 Committee Reports on P. L. 88-272 are at 1964-1 (Part 2) CB 125, 505 and 774.

.20 Committee Reports on 1954 Code Sec. 165 as originally enacted were reproduced at 561 CCH ¶ 1512.10, 1512.15, and 1512.20.

• Regulations

[¶ 1520] § 1.165-1 Losses.—(a) *Allowance of deduction.* Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see § 1.271-1.

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) *Amount deductible.* (1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by § 1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition

