

Worthless Investments - Not Ideal, but There Is a Silver Lining

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While minimizing tax exposure is by no means a unique planning goal, there has been an increased interest in discussing certain strategies. One of many tax concepts that have been highlighted recently is the topic of how worthless investments work and play into the planning discussion.

When there is a decrease in the stock market, such as the one triggered in the early days of the coronavirus pandemic, investors may see a reduction in the value of their

portfolios. In some cases, the result could be unrealized capital loss positions or investments which are deemed worthless. In the case of worthless investments, there could be an ability to use these losses to offset certain other income.

Marketable securities and other investment vehicles are capital assets, which, when sold, generate capital gains or losses. Realized capital gains and losses in a given year are netted – short-term gains against short-term losses and long-term gains against long-term losses, with net short-term and net-long term amounts netted. If there are net losses, up to \$3,000 may be used to offset ordinary income (\$1,500 for married taxpayers filing separately). Any realized capital loss in excess of this amount may be carried forward to future years, until it is fully utilized.

Another way of recognizing a loss on an investment is if the investment is deemed worthless. This occurs when the investment has no liquidation value because its assets are worth less than its liabilities, and there is no potential future value, because the investment has no reasonable hope of becoming profitable. The amount deemed worthless is the investor's tax cost in the investment. The entity that is the subject of the investment does not have to be in formal bankruptcy to support worthlessness; the liquidation of the assets to pay off creditors may be sufficient to establish worthlessness. This can be complicated to substantiate and should be discussed with your tax advisor.

In order to not have to prove that an investment security became worthless during the year, it may be sold to an unrelated third party. A bona fide transaction in which the taxpayer transfers ownership at a loss should allow a capital loss to be claimed in the year of the transfer.

In many cases, finding a buyer can be difficult. For instance, if an investment in a publicly traded security results in a loss, and the security is not regularly traded, it becomes difficult to determine when the security becomes worthless. Sometimes a broker will purchase the security for a token amount, as little as \$1, ensuring that the security is delivered out of the investor's account and allowing a loss to be recognized. As an alternative, the worthless investment may be abandoned. Abandonment occurs when all rights of ownership are surrendered. The loss on these investments may be classified as capital or ordinary losses depending on

whether certain qualifications are met. Certain investments qualify as small business stock. Some small business stock losses are eligible for ordinary loss treatment as opposed to capital loss treatment. To determine whether or not you qualify, consult your tax advisor.

If you are evaluating whether an investment has become worthless for tax purposes or want to discuss this topic further, please contact your Anchin Relationship Partner or Susan Fludgate and Jordan Reback, members of Anchin Private Client, at 212.840.3456 or info@anchin.com.