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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR District Counsel,

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =
State A =
State B =
Region C =
Year 1 =

ISSUE:

Whether the effect of section 601 of the Federal Aviation Administration (FAA) Authorization Act of 1994, on taxpayer's intrastate operating authorities entitles taxpayer to a deductible loss under I.R.C. § 165.

CONCLUSION:

Despite arguments supporting disallowance, where total economic regulation is eliminated and only a general business or vehicular regulation remains, i.e, where there is no significant industry or activity specific regulation, litigating this issue is not recommended.

<u>FACTS:</u>

X (taxpayer), a State A corporation, is engaged in the transportation of goods by truck throughout Region C. Prior to 1995, in order to operate its trucks within a particular state's borders, taxpayer was required to maintain state issued operating authorities for each state in which its trucks regularly traveled. In general, these operating authorities specified various terms and conditions for operating within the issuing state, including the routes that could be traveled, the loads that could be carried and the prices that could be charged for services. Maintaining these authorities further required that carriers abide by applicable state rules and regulations relating to insurance, safety and licensing requirements. Prior to January 1, 1995, taxpayer held operating authorities in State A and State B. These operating authorities were freely transferable, non-depreciable and had a combined basis to taxpayer of $.[1]

Effective January 1, 1995, the Federal Aviation Administration Authorization Act of 1994, 49 U.S.C. § 11501 (1994), (the Act), preempted the states' power to "enact or enforce a law, regulation, or other provision having the force and effect of law related to a price, route, or service of any motor carriers with respect to the transportation of property." This federal prohibition did not extend to the transportation of household goods. While eliminating all economic regulation, the Act did not preclude all state regulation of motor carriers. Congress provided that states may continue to regulate safety, truck routing by size and weight, insurance coverage, and hazardous materials routing. 49 U.S.C. § 11501(h)(2). Moreover, Congress indicated that this list of noneconomic items was not exclusive, but rather was an enumeration of "some of the matters which are not 'prices, rates or services' and which are therefore not preempted." H.R. CONF. REP. NO. 677, 103d Cong., 2d Sess. 84 (1994). Additionally, a carrier may elect to be subject to further state regulation regarding certain uniform business practices, including cargo liability, bills of lading, credit rules and antitrust immunity for joint lines. Like pre-deregulation requirements, actual post-deregulation requirements vary by state. Before January 1, 1995, State A regulated various aspects of a motor carrier's operation, including safety, tariffs, routes, and insurance. Since January 1, 1995, State A continues to regulate carriers as to issues of safety and insurance. With

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[1] I.R.C. § 197(a) and (d)(1)(D) permit amortization of the costs of acquiring certain property, including licenses, permits, and other rights granted by governmental units, agencies or instrumentalities if the property in issue was acquired by the taxpayer after July 25, 1991, and on or before August 10, 1993. None of taxpayer's operating authorities were purchased during this period.

respect to pre-deregulation operating authorities, State A eventually issued new permits to carriers whose operating authorities were in good standing. Recognizing that it would be administratively infeasible to issue new permits to all holders of authorities by the effective date of the Act, the state treated certain qualifying operating authorities as "interim permits" effective from January 1, 1995 until a new permit was issued. On , the State A Regulatory Agency issued canceling then-existing operating authorities and simultaneously recognizing interim permits. To qualify for an interim permit, an existing carrier had to satisfy three requirements: (1) continuation in the business of transporting property, (2) compliance with pertinent law and regulation (i.e., proof of insurance and a satisfactory safety fitness review), and (3) demonstration that its pre-deregulation operating authorities were in good standing. State A Code[2].

Before January 1, 1995, State B regulated various aspects of a motor carrier's operations, including safety, services (must be required by public convenience or necessity, and not damaging to the highway or highway traffic), rates, schedules or contracts, highway use taxes and insurance. After [3], State B continued to maintain safety, insurance and highway use tax regulations. State B also established optional regulations related to cargo liability, cargo credit, bill of lading, joint line rates, mileage guides and commodity classifications. After deregulation State B required all carriers to obtain a new permit. To obtain the new permit, carriers holding operating authorities on January 1, 1995 were required only to file an application and safety plan with the State B Regulatory Agency.

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Taxpayer's C.P.A. initially indicated that taxpayer surrendered its authorities to the issuing states after the Act became effective, but taxpayer's counsel has subsequently denied knowledge of this transaction. It is noteworthy that neither State A nor State B required that operating authorities be surrendered.

On its Year 1 income tax return the taxpayer claimed a deduction for its basis in its State A and State B operating authorities.

LAW AND ANALYSIS

In general, I.R.C. § 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise.

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[2] contained the "emergency rules" in force from to , the effective date of the final rules.

[3]On , State B passed which conformed State B intrastate transportation regulations to the requirements of the Act.

Only a bona fide loss is allowable. To qualify as "bona fide," the loss must be evidenced by closed and completed transactions and fixed by identifiable events. Treas. Reg. § 1.165-1(b). Only losses "actually sustained" during the taxable year are deductible. Mere book entries or charge-offs do not establish a loss. A taxpayer is not entitled to a section 165 deduction for income anticipated but not received. Ordinary income actually received may not be reduced by the amount of income a taxpayer fails to receive. Nor may a deduction be claimed for profits that will never be reported. See generally, Hort v. Commissioner, 313 U.S. 28 (1941)(difference between value of canceled lease and amount received for cancellation not a deductible loss); J.G. Boswell Co. v. Commissioner, 34 T.C. 539 (1960) aff'd, 302 F.2d 682 (9th Cir. 1962); Greenway v. Commissioner, T.C. Memo. 1980-97; Carroll v. Commissioner, T.C. Memo. 1981-347.

To be entitled to deduct an abandonment loss a taxpayer/owner must satisfy a two prong test: (1) an intention on the part of the owner to abandon the asset, and (2) an affirmative act of abandonment. United States v. SS. White Dental Manufacturing Co., 274 U.S. 398 (1927); A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990).

The existence of each prong must be ascertained from all the surrounding facts and circumstances. Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220, 225 (1972). In showing an intent to abandon such manifestation must set to rest the possibility of future use of the abandoned property. Citizens Bank of Weston v. Commissioner, 252 F.2d 425, 428 (4th Cir. 1958). Neither intent nor non-use alone is sufficient to accomplish abandonment. Citron v. Commissioner, 92 T.C. 200, 210 (1991). The concept of abandonment is not limited to tangible property, Citron v. Commissioner, 97 T.C. 200 (1991); Echols v. Commissioner, 93 T.C. 553 (1989), rev'd, 935 F.2d (5th Cir. 1991). Whether tangible or intangible the same principles and analysis apply. Id.

Treas. Reg. § 1.165-2(a) specifically allows a deduction for a loss arising from the sudden termination of the usefulness of any non-depreciable business property or the permanent discarding of the property. Therefore, to establish that it is allowed a deduction under I.R.C. § 165, taxpayer must establish that its operating authorities became worthless or that it abandoned those authorities and that its loss is evidenced by closed and completed transactions, fixed by identifiable events and actually sustained during 1994.

The tax consequences of federal deregulation has been addressed in Rev. Rul. 84-145, 1984-2 C.B. 47, considering whether a commercial air carrier sustained a deductible loss arising from the deregulation of the airline industry. Prior to deregulation, the air carrier incurred considerable expense to obtain route authorities permitting it to service specific geographic regions. To obtain its route authorities, the air carrier was required to apply to the Civil Aeronautics Board (CAB) and demonstrate that it was fit, willing, and able to perform the services for which it sought the authorities. The carrier was also required to demonstrate to the CAB that it conformed to applicable rules and regulations, and that its services were required by public convenience and necessity. Deregulation significantly reduced the requirements air carriers must satisfy to obtain route authorities. These reduced requirements had the effect of increasing competition to service specific routes and, therefore, decreasing the value to the taxpayer of its route authorities.

In considering whether the taxpayer could deduct the value of its route authorities, Rev. Rul. 84-145 relies upon two cases. It first refers to Reporter Publishing Co., Inc. v. Commissioner, 201 F.2d 743 (10th Cir. 1964), cert denied, 345 U.S. 993 (1953), wherein the court held that the taxpayer, a newspaper publisher, did not sustain a deductible loss as a result of the Supreme Court’s holding that the by-laws of the Associated Press (which granted the taxpayer exclusive access to local Associated Press news gathering facilities) violated the Sherman Anti-Trust Act.

After the Supreme Court's decision, other news organizations could not be denied Associated Press membership. The taxpayer claimed a deduction for the value of its Associated Press membership on the basis that the Supreme Court's decision completely destroyed the value of the membership. While acknowledging that the value of the asset (membership in Associated Press) had diminished, finding that the taxpayer continued to use the Associated Press and enjoy the other benefits available through its membership, the court concluded that the asset was not worthless. In sustaining the Service’s denial the court stated ,"[a] taxpayer is not chargeable with a capital gain resulting from an enhanced value of a capital asset while it is still being used in the business; neither may he take a deduction from gross income because of the diminution in value of such an asset while it is still a part of the business and is being used in the business." Reporter Publishing Co., Inc. at 744**.**

Rev. Rul. 84-145 also relies upon Consolidated Freight Lines v. Commissioner, 37 B.T.A. 576 (1938), aff'd, 101 F.2d 813 (9^{th} Cir. 1939), cert. denied, 308 U.S. 562 (1939). In this case, Consolidated Freight Lines (CFL), an operator of trucking lines, had purchased several freely transferable certificates of public convenience and necessity. These certificates were issued by the Washington Department of Public Works (later the Department of Public Service) pursuant to a 1921 law. The certificates permitted CFL to operate its trucking lines over specified routes within the State of Washington. Prior to deregulation, the franchise to transport freight over specified routes conferred by an operating authority were extremely valuable to the holder.

In 1934, legislation became effective which abolished the exclusive character of the certificates. As under prior law, the 1934 legislation required carriers to obtain certificates of public convenience and necessity, i.e., new certificates. Also, as under prior law, the new certificates were freely transferable. Operators that held certificates issued under the 1921 law were, however, permitted to continue to operate under those certificates "in the same manner and to the same effect as if such certificates were [new certificates]." CFL was not required to obtain a new certificate.

The taxpayer, claiming that the operating rights certificates of convenience and necessity were worthless as a result of the new law's repealing the monopolistic characteristics the certificates enjoyed under prior law, sought a deduction for the cost of the operating rights. While agreeing with the taxpayer that the new statute destroyed its monopolistic rights, the Board of Tax Appeals denied the deduction, explaining that the monopolistic character of the certificates was not separable from the right to operate a business and, therefore, did not have a value separable from the value of the right to operate a business.

The United States Court of Appeals for the Ninth Circuit affirmed the Board's decision, noting that a monopoly was not granted by the operating rights certificates, but rather sprang from the old law. The certificates were merely a means by which a carrier might take advantage of the monopoly conferred by the statute. Contrasting this situation with that faced by saloons as a result of prohibition, wherein prohibition led to the complete cessation of the taxpayers' businesses, the court noted that CFL continued to operate its business despite changes in the character of its certificates. After "assuming" that the monopolistic features of the certificates had some value apart from the operating rights they conferred, and that those monopolistic features were destroyed by the 1934 legislation, the court held that CFL was not entitled to a deductible loss as it had not established what proportion of the certificates' cost was attributable to the monopolistic features.

Based on <u>Reporter Publishing</u> and <u>Consolidated Freight Lines</u>, Rev. Rul. 84-145 concludes that the air carrier did not sustain a deductible loss due to the devaluation of its route authorities after deregulation. Specifically, the carrier's route authorities were not worthless, and its loss was not evidenced by closed and completed transactions fixed by identifiable events. The carrier, like RPC and the taxpayer in the instant case, owned an asset having operating rights undividable from its monopolistic features. As in each of these cases, an event subsequently destroyed the monopolistic features of the asset, but left the operating rights intact. There is little doubt the carrier, like RPC and the taxpayer, would receive little or no return on the sale of its asset. This result indicates not that the asset's operating rights are worthless, but that the value of those rights is no more than the sum of the costs of procuring the asset directly from the original source (e.g., obtaining an operating authority from the state, rather than from an existing carrier). Unless the monopolistic features of the authorities are separated from their operating rights, the operating rights must be worthless before the authorities can be worthless. Additionally, because the carrier, like RPC, continued to use the operating rights of the route authority after its monopolistic features were destroyed, there was no closed and completed transaction.

Subsequent to the publication of Rev. Rul. 84-145, the issue arose in CRST, Inc. v. Commissioner, 92 T.C. 1249 (1989), wherein the taxpayer sought an abandonment loss as a result of the enactment of the Motor Carrier Act of 1989, Pub. L. No. 96-296, 94 Stat. 793. As a result of that legislation, the interstate motor carrier industry underwent substantial deregulation. Prior to 1980, the taxpayer, a motor carrier engaged in the interstate transportation of goods, obtained numerous operating authorities. Authorities were difficult to acquire during this period because a carrier seeking an operating authority was required to demonstrate to the Interstate Commerce Commission (ICC) that its services were necessary. Moreover, existing carriers had the right to intervene and oppose applications for new authorities. In 1980, legislation became effective requiring the ICC to issue new authorities unless existing carriers could demonstrate that such action was unnecessary. Easier access to operating authorities had a "dramatic deleterious effect" upon the resale value of CRST's authorities. CRST at 1254. CRST subsequently applied for a new national authority to replace its existing operating authorities. Its board of directors, therefore, decided to abandon the old authorities and the taxpayer deducted the value of these authorities on its federal income tax return. The Internal Revenue Service disallowed this deduction.

The Tax Court held that CRST was not entitled to deduct the value of its old authorities. As in Consolidated Freight Lines v. Commissioner, supra, the court indicated that CRST could not split its operating authorities into monopolistic features and operating rights such that the elimination of one characteristic constitutes a closed and completed transaction. The court also addressed CRST's argument that it had abandoned its operating authorities. Explaining that abandonment requires an intent to abandon the asset and an affirmative act of abandonment, the court found that CRST had satisfied neither requirement. In affirming the Tax Court's decision, the Eighth Circuit noted that CRST claimed to have abandoned its existing operating authorities before it received, and without knowing if or when it would receive, its national authority. Moreover, CRST continued its operations along various routes specified in the supposedly abandoned authorities.

While the arguments supporting disallowance of the deduction are sound, they are not above challenge. Indeed, several of the counter arguments made by taxpayer's counsel and the national trucking association are not without merit.

Distinctions between the 1994 Act and prior deregulation may justify a different legal conclusion from that in CRST, supra. Under the Motor Carrier Act of 1980, Pub. L. No.96-296, 94 Stat. 793, carriers were still required to obtain operating authorities from the ICC in order to haul freight in a specific market. However, whereas new applicants formerly had the burden of proving the public necessity of the authority sought, new authorities would now be issued by the ICC absent a showing by an existing carrier that it was unnecessary. Facilitating the ability to enter the market by making it easier to obtain the needed authority, resulted in the diminution of value of existing authorities. While it may have opened up competition and eased the regulatory burden, industry specific economic regulation was not eliminated and thus operators had a continuing need to maintain their operating authorities. Here however, it is precisely the states' authority to economically regulate that has been abolished by federal law. Thus, this is not a case of the state issuing more operating authorities thereby diluting their value, rather now the states have no power to grant such operating authorities at all.

The nature of the regulatory change wrought by federal preemption may also be distinguished from that of the Airline Deregulation Act of 1978, Pub. L. No. 95-5004, 95th Cong., 2d Sess., at issue in Rev. Rul. 84-145, likewise supporting a contrary conclusion to that of the revenue ruling. Whereas, the deregulation achieved by previous legislation reduced the restrictions on competition, here restrictions on competition have been eliminated.

While not necessarily determinative for tax purposes, we note that the legislative history of the 1994 Act acknowledges that the legislation will "eliminate the asset value of the operating authority." H.R. CONF. REP. NO. 677, 103d Cong., 2d Sess. 88-89 (1994). The awareness that deregulation would result in genuine economic loss, coupled with the failure of the legislature to provide a specific remedy as it had done previously in ERTA[4], could be interpreted as evidence that Congress expected that relief would be provided under section 165.

As noted above, actual post-deregulation requirements vary by state. The variety of state regulatory schemes after deregulation presents another significant concern. A number of states subsequently enacted legislation abolishing the need to possess any form of business license in order to operate within state boundaries. There is no question that in those jurisdictions taxpayers could abandon the

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[4] [redacted]

operating authority as worthless and claim a deduction under I.R.C. § 165[5]. Thus, while the effect of federal law prohibiting economic regulation by the states was uniform throughout the industry, i.e., holders of authorities experienced an economic loss, allowing the deduction in some jurisdictions and not others would arguably treat similarly situated taxpayers differently.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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[redacted]

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