Office of Chief Counsel
Internal Revenue Service

Memorandum

Number: **201552026**
Release Date: 12/24/2015

CC:CORP:BO5:
POSTS-123210-15

UILC: 165.06-00, 165.11-00, 351.05-00, 351.15-00

date: August 12, 2015

to:

AP:SO:ATCL:Team 3

from:

General Attorney
(Corporate)

Special Counsel
(Corporate)

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subject: Response to Taxpayer's May 20, 2015 letter regarding §165(g)(3).

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Tax Professional =

Parent =

Subsidiary =

Business =

Agency 1 =

Agency 2 =

A =

Status Letter =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

This letter responds to your request for advice regarding a letter from Tax Professional, dated May 20, 2015. Specifically, you requested our opinion as to Tax Professional's argument that the Subsidiary stock could become worthless for purposes of claiming an ordinary deduction under §165(g)(3). We conclude that Taxpayer's argument is without merit and we would deny the claim of a deduction under §165(g)(3).

Summary of relevant facts

Taxpayer is an S corporation holding company that owns Subsidiary, a qualified subchapter S subsidiary ("QSub"), that operates regulated Business. In Year 1, Subsidiary's Business operations were depressed and Agency 1 issued Subsidiary a Status Letter. In Year 2, Agency 1 appointed Agency 2 as receiver of Subsidiary after finding that Subsidiary was in an unsafe and unsound condition to transact business. Based on this downturn, it appears that Taxpayer and its shareholders wanted to maximize and pass-through Subsidiary's losses in Year 1, before Agency 1 placed Subsidiary in receivership. Specifically, Taxpayer wanted to recognize a $A loss realized by Subsidiary and have that loss flow-through to its shareholders as an ordinary loss.

As an S corporation holding company owning a QSub, Taxpayer has several obstacles to overcome in order to pass-through an ordinary deduction to its shareholders. A QSub is a disregarded entity, that is, it is not treated as a separate corporation for federal income tax purposes, even though it remains a separate legal entity under state law. Instead, all of a QSub's assets, liabilities, items of income, deduction and credit are treated as items of the parent S corporation. With Taxpayer's initial structure the shareholders primarily had three ways to recognize a loss, none of which resulted in a $A ordinary loss:

(1) have the shareholders take a worthless stock deduction on their S corporation shares, resulting in a capital loss (assuming qualification under §165(g)(1));

(2) have the shareholders sell their shares to a third-party for a nominal arm's length price, resulting in a capital loss (assuming someone would buy a "worthless" S corporation); or

(3) have the S corporation sell the Subsidiary stock (treated as a deemed asset sale) or assets to a third-party for an arm's length price which could result in a mix of ordinary and capital loss (depending on the character of the assets held by Subsidiary).

In an attempt to qualify its shareholders for ordinary loss treatment for the full amount of their investment, Taxpayer affirmatively terminated its S corporation status effective Date 2. As a result, Subsidiary's QSub status also terminated. Under Reg. §1.1361-5(a)(1)(ii), if an S corporation parent's status as an S corporation terminates by revocation, the QSub's status of its QSubs terminate at the close of the last day of the parent's last taxable year as an S corporation. Regulation §1.1361-5(b)(1)(i) details the effect of such a QSub termination: "If a QSub election terminates …, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation." Thus, on Date 2 Taxpayer's S election terminated, and on Date 1, immediately before Taxpayer's election terminated, Subsidiary's QSub election terminated and it became a C corporation.

Section 165(g)(3) provides that for purposes of §165(g)(1), any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset. Put simply, an ordinary loss may be generated from the worthlessness of the stock notwithstanding that the stock otherwise is a capital asset if the affiliation and gross receipts tests are satisfied. Under §165(g)(3), a corporation is treated as affiliated with the taxpayer if, (1) the taxpayer owns directly stock in that corporation meeting the requirements of §1504(a)(2); and (2) generally, more than 90 percent of the aggregate of its gross receipts for all tax years has been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock and securities.

In the present case, Taxpayer argues that on Date 1 when it was still an S corporation, but after Subsidiary became a C corporation, was the moment at which worthlessness occurred. Based upon this analysis, Taxpayer concluded it was entitled to the ordinary deduction under §165(g)(3) provided its subsidiary C corporation was affiliated and worthless. Once that deduction was recognized, Taxpayer passed through the ordinary deduction to its shareholders pursuant to §1366.

<u>Analysis</u>

I. Subsidiary's QSub termination results in a failed §351.

Regulation §1.1361-5(b) describes the effect of a QSub termination. "The former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation." In such a case, if the deemed creation of a new corporation qualifies under §351, the transaction is tax-free. Alternatively, if the formation of the new C corporation fails to qualify under §351, the transaction is taxable under §1001 and, if any of the transferred assets has a basis in excess of fair value (a loss asset), the loss will be deferred under §267(f)(2)(B) until the loss asset is transferred outside the §267(f) controlled group, or the corporations cease to be in a controlled group relationship.

Section 351(a) provides "[n]o gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of such corporation and, immediately after the exchange, such person or persons are in control of the corporation." In other words, §351 provides an exception to the general rule requiring a taxpayer to recognize gain or loss upon the sale or other disposition of an asset. This exception allows taxpayers to exchange assets for corporate stock and facilitates their ability to do business in a corporate form. The ability to use §351 to incorporate is not unlimited. Specifically, §351 requires the exchange of property for the stock received.

Insolvency occurs when the liabilities of the debtor exceed the fair valuation of its assets.[1] Insolvency can destroy an otherwise a tax-free §351 in two ways. First, significantly encumbered property is not considered "property" for purposes of §351. Second, the "in exchange for stock" requirement is not met when the transferor receives stock in an insolvent corporation. This second point is commonly referred to as the "net value requirement."

Rarely have taxpayers argued that assets encumbered with liabilities in excess of the assets' value are in fact property that may be exchanged tax-free for corporate stock under §351. In *Meyer v. United States*, 121 F. Supp. 898 (Ct. Cl. 1954), cert. denied, 348 U.S. 929 (1955), shareholders transferred worthless stock to a newly formed corporation in what a taxpayer treated as a §351 exchange. The court concluded that the "term 'exchange,' in this context, connotes the transfer of stock in consideration of stock, and not the transfer of valuable stock for absolute worthless stock, as was the case here." According to the court, the "insolvency of the old corporation in the bankruptcy sense [i.e., the transferred liabilities exceeded the fair market value of the asset transferred], gave the creditors an effective command in fact and in law over the assets of the corporation" (citing *Helvering v. Alabama Asphaltic Limestone Co.,* 315 U.S. 179 (1942)).[2] The Fifth Circuit in *Stafford v. United States*,[3] examined *Meyer's*

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[1] Rev. Rul. 2003-125, 2003-2 C.B. 1243. Courts and the IRS generally borrow from the valuation standards in the estate tax regulations to determine asset value. See *Krapf v. U.S.*, 977 F.2d 1454, 1457 (Fed. Cir.1992); *Martin Ice Cream Co. v. Comr*., 110 T.C. 189, 220 (1998).

[2] Cf. *Rosen v. Comr*, 62 T.C. 11 (1974)(A taxpayer, a sole proprietor, transferred assets and liabilities to a newly formed corporation. The liabilities exceeded the value of the assets at the time of the transfer. The Tax Court held the taxpayer recognized gain under §357(c) to the extent the liabilities assumed exceeded

holding and interpreted it as meaning "'property'… [does] not include the worthless stock of a corporation which has an excess of liabilities over assets, because the requirement, in the predecessor of §351, of an 'exchange' connotes the transfer of something of value for the interest received."[4]

Taxpayers arguing that there is no net value requirement ignore the holdings of *Meyer*, *Alabama Asphaltic Limestone Co. and Stafford.* Specifically, "property" must have value and §351's exchange requirement means something of value must be exchanged between the shareholder and corporation. Because worthless stock does not have value, those taxpayer incorporating liabilities in excess of the value of the transferred assets do not satisfy the §351 requirements. Thus, such transactions are taxable under §1001.

II. One may not acquire stock with the sole purpose of creating a §165(g)(3) deduction.

Regulation §1.165-5(d)(2)(ii) limits the application of §165(g)(3) by providing that a corporation is treated as affiliated only if none of the stock of the corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under §165(g)(3). *Assuming arguendo* Subsidiary's QSub-to-C corporation conversion qualifies for tax-free treatment under §351 (see I. above) *and* that §165(g)(3) applies to an S corporation (see III. below), Taxpayer must explain why it acquired the C corporation stock for reasons other than to obtain a $A ordinary deduction.

In determining whether Reg. §1.165-5(d)(2)(ii) applies, Taxpayer had many options to create a deduction from Subsidiary's alleged worthlessness (listed in the fact section). Of the options available to Taxpayer, terminating the QSub election, resulting in acquiring C corporation stock from which to claim a §165(g)(3) deduction, was the only option that arguably generated a $A ordinary loss. This stock acquisition coupled with an immediate claim of §165(g)(3) (ordinary) deduction is evidence that the sole purposes of converting the disregarded entity to a C corporation was to attempt to qualify for an ordinary deduction under §165(g)(3).

Taxpayer will likely emphasize Reg. §1.165-5(d)(2)(ii) has a "solely" requirement and then point to a reason Taxpayer acquired the C corporation independent of creating a $A ordinary loss. However, a fundamental rule of regulatory interpretation requires a presumption against ineffectiveness. Stated differently, Reg. §1.165-5(d)(2)(ii) should

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the adjusted basis of the assets transferred); *Focht v. Comr*, 68 T.C. 223 (1977) (A taxpayer, a sole proprietor, transferred substantially all of its assets and liabilities to a newly formed corporation, including a zero basis unrealized accounts receivable and an unrealized accounts payable. The Tax Court held the unrealized accounts payable were not to be included in the liabilities assumed for purposes of gain recognition under §357(c)), and GCM 33,915 (Aug. 26, 1968).

[3] 611 F.2d 990 (5th Cir. 1980)

[4] Id. at 995, n.6.

be read to manifest its purpose, not thwart it. In particular, if “solely” is interpreted as “any,” so long as creative lawyering exits, Reg. §1.165-5(d)(2)(ii) has no function. There are a few benefits bestowed on taxpayers that terminate their QSub election, but in the context of an S corporation running a defunct business, none of those benefits are relevant. Some of the usual reasons a taxpayer may convert from QSub-to-C status are:

- federal income tax rates are sometimes lower for C corporations than individuals;
- employee-owners of C corporations do not have to include certain fringe benefits as income;
- C corporations may carryback capital losses two years; and
- C corporations have greater flexibility to choose when their fiscal year ends.

An S corporation in the process of receivership would not be engaged in tax planning about future tax brackets, shareholder-employee fringe benefits, carrying back of losses or changing to a fiscal year. With a $A ordinary loss at stake, Taxpayer’s purpose is clear. This is exactly the type of acquisition of stock with the intent to convert a capital loss into an ordinary loss that Reg. §1.165-5(d)(2)(ii) was designed to prevent. Under Reg. §1.165-5(d)(2)(ii), the newly created C corporation will not be treated as affiliated with Taxpayer for purposes of §165(g)(3). Thus, the §165(g)(3) (ordinary) deduction is disallowed and Taxpayer may claim a §165(g)(1) (capital) deduction. This conclusion applies even in the unlikely event Taxpayer overcomes the obstacles regarding §165(g)(3) non-application to S corporations (below) and §351 non-application to a worthless company (above).

III. S corporations may not take a §165(g)(3) deduction.

This alternative argument for limiting the claimed loss has not been previously discussed with Taxpayer. It would only become relevant should Taxpayer prevail on the two issues discussed above.

Section 1363(b) generally provides that the taxable income of an S corporation “shall be computed in the same manner as in the case of an individual.” Section 1363(b) specifies only four exceptions to the general rule: (1) the items described in §1366(a)(1)(A) shall be separately stated; (2) the deductions referred to in §703(a)(2) shall not be allowed to the corporation; (3) §248 shall apply; and (4) §291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.

Section 165(g)(3) is not listed as an exception to the general rule in §1363(b). Thus, the general rule of computing S corporation income in the same manner as an individual applies. Because individuals are ineligible to claim an ordinary loss under §165(g)(3), S corporations are ineligible.

This position is supported by Revenue Ruling 93-36, which addresses whether an S corporation may claim an ordinary loss for a nonbusiness bad debt under §166(a) or whether the S corporation instead must claim a short-term capital loss under §166(d) (which expressly applies to "a taxpayer other than a corporation").

The revenue ruling states that, but for certain exceptions enumerated in §1363(b), an S corporation's taxable income is computed in the same manner as an individual's income. Given that §166 is not specifically listed as an exception to the general rule of §1363(b), the revenue ruling concludes that §166 applies to an S corporation in the same manner as it applies to an individual. Thus, an S corporation must claim a short-term capital loss for its wholly worthless nonbusiness debt.

Also, Revenue Ruling 2000-43 addresses whether an accrual-basis S corporation may make an election under §170(a)(2) (which applies to "a corporation reporting its taxable income on the accrual basis") to treat a charitable contribution as paid in the year in which it is authorized by the board of directors if paid within 2½ months of the following year. The ruling notes that,

> Under § 1363(b), a subchapter S corporation computes its taxable income in the same manner as an individual. The election in §170(a)(2) is not available to an individual. … Furthermore, the rationale behind §170(a)(2), a corporation's difficulty in determining its charitable contribution limit under §170(b)(2), does not apply to subchapter S corporations because a subchapter S corporation is not subject to the same §170(b)(2) limit.

Legislative History

The ordinary loss exception in §23(g)(4) (the predecessor to §165(g)(3)) was added in 1942. The basis for the exception was linked to the tax treatment of consolidated corporations. More specifically, since the losses of one corporation in a consolidated group may be offset against the income of another, Congress concluded that it was "desirable and equitable" to permit a parent corporation that owns sufficient interests in a subsidiary to receive an ordinary loss deduction when the subsidiary's stock becomes worthless, because the parent could reach the same result by choosing to file on a consolidated basis.[5]

In 2000, Congress amended §165(g)(3) to specifically reference §1504(a)(2) for the ownership requirements for affiliation. Congress made no changes to expressly apply §165(g)(3) to S corporations.

The legislative history of §165(g)(3) suggests that Congress intended the ordinary loss exception to be available only to corporations that are so closely related as to effectively be operating a single business. Under those circumstances, if stock in a non-consolidated subsidiary becomes worthless, the loss is treated as part of the parent corporation's business rather than as an investment loss. Congress did not intend the ordinary loss exception to be available to an individual (or to an entity that computes its taxable income in the same manner as an individual) and its C corporation subsidiary.[6]

Congress enacted §1363(b) in the Subchapter S Revision Act of 1982 ("SSRA"). The Senate Report provided that subchapter C generally will apply to S corporations, but that an S corporation "**will be treated in the same manner as an individual in transactions,** such as the treatment of dividends received under §301, **where the [S] corporation is a shareholder in a regular corporation [emphasis added],"** and that "the subchapter C rules are not to apply where the result would be inconsistent with the purpose of the subchapter S rules which treat the corporation as a pass-through entity."[7] The language in this Senate Report appears to further support the conclusion that S corporations generally should be treated as individuals with respect to their ownership of worthless stock in a C corporation.

Before 1996, §1371(a)(2) provided that, "[f]or purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual." This rule was repealed in 1996 because it was inconsistent with the IRS's position that C corporations could liquidate into S corporations under §332.[8] The House Report further stated, however, that the repeal of this rule,

> . . . does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, … *to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers* [emphasis added].

Although section 1371(a) provides (with certain exceptions, that "subchapter C shall apply to an S corporation and its shareholders," §165 does not fall within subchapter C.

We do note, however, that in *Rath v. Commissioner*,[9] the Tax Court ruled that S corporations are treated as corporations rather than as individuals for purposes of §1244. Section 1244 generally provides that

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[9] 101 T.C. 196 (1993).

> [i]n the case of an individual, a loss on section 1244 stock [i.e., certain stock in domestic small business corporations] ***issued*** to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as an ordinary loss [emphasis added].

For these purposes, §1244(d) provides that the term "individual" does not include a trust or estate.

The Tax Court noted that the term "individual" in §1244 should be given its plain and ordinary meaning (in accordance with general rules of statutory construction), and that "[t]here is no indication in the pertinent legislative history that §1244(a) was intended to apply to §1244 stock issued to an S corporation."[10] In fact, the legislative history expressly states that a corporation cannot receive ordinary loss treatment under this section.[11] The court also noted that Congress has not expressly extended the application of §1244 to S corporations.[12]

Considering the plain meaning of §1363(b), the other authorities discussed above, and Congress's failure to expressly extend the application of §165(g)(3) to S corporations, an ordinary loss under §165(g)(3) should not be available to S corporations and their shareholders.

IV. The May 20, 2015 letter

In its letter dated May 20, 2015, Taxpayer defends its claiming a $<u>A</u> ordinary loss under §165(g)(3) with a narrow argument. Taxpayer admits it has "unusual" facts and then focuses on when and whether the newly formed C corporation stock "became worthless." The gist of Taxpayer's argument is that the newly formed wholly-owned C corporation stock was worthless the moment it came into existence (i.e., *immediately before* Taxpayer's S election terminated) and the Status Letter created an identifiable event supporting the claim of worthlessness. These two points, in Taxpayer's opinion, entitled it to a §165(g)(3) deduction on their newly formed subsidiary C corporation stock. Considering the obstacles Taxpayer faces to create an ordinary deduction for its shareholders, we conclude Taxpayer's argument is without merit and we would deny the claim of a deduction under §165(g)(3).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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[10] 101 T.C. at 201.
[11] Id.
[12] Id. at 206.

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