Office of Chief Counsel
Internal Revenue Service
Memorandum

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from: Gerald B. Fleming
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(Corporate)

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subject: Proper Year of Deduction for a Worthless Stock Loss

This Chief Counsel Advice responds to your request for assistance dated May 10, 2016. This advice may not be used or cited as precedent.

LEGEND

Foreign Parent =

Historic Parent =

Taxpayer =

FSub =

Sub =

Country A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

ISSUE

This memorandum responds to your request for advice relating to the interrelation between section 165[1] and Treas. Reg. §1.1502-80(c)[2] in order to determine the appropriate year of deduction by Taxpayer for a loss under section 165(g) for the worthlessness of the stock of Sub.

CONCLUSION

Provided that the Taxpayer meets the general requirements under section 165 to deduct its loss on the worthlessness of the stock of Sub during all of the years at issue, Treas. Reg. §1.1502-80(c)(1) defers the Taxpayer's deduction of the loss on the Sub stock until the earliest of one of four identifiable events occur.[3] The only identifiable event that occurred during the years at issue occurred when the Taxpayer elected in Year 6 to change the classification of Sub from a corporation to an entity disregarded as separate from the Taxpayer. The change in classification in Year 6 caused Sub to cease to be a member of the Taxpayer's consolidated group and, as such, permits the Taxpayer to recognize its loss on the Sub stock in Year 6. Treas. Reg. §1.1502-80(c)(1)(ii).

SUMMARY OF FACTS

The Taxpayer is the common parent of a consolidated group of corporations that join in the filing of a consolidated federal income tax return. The Taxpayer is wholly owned, directly and indirectly, by Foreign Parent, a Country A corporation. Foreign Parent historically was part of the Historic Parent group and was separated from the Historic Parent group as part of a restructuring in Year 2. Foreign Parent directly and indirectly owns all of the stock of FSub, a Country A Corporation. Prior to Date 4, Year 4, the

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, that was in effect during the years at issue or the regulations issued thereunder that were in effect during the years at issue.

[2] During the years at issue, Treas. Reg. §1.1502-80(c) provided "[f]or consolidated return years beginning on or after January 1, 1995, stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of § 1.1502-19(c)(1)(iii)." However, current Treas. Reg. §1.1502-80(c)(3) provides that "this paragraph (c) applies to taxable years for which the original Federal income tax return is due without extensions) after July 18, 2007. However, taxpayers may apply this paragraph (c) to taxable years beginning on or after January 1, 1995." The Taxpayer appears to have applied current Treas. Reg. §1.1502-80(c) to the transaction at issue and as such, this memorandum applies current Treas. Reg. §1.1502-80(c).

[3] We understand that there is controversy over the valuation of Sub, specifically whether Sub was in fact worthless for purposes of section 165 during the years at issue and at the time the Taxpayer elected to change Sub's classification. However, in order to examine the operation of Treas. Reg. §1.1502-80(c), we assume for purposes of this memorandum that the Sub stock was worthless for section 165 purposes as of the end of Year 3 and at all times during the years at issue.

Taxpayer owned all of the stock of Sub. On Date 4, Year 4, the Taxpayer sold a% of the common stock of Sub to FSub for nominal consideration. On Date 2, Year 6, FSub sold the a% interest in Sub back to the Taxpayer for nominal consideration.

Prior to its acquisition, Sub was publicly traded. Historic Parent purchased Sub from its public shareholders on Date 1, Year 1. As part of the acquisition transaction, Sub became liable on approximately $b of intercompany loans used to finance the acquisition transaction.[4] After various assignments of debt, most of Sub's intercompany debt was owed to FSub.

Between Year 2 and Year 3, Sub sold various non-core assets to third parties for a total of approximately $c. Of this amount, Sub used approximately $d to repay intercompany debt. After the various restructurings of Sub's operations and the repayment of debt, as of the end of Year 3 Sub owed approximately $e to FSub and a very small amount to the Taxpayer.

According to documentation provided by the Taxpayer, the Taxpayer determined that the value of Sub's assets had declined by approximately $f by the end of Year 3. Because of the decline in the value of Sub's assets and the sales of operating assets to pay intercompany debt, the Taxpayer determined that at the end of Year 3 Sub had a negative net worth of approximately $g. Additional documentation provided by the Taxpayer indicates that the Taxpayer determined that Sub had a negative net worth at the end of both Year 4 and Year 5.

Because of Sub's reduced scope of operations, and because Sub's continued insolvency could trigger a springing guarantee made by FSub to one of the third-party purchasers of Sub's assets, Foreign Parent determined that part of the remaining debt Sub owed to FSub should be forgiven. Thus, on Date 5, Year 4, FSub forgave approximately $h of the Sub debt. Then, on Date 5, Year 5, FSub forgave an additional $i of the Sub debt. The taxpayer treated the cancellation of debt as a contribution to the capital of Sub under section 108(e)(6).

On Date 3, Year 6, the Taxpayer filed a Form 8832 to elect to treat Sub as an entity disregarded as separate from the Taxpayer. On its federal income tax return for Year 6, the Taxpayer claimed a loss on the stock of Sub of $j under section 165(g)(3) and Rev. Rul. 2003-125, 2003-2 C.B. 1243.

LAW

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.

[4] For purposes of this memorandum, we assume that all of the intercompany debt is valid debt for federal income tax purposes.

Treas. Reg. §§1.165-1(b) and -1(d) provide that 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 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.

Section 165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2)(A) provides that the term "security" includes a share of stock in a corporation.

Section 165(g)(3) provides that for the purposes of section 165(g)(1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. A corporation shall be treated as affiliated with the taxpayer only if the taxpayer owns directly stock in such corporation meeting the requirements of section 1504(a)(2), and more than 90 percent of the aggregate of its gross receipts for all taxable years have been from sources other than royalties, certain rents, dividends, interest annuities, and gains from sales or exchanges of stocks and securities.

Whether a loss due to worthlessness actually is sustained during the taxable year is a factual determination. Boehm v. Commissioner, 326 U.S. 287, 293 (1945), reh'g denied, 326 U.S. 811 (1946). A taxpayer must prove with objective evidence that the stock in question became worthless during the taxable year. Id. at 292.

In Morton v. Commissioner, 38 B.T.A. 1270, 1279 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940), a shareholder claimed a deduction for worthless stock for the year in which the corporation liquidated; the Commissioner denied the deduction on the grounds that the stock had become worthless in a prior year. The court concluded that stock is worthless when it has neither liquidating value nor potential future value. Thus, the court concluded that the stock became worthless in a prior year and denied the taxpayer's deduction for the year in which the deduction was claimed. In the event of a corporate liquidation, the stock of the corporation is worthless if the shareholders do not receive payment for their stock. See H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).

If a shareholder receives no payment for its stock in a liquidation of the corporation, neither section 331 nor section 332 applies to the liquidation. The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that such shareholder's stock is worthless. Additionally, the liquidation is an identifiable event that fixes the loss with respect to the stock.

In Rev. Rul. 2003-125, an eligible entity treated as a corporation for U.S. federal income tax purposes elected to change its classification from a corporation to a disregarded entity. Rev. Rul. 2003-125 held that the shareholders of such entity are allowed a worthless security deduction under section 165(g) if the fair market value of the assets

of the entity, including intangibles, does not exceed the entity's liabilities such that on the deemed liquidation of the entity, the shareholder receives no payment on its stock.

Treas. Reg. §1.1502-80(a) provides that the Internal Revenue Code or other law shall be applicable to the group to the extent that the regulations do not exclude its application. To the extent not excluded, other rules operate in addition, and may be modified by, these regulations.

Treas. Reg. §1.1502-80(c)(1) provides that subsidiary stock is not treated as worthless under section 165 until immediately before the earlier of the time (i) the stock is worthless within the meaning of Treas. Reg. §1.1502-19(c)(1)(iii), or (ii) the subsidiary for any reason ceases to be a member of the group.

In general, Treas. Reg. §1.1502-19(c) provides rules to determine when a member of a group is treated as disposing of a share of subsidiary stock. Treas. Reg. §1.1502-19(c)(1)(iii) treats a member of disposing of a share of subsidiary stock when the stock of the subsidiary is worthless, and provides three different measures to determine worthlessness:

(A) Substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or Treas. Reg. §1.1502-80(c), or, if S's asset is stock of a lower-tier member, the stock is treated of as disposed of under [Treas. Reg. §1.1502-19(c)]). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness).

(B) An indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Treas. Reg. §1.1502-32(b)(3)(ii)(C).

(C) A member takes into account a deduction or loss for the uncollectability of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.

Treas. Reg. §1.1502-32(b)(3)(ii)(C) provides that excluded cancellation of indebtedness income is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes attributable to any member of the group under section 108, section 1017, or Treas. Reg. §1.1502-28. However, if S is treated as realizing excluded cancellation of indebtedness income pursuant to Treas. Reg. §1.1502-28(a)(3) [relating to certain look-through rules], S shall not be treated as realizing excluded cancellation of indebtedness income for purposes of the preceding sentence.

Section 108(e)(6) provides that, except as provided in regulations, for purposes of determining the income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, (A) section 118 shall not apply, but (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

Treas. Reg. § 1.61-12(c)(2)(ii) provides that an issuer realizes income from the cancellation of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of Treas. Reg. §1.1275-1(b)). The amount of the discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. For purposes of Treas. Reg. §1.61-12(c)(2), the term "repurchase" includes the retirement of a debt instrument, the conversion of a debt instrument into the stock of the issuer, and the exchange of a newly-issued debt instrument for an existing debt instrument. Treas. Reg. §1.61-12(c)(2)(i).

ANALYSIS

As noted above, we assume for purposes of this memorandum that the Sub stock was worthless for section 165 purposes as of the end of Year 3 and at all times during the years at issue. However, because Sub is a member of the Taxpayer's consolidated group, Treas. Reg. §1.1502-80(c)(1) defers the deduction of Taxpayer's loss on the worthlessness of the Sub stock until one of four identifiable events occurs. Treas. Reg. §1.1502-80(c)(1)(i) and (ii). The four identifiable events are the three events identified in Treas. Reg. §1.1502-19(c)(1)(iii) or Sub's ceasing to be a member of the Taxpayer's group for any reason.

In this case, none of the identifiable events in Treas. Reg. §1.1502-19(c)(1)(iii) are applicable. While Sub disposed of subsidiaries and non-core lines of business, substantially all of Sub's assets were not treated as disposed of, abandoned or destroyed for federal income tax purposes. Thus Treas. Reg. §1.1502-19(c)(1)(iii)(A) is inapplicable. Similarly, Treas. Reg. §1.1502-19(c)(1)(iii)(C) is inapplicable because no member of the Taxpayer's group has taken a deduction or loss on the uncollectability of the debt of Sub.

Treas. Reg. §1.1502-19(c)(1)(iii)(B) is inapplicable because FSub's contribution of the Sub indebtedness to capital under section 108(e)(6) did not produce cancellation of indebtedness income. Under section 108(e)(6), Sub is treated as satisfying the debt with cash in the amount of FSub's basis in the debt. From the information provided, there is no indication that any event occurred that would cause FSub's basis in the Sub debt to be different from the adjusted issue price of the debt. Because the adjusted issue price of the debt and FSub's basis in the debt are equal, Sub will not recognize

any cancellation of indebtedness income upon the contribution of the debt.[5] Treas. Reg. §1.61-12(c)(2)(ii).

As a result, the only identifiable event that could trigger the Taxpayer's loss on its Sub stock is the change in classification of Sub in Year 6. As noted above, we assume that the Taxpayer's loss on its Sub stock was realized prior to the end of Year 3 when the Sub stock became worthless and that Treas. Reg. §1.1502-80(c)(1) deferred such loss. The change in classification of Sub from a corporation to an entity disregarded as separate from the Taxpayer in Year 6 caused Sub to cease to be a member of the Taxpayer's consolidated group, and as such, Treas. Reg. §1.1502-80(c)(1)(ii) permits the Taxpayer to recognize its loss on the Sub stock in Year 6. See also Rev. Rul. 2003-125.

In conclusion, we assume that the Sub stock held by the Taxpayer is worthless as of the end of Year 3 and at all times during the years at issue. However, Treas. Reg. §1.1502-80(c)(1) deferred the Taxpayer's deduction of the loss on the Sub stock until the earliest of one of four identifiable triggering events occur. The only triggering event to occur was the Taxpayer's election to change the classification of Sub from a corporation to an entity disregarded as separate from the Taxpayer. The change in classification in Year 6 caused Sub to cease to be a member of the Taxpayer's consolidated group and as such permits the Taxpayer to recognize its loss on the Sub stock in Year 6. Treas. Reg. §1.1502-80(c)(1)(ii).

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.

Please call (202) 317-6975 if you have any further questions.

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(Corporate)

[5] We note that because Sub has tax attributes, were the contribution of debt to capital to have produced cancellation of indebtedness income: (i) such income would have been excluded from Sub's income under section 108(a)(1)(B) (insolvency); (ii) because the income would have been excluded from Sub's income, Sub would have been required to reduce attributes under section 108(b); and (iii) because the excluded cancellation of indebtedness income would have reduced Sub's attributes, such income would have been treated as tax-exempt income under Treas. Reg. §1.1502-32(b)(3)(ii)(C).