

Applying Recent Code Section 165(g)(3) Guidance in an International Context

By Douglas L. McHoney and J. Michael Cornett*

When determining the optimal structure for investing in foreign subsidiaries, international tax professionals must consider many factors from both a business and tax perspective. These factors include weighing the advantages and disadvantages of a foreign holding company structure, consideration in funding the entity with debt versus equity, and planning for the optimal tax consequences upon exit of the foreign investment.

When a foreign subsidiary becomes unprofitable or worthless, a foreign holding company can be disadvantageous as it often prevents the U.S. parent from taking an ordinary loss on the worthlessness of the foreign subsidiary under Code Sec. 165(g)(3).¹ In addition, issues arise as to how related party or parent guaranteed debt should be factored into the analysis of whether a foreign subsidiary is worthless or subject to the liquidation rules of Code Sec. 332. There is also much debate among practitioners and academics with respect to whether the abandonment of a security qualifies as a worthless event that could give rise to a deduction.²

Three administrative rulings and a proposed regulation released in the past year provide additional guidance on Code Sec. 165(g)(3) that can be useful for international practitioners and help address some of these unanswered questions.³ Prior to these rulings, the primary method to preserve an ordinary deduction when an international subsidiary became worthless was to have the entity held as a first-tier controlled foreign corporation (CFC)⁴ of a domestic parent corporation. Alternatively, some practitioners would utilize a holding company that owned a single operating company that made an election to be treated as a disregarded entity. These administrative rulings and proposed regulations should now provide additional comfort to taxpayers when taking worthless stock deductions in a foreign holding company



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Douglas L. McHoney is a Director in the International Tax Services practice at PricewaterhouseCoopers LLP in St. Louis, Missouri.



J. Michael Cornett is a Shareholder at Polsinelli Shalton Flanigan Suelthaus PC in St. Louis, Missouri.

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structure and provide a better understanding of the collateral issues with intercompany loans.

This article will provide a general background of Code Sec. 165(g)(3) including the potential consequences under Code Sec. 332 when an entity is not, in fact, worthless. The focus of the article will be on the recent guidance that may change how tax professionals address tax planning for international entities. The article will also discuss several practical issues involving the conversion of a corporation to a partnership that still remain unanswered in the worthless stock context.

I. Statutory and Regulatory Framework

Code Sec. 165 generally allows a deduction for “any loss sustained during the taxable year and not compensated for by insurance or otherwise.”⁵ This section applies to numerous types of losses, including those caused by worthless securities. A “security” is defined to include “a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note or certificate or other evidence of indebtedness, issued by a corporation or government with interest coupons or in registered form.”⁶

If any security, which is a capital asset, becomes worthless during the tax year, the loss is generally treated as a loss from the sale or exchange of a capital asset.⁷ As all practitioners appreciate, capital losses are often difficult for taxpayers to utilize,⁸ and the carryover period for capital losses is not as favorable as that of net operating losses.⁹

Code Sec. 165(g)(3) entitles a domestic corporation to an ordinary loss on stock held in another corporation if certain requirements are met.¹⁰ First, the taxpayer must own more than 80 percent of the voting stock and 80 percent of the total value of the stock of the other corporation.¹¹ Second, more than 90 percent of the gross receipts for all tax years of the other corporation must come from sources other than passive activities (*i.e.*, royalties, rents, dividends, interest, annuities and gains from the sale of stock).¹² Third, the stock held by a domestic corporation must become worthless during the tax year. The regulations provide that for a deduction to be allowed, the loss “must be evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year.”¹³

The entity classification (“check-the-box”) regulations have become an often-utilized tool for taxpayers looking to generate a worthless stock deduction. Promulgated in 1996,¹⁴ the check-the-box regulations provide that an eligible foreign entity that changes its classification as a corporation for U.S. tax purposes to a partnership or disregarded entity is deemed to liquidate and distribute all of its assets and liabilities at the time of the election.¹⁵

Code Sec. 332 generally provides for tax-free treatment to the corporate shareholder upon the liquidation of a controlled subsidiary. The regulations, however, provide that Code Sec. 332 does not apply to a liquidation in which a shareholder receives no payment for its stock upon the liquidation of the corporation.¹⁶ In addition, the shareholder receives payment for its *common* stock only after both the creditors and preferred shareholders have received property in satisfaction of indebtedness or liquidation preference, respectively.¹⁷ If the liquidating corporation is insolvent on the date of the liquidation, a shareholder will receive no payment for its stock in that liquidating corporation and Code Sec. 332 will not apply. In the context of actual liquidations or deemed liquidations resulting from check-the-box elections, if Code Sec. 332 does not apply to the liquidating distribution, an ordinary worthless stock deduction may be available provided the requirements of Code Sec. 165(g)(3) are met.¹⁸

II. Recent Guidance Involving Code Sec. 165(g)(3)

Over the past year, three IRS administrative rulings and a proposed regulation have been issued addressing (1) the active gross receipts test, (2) whether abandonment of a security constitutes an identifiable event, and (3) how related-party debt should be treated for purposes of determining whether a subsidiary is worthless. The guidance is informative for international tax planners attempting to understand the IRS’s current positions relating to ordinary worthless stock deductions in a post-check-the-box era. This section will provide an overview of the three aforementioned areas and a detailed review of the recent authorities.

A. Active Gross Receipts Test

1. Overview. Code Sec. 165(g)(3)(B) requires that “more than 90 percent of the liquidating corporation’s gross receipts, for all taxable years, must have been

from sources other than royalties, rents, dividends, interest, annuities and gains from the sale or exchange of stocks and securities.”¹⁹ There are, however, two exceptions. The first is for rents derived from rental of properties to employees in the ordinary course of the company’s business; and the second is for interest received on the deferred purchase price of operating assets sold.²⁰ In calculating the 90-percent requirement, gross receipts from sale or exchanges of stocks and securities are taken into account only to the extent of gains from such sales or exchanges.²¹ This requirement is determined by considering all taxable years combined, rather than testing each year individually.

When Congress passed Code Sec. 165(g), its intent was to allow an ordinary loss deduction for worthless stock only when the subsidiary was an operating company.²² Originally, the active trade or business requirement of Code Sec. 165(g)(3) required 90 percent of gross income, but was amended to read 90 percent of gross receipts. The rationale for this was to make the provision less restrictive. The Senate Report stated that the provision should not be influenced by a decline in the gross profit margin.²³

Taxpayers attempting to utilize holding companies without check-the-box elections on the underlying operating subsidiaries historically have been unable to avail themselves of Code Sec. 165(g)(3) ordinary losses as those holding companies typically fail the active gross receipts test. While “look-through” treatment on dividends is prevalent in the international context, the statute is unclear about whether dividends should be provided similar treatment for purposes of the active gross receipts test in Code Sec. 165(g)(3).

2. Historical Perspective. In LTR 8939001, a U.S. parent corporation owned a foreign operating entity through a foreign holding company because the U.S. parent was not allowed to hold the stock of the operating company directly under the laws of the foreign country.²⁴ When the operating company became worthless, the taxpayer requested a ruling on whether the U.S. parent could take a Code Sec. 165(g)(3) ordinary loss with respect to its interest in the foreign operating company. The taxpayer argued that no more than 10 percent of aggregate gross receipts of the

holding company were from “forbidden categories” as it had no gross receipts.²⁵ The IRS agreed there were no gross receipts, but concluded that the active trade or business test was not satisfied because of this fact.²⁶ The IRS also rejected “look-through” treatment when the taxpayer argued that the IRS should look through the holding company to the operating company to apply the gross receipts test on the combined income of the holding company and operating company. The IRS stated that the “direct ownership” requirement in Code 165(g)(3)(A) precludes look-through to the income of the operating company.²⁷ The ruling did not address whether “look-through” could apply to any dividends paid by the operating company to the holding company.

Since this ruling was published, taxpayers could avoid this issue by making a check-the-box election on the operating company upon formation of the foreign holding company. Taxpayers often employ holding companies, however, with multiple subsidiaries and two-tier holding company structures for earnings and profits and related

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foreign tax credit planning. While it would be a sad day for the taxpayer whose entire global holding company structure becomes worthless, holding company structures with limited subsidiaries (e.g., regional or by-country holding companies) in which the operating companies have not made check-the-box elections would not meet the requirements in Code Sec. 165(g)(3) for an ordinary loss should the investment become worthless. TAM 200727016 reinforces this position and addresses the dividend look-through issue not addressed in LTR 8939001.

3. TAM 200727016. In TAM 200727016, the taxpayer was a domestic corporation (“Taxpayer”) that wholly owned a foreign holding corporation (“Holding”).²⁸ Prior to the underlying business going under, Taxpayer conducted an active business in Holding. In addition, Holding owned a group of foreign subsidiaries located in the same country of incorporation as Holding.²⁹ Holding directly held two foreign subsidiaries (“FSub1” and “FSub2”). FSub1, in turn, owned two other foreign subsidiaries (“FSub3” and “FSub4”).³⁰ While both FSub1 and FSub3 were operating companies whose gross receipts came from the conduct of an active trade or business, FSub2 was

a holding company and FSub4 primarily received rents from FSub3.³¹ As a result of the structure, “[m]ore than 90 percent of Holdings gross receipts were from dividends received from its subsidiaries.”³² In the tax year at issue, Taxpayer discontinued operations in the foreign country and the stock of Holding became worthless.³³ The issue was whether the loss on the worthlessness of Holding’s stock was capital or ordinary, the determination of which depended on the character of Holding’s gross receipts.

When analyzing whether Holding met the active gross receipts test requirement of Code Sec. 165(g)(3), the IRS focused on the definition of “dividend.” The IRS noted that the Code provides that, under Code Sec. 316(a), “dividend” is defined as “any distribution of property made by a corporation to its shareholders” out of accumulated or current earnings and profits.³⁴ Taxpayer argued that the dividends should not be considered passive investment income under Code Sec. 165(g)(3) “to the extent the dividends are attributable to earnings and profits ‘derived from the active conduct of a trade or business.’”³⁵ The taxpayer pointed to Code Sec. 1362(d)(3)(E) that excludes certain dividends in testing for an S corporation election termination event when such dividends are attributable to earnings and profits derived from an active trade or business.³⁶ The IRS rejected this argument, stating that Code Sec. 165(g)(3)(B) does not contain a specific provision distinguishing among dividends depending on whether they derive from a corporation engaged in the active conduct of a trade or business.³⁷

The taxpayer further argued that there is a distinction between dividends from active and passive sources that is supported by the “analytical approach” taken by the IRS in Rev. Rul. 88-65.³⁸ In that ruling, the IRS held that amounts received under a lease are not within the definition of “rents” under Code Sec. 165(g)(3) when significant services are performed by the corporation in connection with the leasing of automobiles.³⁹ In a detailed analysis of the reasoning found in Rev. Rul. 88-65, the IRS argued that the analogies related to rental activities can be clearly

distinguished from that of holding companies receiving dividends.⁴⁰

The IRS also noted that the Taxpayer identified numerous other provisions that treat dividends received from operating subsidiaries as active income. These provisions include Code Sec. 954(c)(3)(A)(i) (foreign personal holding company income as a component of subpart F), former Code Sec. 552(c)(2) (defining foreign personal holding company income for purposes of the tax on foreign personal holding company income), and Code Sec. 1297(b) (defining passive income under the passive foreign investment company rules). Ultimately, the IRS concluded that, without direct statutory authority indicating otherwise, “dividends” under Code Sec. 165(g)(3)(B) means “all dividends received by the worthless subsidiary, whether or not the dividends are attributable to income derived from the conduct of an active trade or business by a lower-tier corporation.”⁴¹

The IRS states its position very clearly in this ruling that an international holding company with no active trade or business (or a limited active business relative to the dividends received from its foreign subsidiaries) and foreign entities that have not made check-the-box elections will not qualify for the active gross receipts test in Code Sec. 165(g)(3)(B). While taxpayers could consider making check-the-box elections at the time the foreign holding company is established to plan around this issue for troubled investments, LTR 200710004, discussed below, may give taxpayers and practitioners additional flexibility.

4. LTR 200710004. LTR 200710004 involved a foreign-owned U.S. parent corporation (“Taxpayer”) with a U.S. holding company (“Holding”) that became worthless during the tax year.⁴² Holding owed significant debt to Taxpayer’s foreign parent and other foreign affiliates of Taxpayer’s foreign parent. In the four years before the worthlessness occurred, Holding disposed of a substantial portion of its operations and subsidiaries to reduce a portion of this debt. A portion of these sales occurred as (1) stock sales in which elections under Code Sec. 338(h)(10) were made to

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treat the transaction as a sale of assets followed by a Code Sec. 332 liquidation, (2) asset sales of the operating subsidiaries followed by Code Sec. 332 liquidations, and (3) asset sales by operating subsidiaries followed by a distribution of the proceeds and all assets absent a formal liquidation. Subsequent to these transactions, Holding conducted substantially all of its operations through two operating subsidiaries, one of which made a check-the-box election to be treated as a disregarded entity.

The primary issue was whether Taxpayer could meet the active gross receipts test under Code Sec. 165(g)(3)(B) and take an ordinary loss on its interest in Holding upon conversion of Holding to a limited liability company.⁴³ Code Sec. 381, which applies to Code Sec. 332 and 361 transactions, provides that “the acquiring corporation shall succeed to and take into account” certain items of the transferor corporation.⁴⁴ The IRS found that for purposes of the active gross receipts test, Holding was allowed to take into account the historic gross receipts of the subsidiary corporations involved in Code Sec. 381 transactions.⁴⁵ Holding was also required to eliminate intercompany distributions from those subsidiaries to prevent duplication.⁴⁶

Moreover, because Holding and its subsidiaries were part of a U.S. tax consolidated group, the consolidated return provisions were also analyzed by the IRS. Included in the computation of the active gross receipts test were the dividends Holding received from lower-tier members of its consolidated group. Citing Reg. §1.1502-13, the IRS stated that dividends received by Holding were treated as being from passive sources, but only to the extent they were attributable to the respective distributing member’s gross receipts from passive sources.⁴⁷

While the aforementioned ruling was purely in the domestic context, the ruling has interesting applicability for international holding companies. Most importantly, the ruling establishes the IRS position that Code Sec. 381 can be affirmatively used by taxpayers to meet the active gross receipts test under Code Sec. 165(g)(3)(B). This position should apply in the international context based on the holding in the *Dover* case.⁴⁸ The check-the-box rules, which after Rev. Rul. 2003-125 allow taxpayers to create their own identifiable event, can also be used prior to the worthlessness of a holding company to assure a foreign holding company can meet the active gross receipts test.

To accomplish this, taxpayers will need to make check-the-box elections on the operating subsidiaries.

This election should occur prior to their insolvency to ensure that a valid Code Sec. 332 liquidation of the operating subsidiaries occurs subject to the attribute carryover rules in Code Sec. 381. Taxpayers and their advisors will need to work in conjunction with their business counterparts to appropriately identify these issues in advance of any insolvency of the operating companies. Later, when the holding company is worthless, taxpayers can make a check-the-box election on their foreign holding company so they can now take an ordinary deduction, assuming all requirements of Code Sec. 165(g)(3) are met.

While the ruling appears to provide “look-through” treatment of dividends for domestic entities in a consolidated return context, TAM 200727016 (discussed above) clearly states the IRS position and thus, taxpayers should not be able to avail themselves of this “look-through” treatment in the international context. Taxpayers and practitioners should also note that the ruling specifically addresses how dividends from operating companies to their holding companies should be treated when the operating company is later subject to a Code Sec. 381 event. An adjustment must be made to prevent double-counting of the dividends and the underlying gross receipts of the liquidating operating subsidiary. Thus, any intercompany distribution should be excluded from the active gross receipts computation.

B. Identifiable Events

1. Overview. For a taxpayer to establish that stock or securities have become worthless, an “identifiable event” establishing worthlessness must occur during the tax year.⁴⁹ Examples of identifiable events include cessation of normal business operations, bankruptcy, liquidation, government takeover or a sale for a nominal amount.⁵⁰ Although the list primarily includes events that end a business, continuing the business as a branch or a partnership does not necessarily preclude a worthless stock deduction.⁵¹ Whether worthlessness is actually sustained during the tax year is a factual determination.⁵²

There has recently been attention surrounding check-the-box elections and whether such elections constitute an identifiable event. A 2002 field service advice concluded that a check-the-box liquidation, in itself, was not an identifiable event that resulted in a worthless stock loss.⁵³ Rev. Rul. 2003-125, however, held that a check-the-box liquidation constitutes an identifiable event.⁵⁴ The ruling stated:

When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under Code Sec. 165(g)(3) if the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities such that on the deemed liquidation of the entity the shareholder receives no payment on its stock.

Rev. Rul. 2003-125 gave taxpayers support that a liquidation arising from a check-the-box election was an identifiable event for purposes of Code Sec. 165(g)(3) and, arguably, gives tax planners greater certainty in timing the inclusion of the deduction.

While a check-the-box election is the most taxpayer friendly vehicle to establish worthlessness, taxpayers may also be able to obtain a tax loss by abandoning the stock. Historically, it was not entirely clear whether a taxpayer could obtain an ordinary loss from the abandonment of securities within the meaning of Code Sec. 165(g), and neither the courts nor the IRS have publicly considered the issue. The regulations to Code Sec. 165(g) state: "No loss for a decline in value of stock owned by the taxpayer shall be allowed as a deduction under Code Sec. 165(a) except insofar as the loss is recognized under Reg. §1.1002-1 upon the sale or exchange of stock and except as otherwise provided in Reg. §1.165-5 with respect to stock which becomes worthless during the taxable year."⁵⁵ Thus, it appeared that a sale or exchange must be a prerequisite to a worthless stock deduction.

2. Proposed Reg. §1.165-5(i). On July 30, 2007, the Treasury and the IRS proposed a regulation providing guidance concerning the availability and character of losses sustained from the abandonment of securities.⁵⁶ The proposed regulation provides that a security that is "abandoned" is an identifiable event that establishes the worthlessness of a security.⁵⁷ The proposed regulation makes it clear that a loss is subject to the requirements for a deductible loss under Code Sec. 165, including Code Sec. 165(g)(3).⁵⁸ While the proposed regulation specifically states that all facts and circumstances will determine whether a transaction is characterized as an abandonment, it also states, "To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security."⁵⁹ In the preamble, the Treasury and

the IRS provide that a taxpayer need not relinquish legal title of the property in all cases to establish abandonment.⁶⁰ No further guidance is provided on this statement nor is there any discussion of the situation to which this statement would apply. While a discussion of how a taxpayer would demonstrate that the security has been "permanently surrendered" and all rights relinquished is beyond the scope of this article, query whether this provision could apply to situations involving a special purpose vehicle that was formed to undertake a single activity and upon completion of that activity claim a worthless stock deduction, if appropriate, while maintaining the special purpose vehicle for future activities.

C. Establishing Worthlessness

1. Overview. Once an identifiable event has been established, the taxpayer must establish that the stock became worthless during the tax year. To do so, the taxpayer must prove that the security had value at the beginning of the year and that it became completely worthless during the year the deduction is claimed.⁶¹ The taxpayer bears the burden of proving worthlessness.⁶² Historically, to prove worthlessness, the taxpayer must show that there was both a lack of liquidating value and lack of potential value that occurred during the tax year.⁶³

Lack of liquidating value includes proving that balance sheet insolvency occurred during the year. However, liquidating value is not measured strictly on a historic balance sheet basis. Assets and liabilities should be adjusted to reflect any difference between book value and fair market value, including intangible assets. In addition, traditional debt versus equity principles should be considered in determining whether balance sheet insolvency exists.⁶⁴ The impact of a contribution to capital of debt held by the shareholder immediately prior to a Code Sec. 165(g)(3) identifiable event must also be considered.⁶⁵

In addition to proving lack of liquidating value, the taxpayer must also prove a lack of potential value.⁶⁶ To do so, the taxpayer must prove there is no reasonable expectation that assets will exceed liabilities in the future.⁶⁷ Lack of potential value can be established in one of two ways: (1) an identifiable event occurs destroying the potential value of a company, which could include cessation of normal business operations, bankruptcy, or liquidation or sale for a nominal amount; or (2) liabilities so greatly exceed the value of a company's assets that there is no hope of recovery, which usually involves exceptional cases

in which the nature of the corporation's business is such that there is no reasonable expectation that a continuation of the business will result in any profit to its shareholders.⁶⁸ Although there are two prongs, these are so closely related that many taxpayers and practitioners view them as one.⁶⁹

2. Historical Perspective. In the last five years, the IRS has addressed the issue of potential value, or lack thereof, in both a field service advice and a revenue ruling.⁷⁰ In FSA 200226004, the business of the liquidating corporation continued and the continuation of such business raised issues regarding the potential value. The IRS held in FSA 200226004 that the entities were carrying on the business because of "reasonable expectations of future value."⁷¹ While several cases have held that continuity of business is normally an indication of potential worth,⁷² certain cases support a worthless stock deduction even though the business continues.⁷³ Generally, the issue is whether activities were in the "nature of salvaging something for the creditors" or "whether the activities are so related to continuation of general operations that they manifest reasonable expectations of future value."⁷⁴

In Rev. Rul. 2003-125, the IRS did not differentiate between lack of liquidating value and lack of potential value in determining worthlessness and appears to have combined the historic two-part test. The ruling analyzed a potential worthless stock deduction in two separate scenarios. In the first situation, the fair market value of the liquidating corporation's assets, including intangible assets such as goodwill and going concern value, exceeded the sum of its liabilities. The IRS concluded that the corporate shareholder received at least partial payment on its stock in the liquidating corporation. Thus, Code Sec. 332 applied and no loss was allowed.⁷⁵

In the second situation, the fair market value of the liquidating corporation's assets, including intangible assets such as goodwill and going concern value, did not exceed the sum of its liabilities. In this situation, the IRS found that the corporate shareholder did not receive any payment in exchange for its stock in the liquidating corporation; thus, Code Sec. 332 did not apply.⁷⁶ The IRS further concluded that the deemed liquidation constituted an identifiable event and a Code Sec. 165(g)(3) ordinary loss was allowed.⁷⁷

While a check-the-box election is the most taxpayer friendly vehicle to establish worthlessness, taxpayers may also be able to obtain a tax loss by abandoning the stock.

3. CCA 200706011. In CCA 200706011, the U.S. parent company ("Parent") wholly owned a domestic subsidiary, which, in turn, had a wholly owned foreign subsidiary.⁷⁸ The foreign subsidiary was indebted to both the domestic subsidiary and a local bank. The indebtedness to the local bank was guaranteed by Parent. A check-the-box election was filed on behalf of the foreign subsidiary, changing the classification of the foreign subsidiary from a corporation to a disregarded entity for federal tax purposes. After hiring an independent appraiser, the taxpayer claimed a bad debt deduction and a worthless stock deduction on the foreign subsidiary. The IRS argued that Code Sec. 332 should apply because the related-party debt should be recharacterized as equity.

As stated earlier in the article, the Code Sec. 332 regulations provide that the section only applies to a liquidating distribution in which the 80-percent shareholder "receives at least partial payment for the stock which it owns in the liquidating corporation."⁷⁹ The shareholder must receive partial payment for its common stock in the liquidating corporation, after satisfying its indebtedness to creditors and satisfying its preferred shareholders' liquidation preference.⁸⁰ A liquidating subsidiary whose liabilities exceed the fair market value of the asset will thus not qualify under Code Sec. 332. Under both the taxpayer and audit team's valuation, the foreign subsidiary had insufficient assets to satisfy its liabilities.

If Code Sec. 332 does not apply, Code Sec. 165 can apply to allow the shareholder an ordinary worthless stock deduction, provided the requirements of Code Sec. 165(g)(3) are met. The IRS found that rendering a corporation solvent by recharacterizing debt as equity is ineffective if the debt is not respected as debt for tax purposes because such debt would be characterized as "preferred" stock. The liquidating corporation must be able to satisfy both the claims of its creditors and the preferred shareholders and still have assets remaining to distribute to common shareholders for Code Sec. 332 to apply.⁸¹ If the debt was classified as preferred stock, the CCA states, the taxpayer would be allowed a capital loss under Code Sec. 331(a) and Code Sec. 1001 for the portion of debt recharacterized as preferred equity for which no compensation was received.

In addition to the Code Sec. 332 argument, the agent proposed treating the bank debt as debt of Parent and therefore, as a capital contribution by Parent to foreign subsidiary. The IRS stated that such recharacterization still would not cause the deemed liquidation to fall under Code Sec. 332. Treating the bank debt as a capital contribution by Parent, with Parent's equity interest being treated as common stock would not change the outcome. The IRS held that the foreign subsidiary would still not have adequate assets to satisfy the debt to the domestic subsidiary, and thus, would not have anything to distribute to common stock shareholders. Under the facts of this ruling, a lack of liquidating value exists even after reclassification of debt, therefore allowing a Code Sec. 165(g)(3) worthless stock deduction.⁸²

4. Partnership Issues. As evidenced by the prior discussion, the amount and nature of indebtedness play a critical role in the determination of worthlessness. In cases involving the conversion of a corporation to a partnership, the impact of indebtedness is even greater. The guidance discussed above relates to the conversion of a corporation to a branch or disregarded entity. There is virtually no guidance on the consequences associated with a conversion of a corporation to a partnership. This issue often arises in the international context as foreign jurisdictions sometimes require two owners of a foreign entity under local law. This issue can also exist when profitable subsidiaries make equity contributions to an unprofitable foreign subsidiary resulting in multiple owners of such foreign subsidiary.

FSA 200226004, discussed above, involved the conversion of a CFC to a partnership. Unfortunately, the only issue addressed was whether the act of checking-the-box was an identifiable event.⁸³ The FSA failed to address the determination of the bad debt deduction, if any, that occurs upon the deemed liquidation. For example, is it only that debt that is owed to the shareholder or future "partner" that can be written off as a bad debt under Code Sec. 166 or can the debt owed to a person related to the partner be written off? Further, what happens to any debt that is written off?

If this were a disregarded entity, the debt would be ignored for federal income tax purposes, and any future payments would likely be treated as branch remittances.⁸⁴ While one would expect a similar answer for a conversion of a corporation to a partnership, there is no guidance that states that this is the case.

The amount of indebtedness and how it is treated during the liquidation (and after) also has an impact

on the calculation of the partner's basis in the partnership and the partnership's basis in the property deemed contributed to the partnership. Unlike in the case of a disregarded entity, a partner's basis in a partnership must be determined if the partner is going to deduct future losses. Failure to determine a partner's basis in the partnership could result in the disallowance of future losses by the partner.⁸⁵ The amount of indebtedness deemed contributed to the partnership by the partner could result in the partner recognizing income upon the formation of the partnership if the partner is not allocated the same amount of indebtedness under the partnership agreement.⁸⁶ Thus, it is important to prepare a partnership agreement to address this issue when a corporation is converted to a partnership.

The partnership also is concerned with its basis in the partnership assets. The deemed liquidation of the corporation, not subject to Code Sec. 332, results in the assets of the corporation being marked to fair market value.⁸⁷ Presumably, the basis of the assets could be increased by the amount of debt to which the assets are subject. Thus, it is important for the partnership to know the basis so that depreciation and amortization can be calculated appropriately. While the IRS has provided relatively extensive guidance in situations involving the conversion of a corporation to a branch or disregarded entity, they should focus on the issues associated with the conversion of a corporation to a partnership.

III. Conclusion

Recent IRS guidance issued over the last year has provided greater certainty for taxpayers and practitioners in the area of Code Sec. 165(g)(3). The guidance has provided clarity for international tax planners in addressing how the active gross receipts test can be met in a foreign holding company structure, whether abandonment of a security constitutes an identifiable event, and how related-party debt should be treated for purposes of determining whether a subsidiary is worthless. While the advent of the check-the-box regulations has made it easier for taxpayers to claim a worthless stock deduction, pressure will always be focused on establishing that the "worthless" corporation has no value, including proving that debt should be respected as such for U.S. tax purposes. Although certain questions remain unanswered when the surviving entity is a partnership, international planners that have created foreign holding companies to hold

foreign subsidiaries should take solace in the fact that such structures, with appropriate planning, may not preclude an ordinary deduction upon worthlessness of the underlying business.

ENDNOTES

- * The views expressed in this article are solely those of the authors and are not necessarily those of PricewaterhouseCoopers LLP or Polsinelli Shalton Flanigan Suelthaus PC. Special thanks to Natalie Brinkley, an Associate at PricewaterhouseCoopers LLP, for her assistance with this article.
- ¹ Unless otherwise indicated, all “Code Sec.” references are to sections of the Internal Revenue Code of 1986, as amended, and all references to a “section” of “the regulations,” “Regulations” or “Reg. §” are to sections of the final regulations issued by the IRS under the Code, all as in effect on the date of publication of this article.
- ² See, e.g., Jerred G. Blanchard, Jr. and David C. Garlock, *Worthless Stock and Debt Losses*, TAXES, Mar. 2005, at 205; John C. Zimmerman, *Abandonment Losses on Stock in Light of Code Sec. 1234A*, TAXES, Dec. 2003, at 33; Jerred G. Blanchard, Jr., Debra J. Bennett and Christopher D. Speer, *The Deductibility of Investments in Financially Troubled Subsidiaries and Related Federal Income Tax Considerations*, TAXES, Mar. 2002, at 91.
- ³ Proposed Reg. §1.165-5(i); LTR 200710004 (Mar. 9, 2007); TAM 200727016 (July 6, 2007); CCA 200706011 (Feb. 9, 2007).
- ⁴ The term “controlled foreign corporation” or “CFC” is defined under Code Sec. 957 as a foreign corporation if more than 50 percent of the voting power or total value of the stock of such corporation is owned or is considered as owned by U.S. shareholders on any day during the tax year of the foreign corporation.
- ⁵ Code Sec. 165(a).
- ⁶ Code Sec. 165(g)(2).
- ⁷ Code Sec. 165(g)(1).
- ⁸ Capital losses can only be utilized to the extent of capital gains. Code Sec. 1211(a).
- ⁹ Capital losses have a three-year carryback and five-year carryforward. Code Sec. 1212(a)(1). The capital loss can only be carried back to the extent that such carryback does not produce a net operating loss as defined in Code Sec. 172(c) for the year to which the capital loss is carried back. *Id.* A net operating loss is defined as “the excess of the deductions allowed by [chapter 1 of the Internal Revenue Code] over the gross income.” Code Sec. 172(c). Taxpayers can carry back net operating losses for two years and carry them forward 20 years. Code Sec. 172(b)(1)(A).
- ¹⁰ Because a Code Sec. 165(g)(3) ordinary deduction is only available to domestic corporations, only first-tier foreign subsidiaries can be the subject of such deduction.
- ¹¹ Code Sec. 165(g)(3)(A) makes specific reference to the ownership requirements in Code Sec. 1504(a)(2).
- ¹² Code Sec. 165(g)(3)(B) and Reg. §1.165-5(b).
- ¹³ Reg. §1.165-1(b)(1); see also *L. Boehm*, SCt, 45-1 USTC ¶9448, 326 US 287, 292, 66 SCt 120.
- ¹⁴ T.D. 8697, 1997-1 CB 215.
- ¹⁵ Reg. §1.301-7701-3(g)(i) and (ii). The check-the-box regulations allow an “eligible entity,” meaning one that is not a *per se* corporation, to elect its classification for federal tax purposes. “[A]n eligible entity with a single owner can elect to be classified as an entity separate from its owner.” Reg. §301.7701-3(a). If an eligible entity with a single owner elects to be disregarded as an entity separate from its owner, the entity is “deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association.” See Reg. §301.7701-3(g)(1)(iii).
- ¹⁶ Reg. §1.332-2(b).
- ¹⁷ Reg. §1.332-2(c); *Spaulding Bakeries, Inc.*, CA-2, 58-1 USTC ¶9320, 252 F2d 693.
- ¹⁸ See Reg. §1.332-2(b) (“[i]f Code Sec. 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities”).
- ¹⁹ Code Sec. 165(g)(3).
- ²⁰ Reg. §1.165-5(d)(2)(iii).
- ²¹ *Id.*
- ²² S. REP. NO. 77-1631, 1942-2 CB 504, 543 (1942) and S. REP. NO. 91-1530, 1971-1 CB 617, 618 (1970).
- ²³ S. REP. NO. 83-1622, as reprinted in 1954 USCCAN 4621, 4654.
- ²⁴ LTR 8939001 (Sept. 29, 1989).
- ²⁵ *Id.*
- ²⁶ *Id.*
- ²⁷ *Id.*
- ²⁸ TAM 200727016 (July 6, 2007).
- ²⁹ *Id.*
- ³⁰ *Id.*
- ³¹ *Id.*
- ³² *Id.*
- ³³ *Id.*
- ³⁴ *Id.*
- ³⁵ *Id.*
- ³⁶ *Id.*
- ³⁷ *Id.*
- ³⁸ *Id.*
- ³⁹ Rev. Rul. 88-65, 1988-2 CB 32.
- ⁴⁰ *Supra* note 28.
- ⁴¹ *Id.*
- ⁴² LTR 200710004 (Dec. 15, 2006)
- ⁴³ The IRS cited Rev. Rul. 2003-125 when holding the conversion of Holding as a U.S. incorporated entity to an LLC and the consequent change of Holding’s federal tax classification to a disregarded entity under Reg. §301.7701-3 was an identifiable event.
- ⁴⁴ Code Sec. 381(a).
- ⁴⁵ *Supra* note 42.
- ⁴⁶ *Id.*
- ⁴⁷ *Id.*
- ⁴⁸ See *Dover Corp.*, 122 TC 324, Dec. 55,630 (2004) (parent corporation deemed to be engaged in business of liquidating subsidiary under Code Sec. 332).
- ⁴⁹ Reg. §1.165-1(b)(1).
- ⁵⁰ *S. Morton*, 38 BTA 1270, Dec. 10,517, *nonacq.*, 1939-1 CB 57, *aff’d*, CA-7, 40-2 USTC ¶9495, 112 F2d 320.
- ⁵¹ See, e.g., *Emhart Corp.*, 75 TCM 2231, Dec. 52,684(M), TC Memo. 1998-62.
- ⁵² *Boehm*, *supra* note 14 (the taxpayer has the burden of proof in proving worthlessness with objective evidence).
- ⁵³ FSA 200226004 (June 28, 2002) (business of the liquidating corporation continued and the IRS held the entities were carrying on the business because of reasonable expectations of future value).
- ⁵⁴ Rev. Rul. 2003-125, 2003-2 CB 1243.
- ⁵⁵ Reg. §1.165-4(a).
- ⁵⁶ 72 FR 41468 (July 30, 2007).
- ⁵⁷ Reg. §1.165-5(i).
- ⁵⁸ *Id.*
- ⁵⁹ *Id.*
- ⁶⁰ 72 FR 41468 (July 30, 2007).
- ⁶¹ Code Sec. 165(g)(1).
- ⁶² *Figgie Int’l, Inc.*, CA-6, 86-2 USTC ¶9813, 807 F2d 59.
- ⁶³ *Morton*, *supra* note 50.
- ⁶⁴ See the discussion at note 78, *infra*.
- ⁶⁵ Rev. Rul. 68-602, 1968-2 CB 135.
- ⁶⁶ *B. Mahler*, CA-2, 41-1 USTC ¶9474, 119 F2d 869, *cert. denied*, 314 US 660 (1941).
- ⁶⁷ *Flint Industries*, 82 TCM 778, Dec. 54,519(M), TC Memo. 2001-276.
- ⁶⁸ *Morton*, *supra* note 50.
- ⁶⁹ See, e.g., Rev. Rul. 2003-125 (IRS appears to treat the two prongs as one test).
- ⁷⁰ FSA 200226004 (June 28, 2002); Rev. Rul. 2003-125, 2003-2 CB 1243.
- ⁷¹ FSA 200226004 (June 28, 2002).
- ⁷² *L.G. Bullard*, CA-2, 45-1 USTC ¶9118, 146 F2d 386; *GE Employees Sec. Corp. v. Manning*, CA-3, 43-2 USTC ¶9563, 137 F2d 637.
- ⁷³ See, e.g., *Emhart*, *supra* note 51; *C.W. Steadman*, 50 TC 369, Dec. 28,968 (1968).
- ⁷⁴ *Frazier*, 34 TCM 951, Dec. 33,306(M), TC Memo. 1975-220; *Boehm*, *supra* note 13.
- ⁷⁵ Rev. Rul. 2003-125, 2003-2 CB 1243.
- ⁷⁶ *Id.*

ENDNOTES

- ⁷⁷ *Id.* 689, Dec. 43,405 (1986). Proposed Reg. §1.987-2(c).
⁷⁸ CCA 200706011 (Feb. 9, 2007). ⁸¹ CCA 200706011 (Feb. 9, 2007). ⁸⁵ Code Sec. 704(d); Reg. §1.704-1(d).
⁷⁹ Reg. §1.332-2(b). ⁸² *Id.* ⁸⁶ See Code Secs. 722 and 752 and the under-
⁸⁰ See *Spaulding Bakeries Inc.*, *supra* note 17; ⁸³ FSA 200226004 (June 28, 2002). lying regulations.
H.K. Porter Co., Inc. & Subsidiaries, 87 TC ⁸⁴ See e.g., Reg. §1.1503(d)-7 Example 23; ⁸⁷ Code Sec. 336.

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