

Part I

Section 165.-Losses

26 CFR 1.165-1: Losses.
(Also § 332; § 1.332-2)

Rev. Rul. 2003-125

ISSUE

Under the circumstances described below, when an election is made to change the federal tax classification of an entity from a corporation to a disregarded entity under § 301.7701-3 of the Procedure and Administration Regulations, is the shareholder allowed a worthless security deduction under § 165(g)(3) of the Internal Revenue Code?

FACTS

Situation 1

P is a domestic corporation that is a calendar year taxpayer. FS is an entity that is organized under the laws of Country X. FS has only one class of equity interests outstanding, all of which is owned by P. Since the date of its organization, FS has derived all of its gross receipts from manufacturing operations. FS is indebted to P and to trade creditors. All of FS's indebtedness constitutes valid indebtedness for federal tax purposes and is recourse to FS. FS is an eligible entity within the meaning of § 301.7701-3(a) and, prior to July 1, 2003, FS is treated as a corporation within the meaning of § 7701(a)(3) for federal tax purposes.

On December 31, 2002, P's FS stock was not worthless. On July 1, 2003, P files a valid Form 8832, *Entity Classification Election*, changing the classification of FS from a corporation to a disregarded entity for federal tax purposes effective as of that date. The election has no effect on the treatment of FS under Country X law. After the election is effective, FS continues its manufacturing operations. At the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, exceeds the sum of its liabilities. However, at that time, the fair market value of FS's assets, excluding intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities.

Situation 2

The facts are the same as in *Situation 1*, except that at the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities.

LAW AND ANALYSIS

Section 301.7701-3(g)(1)(iii) provides that if an eligible entity classified as an association properly elects under § 301.7701-3(c)(1)(i) to be classified as a disregarded entity, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association.

Under § 301.7701-3(g)(2), the tax treatment of a change in the classification of an entity for federal income tax purposes by an election under § 301.7701-3(c)(1)(i) is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 301.7701-3(g)(3) provides that any transaction deemed to occur as a result of a change in classification is treated as occurring immediately before the close of the day before the election is effective.

Under § 332(a), no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(b) provides, in part, that a distribution shall be considered to be in complete liquidation only if the corporation receiving such property was, on the date of the adoption of the plan of liquidation and at all times thereafter until the receipt of the property, the owner of stock that meets the requirements of § 1504(a)(2) and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation.

Section 1.332-2(b) of the Income Tax Regulations provides that § 332 applies only to those cases in which the recipient corporation receives at least partial payment for stock which it owns in the liquidating corporation. If § 332 is not applicable, see § 165(g) relative to allowance of losses on worthless securities.

In determining the amount of gain recognized by shareholders upon a taxable corporate liquidation, courts have recognized that goodwill and other intangible assets that are distributed in the liquidation must be taken into account. *See, e.g., Carty v. Commissioner*, 38 T.C. 46 (1962).

Section 165(a) allows as a deduction any loss sustained during the year and not compensated for by insurance or otherwise. Under § 1.165-1(b) and (d), to be allowable as a deduction under § 165(a), a loss must be evidenced by closed and

completed transactions, fixed by identifiable events, and, with certain exceptions, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form governs in determining a deductible loss.

Under § 165(g)(1), if any security which is a capital asset becomes worthless during the taxable year, the resulting loss is 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 for purposes of a worthless security deduction, the term “security” includes a share of stock in a corporation.

Under § 165(g)(3), any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset. A corporation is treated as affiliated with the taxpayer only if the taxpayer directly owns stock of the corporation that meets the requirements of §1504(a)(2), and more than 90 percent of the aggregate of the corporation’s gross receipts for all taxable years are from sources other than royalties, certain rents, dividends, certain interest, annuities, and gains from sales of stocks and securities.

Section 166(a)(1) allows as a deduction any debt which becomes worthless within the taxable year.

Section 166(a)(2) provides that the Secretary, when satisfied that a debt is recoverable only in part, may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

Whether a loss due to worthlessness is actually 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 becomes 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 worthless stock deduction for the year in which the corporation liquidated and the Commissioner denied the deduction on the grounds that the stock became worthless in a prior year. The court concluded that stock is worthless when it has neither liquidating value nor potential future value. Applying this standard, the court concluded that the stock became worthless in a prior year and, thus, denied the worthless stock deduction in the year claimed by the taxpayer. Where a worthless stock deduction is claimed upon the liquidation of a corporation and the stock did not become worthless in a prior tax year, the standard for determining worthlessness is whether the shareholders receive payment for their stock. See *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).

Rev. Rul. 70-489, 1970-2 C.B. 53, *amplifying* Rev. Rul. 59-296, 1959-2 C.B. 87, holds that where a wholly owned subsidiary had bona fide indebtedness to its parent corporation that exceeded the fair market value of its assets and the subsidiary

transferred all of its assets to its parent in partial satisfaction of its indebtedness, the parent could claim both a bad debt deduction and a worthless security deduction, even though the parent continued the business formerly conducted by the subsidiary. The ruling states as a fact that the stock of the subsidiary became worthless in the year at issue.

If a shareholder receives no payment for its stock in a liquidation of the corporation, neither § 331 nor § 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. In addition, the liquidation is an identifiable event that fixes the loss with respect to the stock.

A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the fair market value of the corporation's assets is less than the corporation's liabilities. In determining the fair market value of a corporation's assets, all of the corporation's assets, including tangible and intangible assets (such as goodwill and going concern value) and assets that may not appear on the corporation's balance sheet, must be taken into account. In addition, the fair market value of an asset may be different than the value that appears on the corporation's balance sheet. The estate tax regulations provide that the fair market value of property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. See § 20.2031-1(b) of the Estate Tax Regulations. The Service and the courts regularly apply the valuation standards in the estate tax regulations for purposes of determining the value of property for income tax purposes. See, e.g., *Krapf v. United States*, 977 F.2d 1454, 1457 (Fed. Cir. 1992); *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 220 (1998).

The fair market value of a corporation's intangible assets is determined by reference to all of the facts and circumstances, which may include, but are not limited to, the corporation's prospects for future profit as evidenced by such things as the corporation's economic outlook, the demand for the corporation's products, the efficiency of the corporation's operations, and the size of the corporation's customer base. Other factors used in making this determination may include, but are not limited to, whether a substantial capital infusion will be necessary in order to continue operations, whether any significant operational changes are anticipated, and whether an impairment loss is or will be reported for financial statement purposes or whether the operations are or will be reported as discontinued operations for financial statement purposes. Where a corporation's business continues after a liquidation of the corporation without a substantial infusion of capital and the revenues of that business following the liquidation exceed the amount required to service debt that existed immediately prior to the liquidation, such facts may suggest that at the time of liquidation the fair market value of the liquidating entity's assets, including goodwill and going concern value, exceeded the sum of its liabilities and that the deemed distribution of assets was with respect to stock within the meaning of § 1.332-2(b).

In *Situation 1*, at the close of the day immediately before the effective date of the election, the stock of FS is not worthless because the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, exceeds the sum of FS's liabilities. Accordingly, P receives at least partial payment on its FS stock in the deemed liquidation of FS. Hence, § 332 applies to the deemed liquidation and no loss is allowable to P.

In *Situation 2*, at the close of the day immediately before the effective date of the election, the stock of FS is worthless because the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, does not exceed the sum of FS's liabilities. Accordingly, P does not receive any payment on its FS stock in the deemed liquidation of FS and § 332 does not apply to the deemed liquidation. The deemed liquidation is an identifiable event that fixes P's loss with respect to the FS stock. Therefore, P is allowed a worthless security deduction under § 165(g)(3) on its tax return for the 2003 taxable year. FS's creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under § 166.

HOLDING

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 § 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.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 70-489 is superseded and Rev. Rul. 59-296 is amplified.

DRAFTING INFORMATION

For further information regarding this revenue ruling, contact Glenn Bogdonoff of the Office of Associate Chief Counsel (Income Tax and Accounting) on (202) 622-4950 (not a toll-free call) or Sean McKeever of the Office of Associate Chief Counsel (Corporate) on (202) 622-7750 (not a toll-free call).