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INTERNAL REVENUE SERVICE
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CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel
Large and Mid-Size Business

FROM: HEATHER MALOY
ASSOCIATE CHIEF COUNSEL (INCOME TAX & ACCOUNTING)
CC:ITA

SUBJECT: Check-the-Box Election and Worthless Stock Loss

This Field Service Advice responds to your memorandum, dated August 7, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Corp A =
Corp B =
Corp C =
Country D =
Entity E =
Entity F =
Classification G =
Date H =
Products I =
Date J =

Date K	=
Date L	=
$M	=
$N	=
$P	=
$Q	=
Tax Year 1	=
Tax Year 2	=

ISSUES

1. Whether the effective date of the classification change from corporation to partnership occurs in Tax Year 1.

2. Whether Corp X is entitled to a worthless securities deduction under section 165(g) of the Internal Revenue Code in the amount of $Q in Tax Year 1.

CONCLUSIONS

1. Subject to the assumption regarding the filing date below, the entity classification change was effective in Tax Year 1.

2. Sufficient facts have not yet been presented to demonstrate that Corp X is entitled to take a worthless stock deduction under section 165(g) for its investment in the Entities.

FACTS

Corp A is a United States holding corporation that has a number of wholly-owned subsidiaries, including Corp B and Corp C. Corp A and its U.S. subsidiaries are an affiliated group that report their income on a consolidated return. Corp A, Corp B, and Corp C are also collectively referred to herein as Corp X. Corp B and Corp C own 99% and 1%, respectively, in each of the two Country D entities: Entity E and Entity F. Entity E was formed as a Classification G on Date H. It markets and sells Products I in Country D. Entity F was formed as a Classification G on Date J. It assembles Products I and sells them to Entity E. Both Entity E and Entity F are corporations within the meaning of section 7701(a)(3).

During Tax Year 2, Corp X filed two Forms 8832, "Entity Classification Election," to change the classification of Entity E and Entity F from that of a "corporation" to a "partnership" for U.S. federal tax purposes. The Forms 8832 were signed on Date K and specified an effective date of Date L (the first day of the Tax Year 2). The change in Entity E's and Entity F's entity classification resulted in no changes to their operating agreements or business practice. Entity E and Entity F continued to operate and maintain their books and records as corporations. Country D continued to treat Entity E and Entity F as corporations. In fact, Corp X has represented that neither Entity E or Entity F is aware of its change in classification from corporation to partnership for U.S. federal tax purposes.

In Tax Year 2, Corp X wrote-off and capitalized debts owed to it by Entity E, in the total amount of $M. However, Corp X deducted $M in the prior tax year, Tax Year 1. In Tax Year 1, Corp also deducted $N, which is attributed to its ownership of the Common Stock of Entity E, and $P, which is attributable to the Common Stock of Entity F. All three amounts, a total of $Q, were claimed as a worthless stock loss. The loss was recognized for book purposes in Tax Year 2 but the entry was reversed by an adjusting entry in the same year.

LAW AND ANALYSIS

Under Treas. Reg. § 301.7701-3(a), an eligible entity may elect its classification for federal tax purposes, under what has been termed colloquially as the "check-the-box" regulations. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation) or a partnership.

Treas. Reg. § 301.7701-3(b)(2)(i) provides that unless a foreign eligible entity elects otherwise, the entity is: (A) a partnership if it has two or more members and at least one member does not have limited liability; (B) an association if all members have limited liability; or (C) disregarded as an entity separate from its owners if it has a single owner that does not have limited liability.

Treas. Reg. § 301.7701-3(c)(1)(i) provides the time and place of filling an election, which involves the filing of a Form 8832.

Under Treas. Reg. § 301.7701-3(c)(1)(iv), a taxpayer generally may not change its classification for 60 months after the effective date of the election. A change in classification may be made sooner in certain circumstances

Treas. Reg. § 301.7701-3(g)(1)(ii) provides that if an eligible entity classified as an association elects under section 301.7701-3(c)(1)(i) to be classified as a partnership, the association is deemed to distribute all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership.

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

Under Treas. Reg. § 301.7701-3(g)(3), any transaction that is 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.

Section 332 provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of a corporation, if the recipient corporation on the date of the adoption of the plan of liquidation and continued to be at all times until the receipt of the property the owner of stock meeting the requirements of section 1504(a)(2), and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation and the transfer of property occurs within one taxable year.

Treas. Reg. § 1.332-2(b) provides that section 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. The regulation further provides that if section 332 does not apply, see section 165(g) relative to allowance of losses on worthless securities.

Timing of the election

To elect to be classified other than as provided in section 301.7701-3(b), an eligible entity must file Form 8832 with the designated service center. Section 301.7701-3(c)(1)(i). An election will be effective on the date specified on the Form 8832 or on the date filed if no such date is specified. The effective date specified on the Form 8832 cannot be more than 75 days prior to the date the election is filed. Section 301.7701-3(c)(2)(iii). In this case the elections were dated Date R. The effective date of the elections was Date L, a date 73 days prior to Date R. The 75th and last day that the election could have been timely filed for Date L, was a Sunday. Therefore, assuming the elections were filed by the following Monday, they would have been timely filed to be effective as of Date L. See § 301.7503-1(a). These transactions will be deemed to occur on the last day of Tax Year 1, because the elective change has an effective date of Date L.

The change in classification in the present case occurred before the effective date of § 301.7701-3(g) which provided for both the deemed conversion transactions, and the timing provisions. However, under § 301.7701-3(g)(4), taxpayers are permitted to retroactively apply § 301.7701-3(g). Therefore, as a result of the change in classification, Taxpayer has the authority to treat the Entities as liquidating immediately prior to the close of Tax Year 1.

Worthless Stock Loss in General

Section 165(a) allows as a deduction any loss sustained during the year and not compensated by insurance or otherwise.

Under section 165(g)(1), if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as the sale or exchange, on the last day of the taxable year, of a capital asset.

Section 165(g)(3) provides an exception allowing ordinary loss treatment for stock in certain affiliated corporations, even if the stock is a capital asset. To qualify, the taxpayer must meet certain requirements found in section 165(g)(3), which we assume that have been met in the current case.

Treas. Reg. § 165-1(b) requires 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. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

Treas. Reg. § 1.165-1(d)(1) provides that a loss is allowable under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss is treated as sustained during the taxable year in which the loss is evidenced by closed and completed transactions and fixed by identifiable events occurring in the taxable year.

The long-standing requirements of the regulations that losses, and specifically worthless stock losses, must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period have the effect of law. Boehm v. Commissioner, 326 U.S. 287, 292 (1945). For worthless stock loss to be actually sustained during the year, the taxpayer must suffer an economic loss. Commissioner v. Fink, 483 U.S. 89, 97-98 (1987). Further, no loss is allowed if there exists at the time of the loss a claim for reimbursement with respect to which there is a reasonable prospect of recovery. Treas. Reg. § 1.165-1(d)(2)(i).

In addition, no loss is allowed unless the stock is wholly worthless. Treas. Reg. § 1.165-5(c) and § 1.165-5(f). A mere shrinkage in the value of stock, even though extensive, does not give rise to a deduction under section 165(a), if the stock has any recognizable value on the date claimed as the date of loss. Treas. Reg. § 1.165-4(a). That "any recognizable value" will deny the deduction means that the stock must be utterly valueless. 875 Park Ave. v. Commissioner, 217 F.2d 699, 701 (2d Cir. 1954); Ditmar v. Commissioner, 23 T.C. 789, 798 (1955), acq. 1955-2 C.B. 5.

Factual Nature of the Inquiry into the Worthlessness of Stock

A determination of the worthlessness of stock is "purely a question of fact." Boehm, 326 U.S. at 293; Klepetko v. Commissioner, T.C. Memo. 1990-644, aff'd in an unpublished opinion, (2d Cir. January 7, 1992). Worthlessness is determined by an objective rather than a subjective standard, although subjective considerations may play a part. Boehm, 326 U.S. at 293. See Aagaard v. Commissioner, 56 T.C. 191, 209 (1971), acq. 1971-2 C.B. 1.

Whether worthlessness occurs in a particular year is also a question of fact. Boehm, 326 U.S. at 293; Klepetko, supra. The burden of showing worthlessness is on the taxpayer. Boehm, 326 U.S. at 294; Figgie International, Inc. v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986).

In Boehm, the Supreme Court clarified the factual nature of the inquiry.

> Such an issue of necessity requires a practical approach, all pertinent facts and circumstances being open to inspection and consideration regardless of their objective or subjective nature. As this Court said in Lucas v. American Code Co., 280 U.S. 445, 449 [(1930)], “no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test.”

326 U.S. at 292-93.

The standard has been stated to be whether a prudent businessman would have considered the stock to be worthless. Steadman v. Commissioner, 50 T.C. 369, 377 (1968), aff'd, 424 F.2d 1 (6th Cir.), cert. denied, 400 U.S. 869 (1970); Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276. See Ainsley v. Commissioner, 332 F.2d 555, 557 (9^{th} Cir. 1954) (“prudent purchaser” test), which appears to control in the current case.

Taxpayer’s position

Since Corp X elected to have the Entities classified as a partnership, the Entities are to be treated under federal tax law as if they liquidated the assets if the association to Corp X and immediately thereafter Corp X contributed all of the assets to a newly formed partnership. Treas. Reg. § 301.7701-3(g)(1)(ii). We assume that the Corp X’s rationale for claiming a worthless stock loss for both Entity E and Entity F, is that the liabilities of each entity exceeded its assets as the date of the deemed liquidation, and, as a result, the stock of each entity is worthless under section 165(g). Because of the purely factual nature of the determination of the worthlessness, we cannot make any final determination whether there is a worthless stock loss under the particular circumstances of this case. However, for the reasons discussed below, we do find that the facts presented thus far are not sufficient to find the stock worthless under section 165(g).

Two-part test for the worthlessness of stock

The essential standards for a determination of worthlessness are lucidly set forth in Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), nonacq. 1939-1 C.B. 57, aff'd, 112 F.2d 320 (7th Cir. 1940):

> From an examination of [the] cases it is apparent that a loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss sustained, that the stock may not be considered worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time, and that such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of corporation, or the appointment of a receiver for it. Such events are called “identifiable” in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock.
>
> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss.... If [the corporation's] assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and cannot be said to be worthless. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.
>
> There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders. In such a case the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can presently be said to have no potential value. Where both of these factors are established, the occurrence in a later year of an "identifiable event” in the corporation's life, such as liquidation or

> receivership, will not, therefore, determine the worthless off of the stock, for already "its value had become finally extinct."

This language from Morton is often relied upon by courts. See e.g. Figgie, 807 F.2d at 62; Corona v. Commissioner, T.C. Memo. 1992-406, aff'd without opinion, 33 F.3d 1381 (11th Cir. 1994), cert. denied, 513 U.S. 1094 (1995); Garner v. Commissioner, T.C. Memo. 1991-569, aff'd, 987 F.2d 267 (5th Cir. 1993).

Thus, Morton established a two-part test for the finding of worthlessness of stock. First, the stock must cease to have liquidating value, i.e., the corporation has an excess of liabilities over assets. Second, the stock must lack potential value. Austin Co. v. Commissioner, 71 T.C. 955, 969-70 (1979), acq. 1979-2 C.B. 1. The stock must be worthless under both factors before the loss is fixed. See Figgie, 807 F.2d at 62.

Application of the two-part test

Insolvency

In the present case, it is not clear that the Entities are insolvent at the time of the liquidation. Further, although, it appears that amounts that Corp X forwarded to Entity E were reclassified as equity, it is not clear that these are the only amounts at Corp X forwarded to the Entities.

In finding whether the subsidiary is in fact insolvent, the loans from the taxpayer to the subsidiary must be bona fide and not in substance equity. See Ditmar, supra; Leuthold v. Commissioner, T.C. Memo. 1987-610; Wildes v. Commissioner, T.C. Memo. 1980-298. Further, any bad debt deduction which may be claimed by a taxpayer under section 166(a) must be shown to involve bona fide debt. Treas. Reg. § 1.166-1(c).

Section 385 and the case law provide some guidance in determining whether any amounts forwarded by Corp X to the Entities is debt or equity. Under section 385(a), the Service is authorized to prescribe regulations as may be necessary or appropriate to determine whether an interest in a corporation is debt or equity. Section 385(b) lists the following factors that the regulations may include in making such a determination: (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (ii) whether there is subordination to or preference over any indebtedness of the corporation, (iii) the ratio of debt to equity of the corporation, (iv) whether there is convertibility into the stock of the corporation, and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

The courts have focused on these factors as well as others in making a determination of whether an interest is debt or equity. See, e.g., Dixie Dairies Corp v. Commissioner, 74 T.C. 476 (1980), acq. 1982-1 C.B. 1; Wachovia Bank & Trust Co. v. United States, 288 F.2d 750 (4th Cir. 1961); Notice 94-47, 1994-1 C.B. 357. Additionally, section 385(c) provides that the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest, unless the holder discloses such inconsistent treatment as provided in section 385(c)(2). In no event will the issuer's characterization be binding on the Service.

In addition, that Corp X continues the business of the Entities after the liquidation indicates that the Entities had going concern value that should be considered in determining the value of each Entity's assets at the time of its liquidation. See Sika Chemical Co. v. Commissioner, 64 T.C. 856, 863 (1975), aff'd without opinion, 538 F.2d 320 (3d Cir. 1976); Hawkins v. Commissioner, T.C. Memo. 1987-91. There may also be some value attached to other intangible assets such as trade marks. See Wally Findlay Galleries International, Inc. v. Commissioner, T.C. Memo. 1996-293.

If an Entity is solvent at the time of its liquidation, Corp X is not entitled to worthless stock deduction under section 165(g). Additionally, a transfer of the subsidiary's assets and liabilities to the taxpayer under section 301.7701-3(g)(1)(iii) generally should qualify as a section 332 liquidation of subsidiary into a parent if the subsidiary is determined to be solvent at the time of its liquidation. See Treas. Reg. § 1.367(b)-3 and Rev. Rul. 72-421, 1972-2 C.B. 166, for some of the possible consequences of such liquidation.

Loss of potential value

Worthlessness without an identifiable event

Under Morton, there are two ways of showing lack of potential value, either liabilities so exceed the assets that there is no hope for recovery or by identifiable events demonstrating the worthlessness of the stock. No evidence has been presented here that the Entities are so insolvent that there is no hope of discovery. See Steadman, 50 T.C. at 376-77; Corona, supra.

Identifiable events in general

Thus, the question is whether the liquidation under Treas. Reg. § 301.7701-3(g)(1) is a identifiable event that qualifies as a recognition event for purposes of section 165(g). As stated in Morton, 38 B.T.A. at 1278, "identifiable events" include such occurrences as bankruptcy, cessation of business, liquidation of the corporation, or the appointment of a receiver for it. See Steadman, 50 T.C. at 376-77; Corona, supra.

Events other than those listed in Morton may be identifiable events. For example, the sale of all the corporate assets and surrender of a corporate charter are often listed as identifiable events. See Wayno v. Commissioner, T.C. Memo. 1992-53. See also Byrum v. Commissioner, 58 T.C. 731 (1972), acq. 1979-2 C.B. 1, where the identifiable events included the indictment of officers and the resulting bad publicity. A review of the case law demonstrates that a single identifiable event is rarely sufficient to conclude that stock is worthless.[1] See, e.g., Murray v. Commissioner, T.C. Memo. 2000-262 (foreclosure not determinative); Osborne v. Commissioner, T.C. Memo. 1995-353, aff'd, 114 F.3d 1188 (6th Cir. 1997)(bankruptcy not determinative); Schnurr v. Commissioner, T.C. Memo. 1989-275 (cessation of business and sale of the assets not determinative); Slater v. Commissioner, T.C. Memo. 1989-35 (cessation of business not determinative). Therefore, the events listed in Morton are not conclusive of worthlessness in themselves.

Timing of the loss using identifiable events

The recognition event for a worthless stock loss occurs, not when any single identifiable event occurs, but when there is no further ability to recover the taxpayer's investment. Identifiable events act to secure that point in time. This is clearly demonstrated by Ditmar, supra. There, the Service argued that the stock of an unsuccessful company became worthless in the year the company sold its assets and went out of business, both of which are identifiable events listed in Morton. However, the Tax Court agreed with the taxpayer that the stock did not become worthless until the next year when the taxpayer received his last distribution upon liquidation. The court found that this was the identifiable event fixing worthlessness because at that point "there was no prospect that he would receive any more." 23 T.C. at 798. See Reese Blizzard v. Commissioner, 16 BTA 242 (1929), no recognition event until the final disposition of property by trustees.

As demonstrated by Ditmar, identifiable events must be analyzed in the context in which they occur to determine if they either evidence or cause the utter worthlessness of the stock. The analysis of the impact of the specific nature of an identifiable event in its context is consistent with Boehm's requirement that the standard for when stock is worthless is a "flexible, practical one, varying with the circumstances." 326 U.S. at 326. Thus, courts will also consider the possibility and ease of reversing what would otherwise be an identifiable event. For example, in Slater, supra, the Tax Court found that the stock of a corporation was not worthless in the year the business ceased but in

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[1] See John Harilee, Jr. and John C. McCoy, Loss Deductions, 527-5th Tax Mgmt. Portfolio (BNA) A-32, ("[A] reading of the cases will make it clear that it is rare for a solitary event to suffice"); Mertens Law of Fed Income Tax § 28.118 ("Under the cases decided in this area, a single identifiable event is seldom sufficient to establish worthlessness.")

the subsequent year when negotiations with creditors were completed and assets disposed of. Until that point, it was not certain that business would not resume if economic conditions improved. The court noted that the corporation had gone out of business once before. Thus, the Tax Court delayed the recognition of a worthless stock loss where there was a possibility that an identifiable event would be undone. Likewise, in Tippen, supra, the court considered the possibility of corporation undoing the surrender of a corporate charter, which caused a dissolution.

Liquidation as an identifiable event

As a result, that liquidation is included in the list provided in Morton, does not in itself mean that a liquidation, including a deemed liquidation under the check-the-box regulations, necessarily leads to worthless stock loss when the subsidiary is insolvent. See Nelson v. United States, 131 F.2d 301, 302-03 (8th Cir. 1942), stating in essence that no identifiable event is sufficient if "the evidence also establishes the existence of a potential value which may be realized on liquidation or through the continuation of the business." Liquidation has been one of several identifiable events occurring in the taxable year, none of which was held to be conclusive in itself. See A.S. Genecov; Saylor Electric & Manufacturing Co. v. United States, 33 F. Supp. 310 (E.D. Mich. 1939); Tippen v. Commissioner, T.C. Memo. 1988-284. Normally, it is the last of a number of identifying events of failing corporation. See, e.g., Smith v. Helvering, 141 F.2d 529 (D.C. Cir. 1944); Nelson, supra. As discussed below, the nature of a liquidation has been examined by courts. See A.S. Genecov v. United States, 412 F.2d 556, 561 (5th Cir. 1969); Greenberg v. Commissioner, T.C. Memo. 1971-220.

Liquidation as evidence of worthlessness

As indicated in the quote from Morton, identifiable events may function as evidence that the stock is worthless. Thus, it has been stated that "[t]o establish worthlessness, the taxpayer 'must show a relevant identifiable event...which clearly evidences destruction'" of the value of the stock. Delk v. Commissioner, 113 F.3d 984, 986 (9th Cir. 1997); Austin, 71 T.C. at 970. As also stated in Morton, an identifiable event should evidence the worthlessness of the corporation to others besides the shareholders. See Tippen, supra, where the court applied this principle in finding stock worthless.

In the present case, the Entities continue to operate in the same manner under foreign law and there is no known indication to outsiders that their stock is worthless. The Entities themselves apparently did not know they had changed form. Under the facts, it is also not clear that Corp X has written the stock off as worthless on its books, which would indicate it is in fact worthless. See Flint Industries Inc. v. Commissioner, T.C. Memo. 2001-276. It is not stated that the stock was cancelled. In fact, Corp X's beneficial ownership of the Entities in Country D has not changed. As a result, we do not see that the check-the-box elections made by Corp X, each of which provides for a deemed liquidation followed by an immediate contribution to a partnership, provide any evidence of the worthlessness of the stock.

Liquidation as destroying potential worth.

Morton also speaks of identifiable events that "limit or destroy" potential worth. As such, identifiable events may function as more than mere evidence and, in certain circumstances, they actually act to "put an end to any reasonable hope and expectation of any potential value." Austin, 71 T.C. at 971. We agree that a liquidation would limit or destroy potential in circumstances where the liquidation destroys the taxpayer's ability to recover its investment. See Drachman v. Commissioner, 23 T.C. 558 (1954), acq. 1955-2 C.B. 5, where assets were taken over by creditors who planned to liquidate the corporation in order to satisfy their own claims.

But whether liquidation has occurred is itself a question of fact. Genecov, 412 F.2d at 561, and cases cited therein. The court in Genecov went on to state-

> The real factor, in determining whether a corporation has been completely liquidated, "…is whether in actual point of fact it is the intent of the corporation to wind up its affairs, gather in its resources, settle up its liabilities, cease taking on new business, and then distribute to its stockholders all that is left over."

Id. quoting Kennemer v. Commissioner, 96 F.2d 177, 178 (5th Cir. 1937). This is the kind of liquidation that could in fact end potential value of an ongoing business.

In contrast in the present case, the business of the Entities continues, which is normally an indication of potential worth. See Bullard v. United States, 146 F.2d 386, 388 (2d Cir. 1944); G.E. Employees Securities Corp. v. Manning, 137 F.2d 637, 639 (3d Cir. 1943); Klepetko, supra. There have been circumstances where a stock is found to be worthless even though the business continues. See Steadman, 50 T.C. at 378; Emhart v. Commissioner, T.C. Memo. 1998-162. The question in such cases is whether the activities of the corporation were in the "nature of salvaging something for the creditors" or "whether the activities are so related to a continuation of general operations that they manifest reasonable expectations of future value in the stock." Frazier v. Commissioner, T.C. Memo. 1975-220, 34 TCM (CCH) 951, 962-63, citing Steadman, 424 F.2d at 4, and Boehm, 326 U.S. at 293. See Continental Illinois National Bank v. United States, 81-1 USTC ¶ 9185 (N.D. Ill 1980), reaching a similar conclusion. Again, the question is whether there are reasonable expectations of future value.[2] The Entities are apparently continuing in business because of reasonable

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[2] Consistent with this, a taxpayer may not postpone the deduction until only an "incorrigible optimist" would fail to recognize the stock was worthless. Keeney v. Commissioner, 116 F.2d 401, 403 (2d Cir. 1940). Nor is a stock precluded from being worthless because it is sold for a small amount to someone is willing to "take a flyer" on the stock. Steadman, 50 T.C. at 378.

expectations of future value and not for reasons that would be consistent with the worthlessness of the stock.

Greenberg, supra, represents facts similar to the present case. There, the Tax Court found that formal dissolution of a corporation was not an identifying event, where, at the same time, the taxpayers created a new corporation that ran a very similar business. The taxpayers had adopted a plan of liquidation and formally dissolved their corporation under state law. In reaching its holding, the court found it significant that no assets were actually turned over to a trustee or creditors. In refusing to recognize the dissolution, the Tax Court also noted the lack of business purpose for the dissolution and the taxpayer's tax motivation to concoct an "identifiable event." The taxpayer was allowed no loss. Similarly, the Tax Court in Osborne, supra, refused to find a bankruptcy under Chapter 11 to be a recognition event corporation, where the corporation continued to exist and operate. The court noted there was no actual liquidation of the assets under Chapter 7, which would have been for the benefit of creditors.

The present case does not involve a liquidation that would in itself be a recognition event for a worthless stock loss. The liquidation in this case does not destroy the potential worth of the Entities' stock because it is immediately followed by a contribution of the assets and liabilities to a partnership. It does not end Corp X's ability to recover its investment in the Entities through continued operations or sale of its interest in the Entities. There is no ultimate disposition of the assets that requires the ending of the business of Entities.

Stock is not worthless because nothing is received for it

Prior arguments under the predecessor of section 332

We do not believe that stock is worthless for purposes of section 165(g) simply because liabilities exceed assets in a liquidation and nothing received in return is attributed to the stock. The case law may be misleading, because for many years the Service argued that no loss should be allowed in any liquidation subject to former section 112(b)(6) of the Internal Revenue Code of 1939, the predecessor of section 332. The argument was that if some amount was received in liquidation the transaction was not to be recognized for tax purposes and therefore no loss was deductible. The argument was rejected by the courts so long as the amount received in liquidation was not in excess of the debt of the corporation. See Spaulding Bakeries, Inc. v. Commissioner, 27 T.C. 684 (1957), aff'd, 252 F.2d 694 (2d Cir. 1958), nonacq. 1957-2 C.B. 8; Northern Coal & Dock Co. v, Commissioner, 12 T.C. 42 (1949), acq. 1949-1 C.B. 3, 4; Iron Fireman Manufacturing Co. v. Commissioner, 5 T.C. 452 (1945), acq. 1945 C.B. 4. See also H.K. Porter, Inc. v. Commissioner, 87 T.C. 689 (1986).

Arguably, this case law could be interpreted to support the argument that so long as the amount received in a liquidation was not in excess of the debt of the corporation, the stock was worthless. However, in these cases, the Service did not argue that the stock had retained potential value. Iron Fireman, for example, involves facts similar to the present case in that the company was liquidated and continued to be run as a branch. However, the Service did not argue that the stock had potential worth, despite of the liquidation or because of the continued operation of the business. Instead, the Service argued that the stock actually became worthless in a year prior to the one at issue and the section 112(b)(6) argument was an alternative argument to disallow the loss in the tax year claimed. Thus, the issues involved here were not raised in Iron Fireman.

Rev. Rul. 70-489

The Service has also published Rev. Rul. 70-489, 1970-2 C.B. 53, holding that a parent that takes over the assets of a subsidiary in a statutory merger may claim both a bad debt deduction on bona fide debt and take a worthless stock loss, where the assets only partially satisfied the debt owed the parent. However, it was one of the facts of the revenue ruling that the stock was worthless in the year the assets were transferred to the parent. The finding of worthlessness was not a legal conclusion and the factual finding that the stock was worthlessness would not have been necessary if that legal conclusion were intended. As a result, Rev. Rul. 70-489 may not be relied upon to conclude that stock is worthless in the instant case.

In Rev. Rul. 70-489, the parent also continued to run the subsidiary as a branch. In this sense, the holding is consistent with case law, previously discussed, holding that it is possible for stock to be worthless even though the business of the corporation continues. See Continental Illinois, supra. However, continuing to run the business usually indicates that the stock is not worthless and the revenue ruling may not be relied upon to reach an opposite conclusion under all facts.

Potential worth of stock disposed of by sale

Cases involving the sale of stock also demonstrate receiving no compensation for the ownership is not enough to establish that the stock is worthless for the purpose of section 165(g). The sale of the stock is a recognition event, which deprives the former shareholder of the beneficial ownership, but the question remains whether the seller is entitled a capital or an ordinary loss. If stock is disposed of by a sale, the taxpayer must show that it was worthless prior to the sale in order to get an ordinary loss under section 165(g). Figgie International v. Commissioner, T.C. Memo. 1985-369, aff'd, 807 F.2d 59 (6^{th} Cir. 1986); Emhart, supra.

Significantly, Figgie held that the stock had potential value, and was, therefore, not worthless, even though it was not shown that the taxpayer received more than the repayment of its debt upon disposition of the stock. Figgie involves the claimed worthlessness of a foreign subsidiary, which was owned by the taxpayer through two other subsidiaries. One of the shareholder's subsidiaries had loaned the foreign subsidiary over 2 million dollars. The foreign subsidiary was operating at a loss for several years but began to turn around in 1968. In 1969, the stock was transferred to a third party for no consideration, when the third party promised to pay the shareholder debt and execute a licensing and assistance agreement under which additional amounts would be paid.

The Service agreed that the taxpayer had a capital loss on the disposition of the stock but argued the stock was not worthless. Both the Tax Court and Sixth Circuit agreed that the taxpayer could not take a worthless stock deduction because the stock still had potential worth when it was transferred. In reaching this conclusion, the both courts looked at the history of the corporation and found that as of the date of the transfer agreement the future of the corporation looked promising. This view was confirmed by the purchaser's ability to pay off the loans in a timely manner.

In addition, the Tax Court found that the taxpayer's decision to accept no money for the stock with the tax consequences in mind was not evidence that the stock was worthless. The court noted that the taxpayer had received valuable consideration including the promise that its debt would be repaid and the licensing and assistance agreements. The Sixth Circuit noted this conclusion, although without mentioning the assistance agreement, but did not rely upon this part of the Tax Court's opinion in reaching its holding on the potential worth of the stock.

Significantly, neither opinion in Figgie concluded that the consideration that the taxpayer received in the transaction was in excess of its indebtedness to the subsidiary or allocable to the stock. Instead, the case rests on a determination that the history of the company indicated that the stock had potential value at the time it was transferred. In such circumstances, the taxpayer was not allowed a worthless stock deduction under section 165(g).

Emhart also dealt with the worthless stock of loss of a subsidiary and the court ultimately held the stock to have been worthless at the time of the sale. The court found that the subsidiary insolvent, and that the taxpayer was not compensated for the stock. However, the decision in Emhart does not rest solely on the finding that nothing was received for the stock, but also on the corporation's lack of potential worth even though it continued to operate.

In a sale, the taxpayer transfers its stock to another party and loses the ability to ever recover its investment, yet the law still requires a showing that the stock lacked potential worth at the time of the sale for the taxpayer to get an ordinary loss. The argument in the present case is that the taxpayer automatically qualifies for a worthless stock deduction and an ordinary loss deduction, when the stock loses its significance under federal tax law, even though the taxpayer still owns the Entities and has not lost its ability to recover its investment.

Potential worth of the investment after the election

The sale of stock does not destroy its potential worth and a sale is therefore distinguishable from a liquidation, which may. As a result, the question here again becomes whether the liquidation destroyed the potential value of Corp X's investment in the Entities. The stock has lost significance of under federal income tax law to the extent the Entities are now classified as partnerships. However, we think the Corp X's position puts too much emphasis on the continuance of the stock. The focus of section 165(g) is on the investment rather than the ownership of stock certificates. Thus, a taxpayer may be subject to section 165(g), even though it only has rights to obtain stock in the future. I.R.C. § 165(g)(2)(B). This is true even though the rights to own the shares are subject to substantial conditions. See Gawler v. Commissioner, 60 T.C. 647(1973), aff'd per curiam, 504 F.2d 425 (4th Cir. 1974); Schnurr, supra. Although there are no cases on whether the stock in the circumstances involved here retains its value, there are analogous cases.

Potential worth because of claims for reimbursement

Our position is also supported by cases dealing with potential reimbursements, which have found investments to have potential worth after the business ceases, Applegate v. Commissioner, T.C. Memo. 1992-156, and even after the assets are subsequently sold off, Schnurr. In both court cases, the taxpayers retained the ability to recover their investments through litigation. As result, even though there were identifiable events, the investment was not worthless, because a means to recoup it remained. In both cases, the investment could not be found to be worthless until the litigation was concluded. Schnurr was decided under section 165(g) as was Shvetz v. Commissioner, T.C. Memo. 1979-298, which also held stock was not worthless because of the possibility of reimbursement.

Applegate, Schnurr, and Shvetz involve potential reimbursement through a claim, and rest on Treas. Reg. § 1.165-1(d)(2)(i), which addresses claims for reimbursements. Still, Morton ties the potential worth of all stock to possibility of reimbursement in that it defines as "the reasonable expectation that the assets would exceed liabilities in the future." See Steadman, 50 T.C. at 376; Emhart, supra, relying on this definition. And again, section 165(a) requires that the taxpayer not be compensated for the loss for it to be deductible. Thus, "[u]ntil it is clearly shown that there is no probability that any portion of the investment will ever be recovered, no deductible [worthless stock] loss under the statute has been sustained." Lawson v. Commissioner, 42 BTA 1103, 1108 (1940), acq. 1941-1 C.B. 7, quoting Metzger v, Commissioner, 21 BTA 1271, 1272 (1931), acq. 1931-1 C.B. 43. Here, the continuing operation of the Entities provides a means for Corp X to recover its investment.

Potential worth of cancelled stock

Coleman v. Commissioner, 31 B.T.A. 319 (1934), aff'd, 81 F.2d 455 (10th Cir. 1936), found that cancelled stock was not worthless, when it led to stock in a new corporation. The court distinguished its facts, where the business of the old corporation was continued in the new, from circumstances where the prior corporation was dissolved and its assets distributed. 31 B.T.A. at 325. Delk v. Commissioner, 113 F.3d 984 (9th Cir. 1997), is a more recent case on the potential value of cancelled stock and is relevant in the present case. Although the Ninth Circuit reversed the Tax Court's finding that the cancelled stock was not worthless, the opinion confirms the underlying principle that cancelled stock retains potential value if it entitles the holders to new shares in a corporation.

In Delk, T.C. Memo. 1995-265, the Tax Court had held that the cancelled stock was not worthless because it entitled the taxpayer to new shares after the corporation reorganized. It distinguished similar cases in which a worthless stock loss was allowed, because they involved a clear separation between the cancellation of the old shares and the sale of the new. It also emphasized that the former shareholders had controlled the reorganization.

The Ninth Circuit reversed, finding on the facts presented that the new stock was not issued for the prior stock but for the additional consideration paid in by the shareholders. The court emphasized that the new stock was offered to outsiders on the same basis as it was provided to the former shareholders. As a result, the retention of the old shares did not provide any benefit to its owners. The Ninth Circuit rejected the Tax Court's emphasis on the separation between the cancellation of the old stock and the sale of the new. But the Ninth Circuit also indicated that if the rights to the old shares had provided its owners rights to new shares, the old shares would not be worthless.

Here, unlike Delk, Corp X retains essentially the same investment in the Entities; no new ownership interests were offered to or purchased by outsiders.

Potential worth of surrendered stock

The Supreme Court decision in Commissioner v. Fink, 483 U.S. 89 (1987), demonstrates that taxpayers may not take a worthless stock loss on stock they have relinquished unless the have suffered a real economic loss. In Fink, the taxpayers had tried to increase the attractiveness of their financially troubled corporation to outside investors by voluntarily surrendering some of their stock. As a result, their combined percentage of ownership was reduced from 72.5 percent to 68.5 percent and thus was a non pro rata reduction in their ownership. They claimed a worthless stock loss for their surrendered shares.

The Supreme Court held that a dominant shareholder who voluntarily surrenders a portion of his shares to the corporation, but retains control, does not sustain an immediate loss deductible from taxable income. Rather, the surrendering shareholder must reallocate basis in the surrendered shares to the shares retained. The shareholder's loss, if any, will be recognized when the remaining shares are disposed of. Significantly, the court concluded that its holding was not inconsistent with the “settled rule” that the gain or loss on the sale or disposition of the sale of stock equals the difference between the amount realized on the disposition and shareholder’s basis in the particular shares sold or exchanged. See I.R.C. § 1001(a); Treas. Reg. § 1.1012-1(c)(1).

In reaching this holding, the court reasoned that the Finks’ voluntary surrender of shares closely resembles an investment or contribution to capital. It noted that the purpose of the surrender had been to protect or increase the Finks’ remaining investment. Thus, if the surrender had achieved its purpose, the Finks would not have suffered an economic loss and there was no way of knowing whether the loss had occurred until the Finks had disposed of all their shares. As a result, the surrender of shares at issue did not meet the requirement of Treas. Reg. § 1.165-1(b) that an immediately deductible loss must be actually sustained during the year. Finally, the Supreme Court reached its decision because holding with the taxpayer would allow taxpayers to manipulate the timing and character of losses by voluntarily surrendering shares before the corporation fails.

Fink is of course distinguishable from the present case in that the taxpayers’ continued stock ownership was recognized for federal income tax purposes. In addition, the Court stated that the recognition event would occur when all the stock was disposed of. On the other hand, the Supreme Court refused to find that the surrender of stock for no consideration created a worthless stock deduction, even though it meant a reduction in the taxpayers’ interest in the corporation. Significantly, in reaching this conclusion, the Court looked to the taxpayers’ continued investment rather than the continued existence of specific shares.

In the present case, the stock is no longer recognized for federal income tax entity classification purposes to the extent that the Entities are partnerships. But Corp X retains the same control of the Entities it did before the election. Thus, we do not think that Corp X has suffered any actual economic loss as required by section 165 and Fink. In fact, the economic loss is less convincing here than in Fink. Lastly, as in Fink, Corp X has the ability to manipulate the timing and character of its loss as well as greatly accelerate it. This concern regarding the taxpayer’s ability to manipulate circumstances to create a worthless stock deduct is also is found in other cases we have discussed, notably Figgie, where nothing was received for stock in a sale, and Greenberg, which involved an asserted liquidation .

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

It may be that a court will accept the logic of Corp X’s argument that the stock is worthless simply because there was a deemed liquidation of a seemingly insolvent corporation. [redacted]

[redacted] Similarly, there are many cases where liquidation was an identifying event. These cases normally involve failing corporations in their final year and Service was often arguing the stock was worthless in an earlier year. However, [redacted]

In addition, because of the inherent factual nature of the determination of worthlessness, courts have come to different conclusion on similar facts. Thus, it was held that the stock of one corporation became worthless in year 1, year 5, and year 7. See G.E. Employees Securities, 137 F.2d at 641. The courts find this acceptable because it is a matter of evidence set forth in that litigation. See Woodward, F.W. v. United States, 106 F.Supp. 14, 31-32 (Iowa D.C. 1952), aff'd, 208 F.2d 893 (8th Cir. 1953). As a result, there are cases that have come to opposite conclusions than we cite on similar facts. Still we believe the tenor of the cases supports our position. For example, we relied upon Greenberg, supra, which refused to recognize a formal dissolution of a corporation, where no assets were dispersed and the business continued in another corporation. In Egly v. Commissioner, T.C. Memo. 1988-223, the Tax Court allowed the taxpayer to take a worthless stock loss, even though the same shareholders created a new corporation, which used some of the same assets, inventory and employees. The assets of the old corporation were apparently never actually distributed in liquidation. However, the products of the two corporations differed and the court found that the taxpayers could reasonably have given up on the old product, which was obsolete, as well as the old corporation. There were also other indications that the stock was worthless.

[redacted] In A.H. Rude & Co. v. Commissioner, No. 103,676 (B.T.A. Memo. 1941), in which a subsidiary was liquidated into a parent company and was continued as a branch. The parent was allowed bad debt and worthless stock loss; the worthless stock loss of $100 clearly was the less important issue. Again, the government was arguing no loss could be claimed because the application of former section 112(b)(6). No argument was made that the stock had potential value and there were other indications that the stock was in fact worthless.

Courier Journal Job Printing Co. v. Glenn, 37 F. Supp. 55 (W.D. Ken. 1941), aff'd, 127 F.2d 820 (6th Cir. 1942), is more troubling. There, the taxpayer was allowed a worthless stock deduction on the liquidation of a corporation even though it immediately exchanged the assets it had received in liquidation for stock in a new corporation, which ran the same business. The taxpayer had acted as the printer for the old corporation, which owed the taxpayer money.

The old corporation had been forced into liquidation by the inadvertent expiration of its corporate charter. The taxpayer wanted to reorganize the old corporation and bought the 72 shares of a recalcitrant stockholder, who would not agree for $2,400. In addition, the shares owned by employees of the old corporation were cancelled for consideration. As a result, the taxpayer owned almost all of the old corporation

The old company was liquidated and the taxpayer agreed to take its assets in exchange for the debts owed. The assets, which did not include any good will, were not sufficient to cover its debts to the taxpayer. The District Court found that in such circumstances the stock became worthless "as a matter of law." 37 F. Supp. at 59. Similarly, District Court found that it did not matter that the taxpayer's financial condition may have been no different from one day from the next because the loss had become deductible "as a matter of law." Id.

The District Court also rejected assertions that stock of the had potential worth because the 72 shares were purchased for $2,400. It reasoned that the price paid to settle with a recalcitrant shareholder might not represent fair market value. Further, it found that liquidation destroyed the value of the stock in the business ended. The District Court also refused to value goodwill in the liquidation because the taxpayer had not agreed to take it in satisfaction of its debts. Finally, the District Court rejected any argument that there was any statutory reorganization that would preclude the recognition of the loss. Although the result would be same as a reorganization, the court held it was "required to give full effect to each step of the actually taken by the parties without reference to the ultimate purpose of the transactions. " 37 F. Supp. at 61. The Sixth affirmed, agreeing with the District Court's general conclusions although without stating that the stock was worthless as a matter of law.

We doubt that any modern court would come to the same conclusions. The district court's determination that stock can be worthless as matter of law, even though a taxpayer's financial condition has not changed, violates the requirement established in Boehm that worthlessness is completely factual issue as well as the requirement established in the regulations and Fink that the loss must be bona fide and economic. Both courts' analysis of the good will issue conflicts with subsequent court cases cited previously. See Sika Chemical, supra; Hawkins, supra. Lastly, modern courts would not see themselves as bound to respect each step of transaction without consideration of the end result. See, e.g., Clark v. Commissioner, 489 U.S. 726, 738 (1989). We note that neither decision in Courier Journal has ever been cited in another court case.

We have relied on Figgie to argue that stock is not worthless under section 165(g) simply because no consideration is received for it in a disposition. Yet the court in Datamation Services, Inc. v. Commissioner, T.C. Memo. 1976-252, which also dealt with worthlessness in the context of the sale of stock, seemed to accept the taxpayer's argument that the stock would in fact be worthless if it had not received more than its liabilities the corporation. The court found the liabilities were not bona fide, and ultimately found the stock not to be worthless. It also held the stock had potential value.

In the final analysis, no case has addressed the facts presented here in this completely factual determination. [redacted]

ROBERT M. CASEY
Senior Technician Reviewer