Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Stuart Mann, Team Manager

from: Area Counsel, LMSB
(Financial Services)

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This memorandum responds to your request for assistance dated October 1, 2003. This memorandum should not be cited as precedent. Prior to issuance, this advice was formally reviewed by National Office.

INTRODUCTION

claimed worthless stock and bad debt losses with respect to its investment in subsidiaries in and

. The losses were claimed on deemed liquidations resulting from the change of entity classification of each entity from a corporation to a disregarded entity. The audit team made a preliminary determination that all or a portion of the intercompany loans made by to the entities should be treated as equity resulting in the solvency of each entity and the disallowance of the losses per I.R.C. section 332. argues that any reclassified debt should be treated as preferred stock, permitting the recognition of the losses with respect to the common stock.

FACTS

. ("taxpayer") owned a 100% interest in the common stock of (“ ”) and (“ ”) during the fiscal tax year ended . is the parent of a group of companies which have operated a chain of retail stores throughout since . is the parent of a group of companies which have operated a chain of retail stores throughout

since .
and were both treated as controlled foreign corporations for U.S. tax purposes from inception to

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Funding of Operations

As of , taxpayer’s equity investment in

and

was and

, respectively. Beginning in , taxpayer adopted a set of guidelines for borrowing U.S. dollars in the U.S. short term commercial paper market and lending local currencies to its foreign subsidiaries. Since the loans were denominated in foreign currency, taxpayer bore the foreign exchange risk. Taxpayer hedged its exposure to such risk by entering into forward contracts. The lending program was referred to as the
”). and

participated in the .[1]

As of , and

outstanding loan balances due to taxpayer were

and

, respectively. The advances to and were represented by promissory notes with stated interest of 8% and repayment terms of 6 days up to 35 days. The audit team has indicated that

and have not made timely

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[1] The short term funds were used by and

to finance the build-up of inventory and the increase in payroll expenses preceding and during the holiday selling season.

payments on the loans. Generally, the outstanding loans were rolled into new loans issued by the taxpayer to

and

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Valuation

Taxpayer hired Ernst & Young to conduct a valuation of a 100% interest in the common stock and the Business Enterprise Value of and . The business enterprise value of was determined to be as of . Assuming total intercompany debt of approximately , a 100% interest in the common stock of was determined to have no positive value.

The business enterprise value of was determined to be . Assuming total intercompany debt of approximately of loans outstanding to taxpayer and loans from another related controlled foreign corporation), a 100% interest in the common stock of was also determined to have no positive value as of .

Claimed Losses

Taxpayer made an election pursuant to Treas. Reg. sec. 301.7701-3(a) to change the entity classifications of and to disregarded entities, i.e., branches, effective

. The change in entity classification from a corporation to a branch resulted in a deemed liquidation of the corporations for U.S. tax purposes. See Treas. Reg. section 301.7701-3(g)(1).

Taxpayer argues that as a result of the deemed liquidations, section 165(g) permits the recognition of worthless stock losses in the amounts of and , with respect to its stock in and , respectively. In addition, taxpayer argues that section 166 permits the recognition of bad debt losses of and with respect to loans outstanding to and , respectively.[2]

The bad debt and worthless stock losses were claimed only

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[2]The bad debt losses were calculated by subtracting from the outstanding loans balances the value of the assets of and .

for U.S. tax purposes and were not reflected for U.S. financial reporting purposes. Furthermore, the capital and the debt remained on the books of and and the losses were not reflected for tax and financial purposes in and

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Debt – Equity Analysis

The audit team engaged in a debt-equity analysis of the intercompany loans to and . The audit team reached a preliminary determination that a significant portion of the loans should be reclassified as equity. As a result of the reclassification, and would have been solvent at the time of the deemed liquidation. Since the entities were solvent, property would have been received by taxpayer in exchange for its stock in the liquidation. Section 332 provides that no gain or loss is recognized by a shareholder in the liquidation of a corporation where property is received by the shareholder in exchange for its stock. Therefore, section 332 would apply and taxpayer would not be entitled to a worthless stock loss under section 165(g) with respect to its stock in

and .[3]

The taxpayer has argued that any reclassified debt should be treated as preferred stock since the advances were documented by notes which provided for a stated rate of return on the advances. In a liquidation, property is deemed distributed first to creditors, then to preferred shareholders and then to common shareholders. In our case, assuming that the value of the assets would not satisfy taxpayer's entire investment in the preferred stock, no assets would be received on the common shares and section 332 would not apply.

ISSUE

Assuming all or a portion of the intercompany loans to and should be treated as equity pursuant to a debt-equity analysis, whether the advances should be treated as contributions for a preferred class of equity.

CONCLUSION

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[3] For purposes of this memorandum, we assume that the amount of intercompany debt that has been reclassified as equity is sufficient to render and solvent.

If the notes representing the advances to and were properly executed and enforceable, then the terms of the notes must be respected for tax purposes. Since the notes provide for stated interest, such terms must be respected as a preference to earnings and profits of the companies. As such, the advances would be treated as made in return for a preferred class of stock. If taxpayer’s investment in the preferred stock exceeds the value of the assets of and , section 332 would not apply to the liquidations with respect to taxpayer’s investment in the common stock.

DISCUSSION

A. Legal Authority

An "eligible entity" can elect its classification for U.S. tax purposes. See Treas. Reg. section 301.7701-3. An eligible entity with a single owner can elect to be classified as an association (corporation) or to be disregarded as an entity separate from its owner. Treas. Reg. Sec. 301.7701-3(a).

If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association. Treas. Reg. section 301.7701-3(g)(1)(iii). A change in entity classification is governed by all relevant provisions of the Internal Revenue Code and general provisions of tax law, including the step transaction doctrine. Treas. Reg. section 301.7701-3(g)(2).

Pursuant to I.R.C. § 332, a shareholder recognizes no gain or loss upon the liquidation of a subsidiary if i) the shareholder possesses at least 80% of the total voting power of the subsidiary stock and ii) the stock possessed by the shareholder constitutes at least 80% of the total value of all the subsidiary stock. I.R.C. §§ 332 and 1504(a)(2).

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 the stock which it owns in the liquidating corporation. If section 332 is inapplicable, see section 165(g) relative to allowance of losses on worthless securities.” Therefore, section 332 does not apply where the liquidating corporation is insolvent since the shareholder does not receive any property in exchange for its stock in the liquidation.[4]

Where section 332 does not apply, a shareholder is entitled to a worthless stock loss pursuant to section 165(g) if it is established that the stock became worthless during the year at issue. If a taxpayer which is a domestic corporation owns stock possessing at least 80% of the voting power of all classes of the stock and at least 80% of the nonvoting stock of a foreign corporation which becomes worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss. Section 165(g)(3).

In establishing that section 332 does not apply to the liquidation of a subsidiary, a taxpayer must establish that the entity was insolvent based on a valuation of all the assets of the entity, taking into account balance sheet and off-balance sheet assets. Where the business of the entity continues after a liquidation, the taxpayer must consider the value of certain intangible assets typically associated with an ongoing business, such as going concern value and goodwill.

Where a shareholder owns common and preferred shares of a liquidating corporation, section 332 applies only where the shareholder receives property in exchange for its common stock. Commissioner v. Spaulding Bakeries, 252 F.2d 693 (2nd Cir. 1958), aff'g, 27 T.C. 684 (1957) and H.K. Porter Company Inc. and Subsidiaries, 87 T.C. 689 (1986).

In Commissioner v. Spaulding Bakeries, 252 F.2d 693 (2nd Cir. 1958), aff'g, 27 T.C. 684 (1957), the petitioner held common and preferred shares of stock of a wholly owned subsidiary ("Hazelton"). The subsidiary dissolved and the assets were transferred to the taxpayer in the liquidation. The fair market value of the corporation's assets satisfied only the taxpayer's investment in the preferred stock. There was no value remaining to cover taxpayer's investment in the common shares.

In arguing that the taxpayer received property in exchange for its common stock, the Service reasoned that the common shares and the preferred shares should be grouped together. Therefore, since property was received in liquidation, section

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[4] In a liquidation the assets are first distributed to satisfy the claims of creditors. Therefore, where there is insufficient assets to satisfy all the claims of creditors (resulting in insolvency), there is no property to distribute with respect to equity holders.

112(b)(6)(predecessor of section 332) applied in denying the recognition of a loss on the liquidation.

In disagreeing with the Service, the Tax Court analyzed what was meant by the phrase “in complete cancellation or redemption of all its [parent’s] stock” in section 112(b)(6). The Court held that the phrase did not include nonvoting stock which is limited and preferred as to dividends. Spaulding Bakeries, 27 T.C. at 688. The Court held that since no property was received for the common stock, section 112(b)(6) did not apply with respect to the common stock and, therefore, taxpayer was entitled to a loss with respect to its investment in the common shares.

In affirming the Tax Court, the Second Circuit stated that “[o]n dissolution of Hazelton, the respective priorities of indebtedness over preferred and common stock and of preferred stock over common stock must be given full force and effect.” Spaulding Bakeries, 252 F.2d at 697. The Court pointed out that “[s]ection 112(b)(6)(C) requires for its application a distribution in complete cancellation or redemption of all stock of the dissolved corporation”. Id.

In H.K. Porter Company Inc. and Subsidiaries, 87 T.C. 689 (1986), the petitioner held two classes of stock in a corporation (Porter Australia) which liquidated. The value of the assets of the corporation was not enough to cover petitioner’s entire investment in the preferred shares. Since there was no value distributed with respect to the common shares, petitioner argued that section 332 did not apply with respect to the common shares and it was entitled to a loss pursuant to section 165(g).

Respondent argued that section 332 applied to the liquidation and no loss was allowed with respect to the investment in the common shares. Respondent advanced two arguments: 1) Spaulding Bakeries was erroneously decided and the decision should be reconsidered; and 2) even under the rationale of Spaulding Bakeries, section 332 applies. H.K. Porter Company, Inc., 87 T.C. at 693.

The Tax Court rejected Respondent’s argument that Spaulding Bakeries was erroneously decided. The Court agreed with the Second Circuit’s focus in Spaulding Bakeries on the importance of priorities on dissolution. Id. at 694. The Court reasoned that since the assets are distributed first to the preferred stock, and there was no property left for distribution to the common stock, the distribution was not a distribution with respect to all of the subsidiary’s stock. Id. Therefore, section 332 did not apply on the liquidation with respect to the common stock.

In H.K. Porter Company, Respondent made two arguments to support its position that section 332 applied even under the reasoning of Spaulding Bakeries: 1) the preferred stock had voting rights and, therefore, the distribution in the present case cannot be considered “immaterial”, and 2) substance prevails over form and, here, petitioner in substance held only one class of stock. Id. at 696.

The Court refused to focus on the voting rights of the preferred stock. Instead, the Court focused on the liquidation preference of the stock and held that since no property was left for distribution with respect to the common shares, section 332 is inapplicable. Id. The Court also rejected Respondent’s substance-over-form argument. Respondent argued that the substance of the transaction indicates that petitioner had only one class of stock, since the preferred stock did not grant petitioner any benefits or privileges that it did not already possess as the only stockholder in the corporation. Id. at 697.

In rejecting Respondent’s argument, the Court focused on the fact that the preferred stock was issued approximately 10 years before Porter Australia was liquidated. The Court concluded that the preferred stock “was not illusory or part of a financial facade constructed of shuffled papers.” Id. The Court discussed that intercompany loans were capitalized into the preferred shares which carried specific rights and privileges.

B. Analysis

In our case, taxpayer produced a valuation report indicating that and were insolvent after taking into account the outstanding loans from the taxpayer. The report valued the entities as ongoing concerns taking into account all tangible and intangible assets of the businesses. Therefore, taxpayer argues that section 332 did not apply on the liquidations and it is entitled to worthless stock losses pursuant to section 165(g) with respect to its stock in and . In addition, taxpayer argues that it is entitled to bad debt losses for the portion of the loans not satisfied in liquidation (excess of outstanding loans over the value of the assets).

The audit team has challenged taxpayer’s position that and were insolvent at the time of the deemed liquidations. Specifically, it has challenged taxpayer’s characterization of the advances to and as debt. If a sufficient portion of the loans to and are reclassified as equity, and would have been solvent at the time of the deemed liquidations, triggering the application of section 332.

The taxpayer disagrees with the audit team's reclassification of the loans as equity. In the alternative, the taxpayer argues that even if the loans to and were characterized as equity, the advances should be treated as a preferred class of equity since the notes issued by and provided for a stated rate of return on the investment. Taxpayer argues that since the reclassified debt is treated as preferred stock, section 332 does not apply with respect to the common stock pursuant to Commissioner v. Spaulding Bakeries, 252 F.2d 693 (2nd Cir. 1958), aff'g, 27 T.C. 684 (1957) and H.K. Porter Company Inc. and Subsidiaries, 87 T.C. 689 (1986).

As discussed above, in a liquidation assets are deemed distributed first with respect to debt, then with respect to preferred stock and finally with respect to common stock. Therefore, in our case, if the intercompany debt is treated as preferred stock (in total or part), then the assets of and are treated as distributed first with respect to the preferred stock and then with respect to the common stock. Pursuant to Spaulding Bakeries and H.K. Porter Company, if there is no property remaining for distribution on the common stock after the preferred, then section 332 does not apply with respect to the common shares. Where the investment in the preferred stock is only partially satisfied, section 331 would apply resulting in a capital loss for the portion of the investment not recaptured.[5]

On the other hand, if the intercompany loans are treated as common stock and there are no other loans outstanding, then the assets of and would be deemed distributed with respect to the common stock on the liquidation. Since property would be received with respect to the common shares, section 332 would apply in denying the recognition of any loss realized in the

[5] If the intercompany debt is not reclassified as equity, then section 166 would permit an ordinary loss for the portion of the intercompany loans not satisfied in the liquidation. Therefore, reclassifying intercompany debt as preferred stock has the result of converting an ordinary loss into a capital loss with respect to the investment in the preferred stock (reclassified debt) not recouped in the liquidation.

liquidation.

In determining the true substance of an intercompany advance, the legal rights and obligations of the parties must be considered. See Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3rd Cir. 1968); Estate of Mixon v. United States, 464 F.2d 394(5th Cir. 1972); and Bauer v. Commissioner, 748 F.2d 1365 (9th Cir. 1984). Therefore, where it is determined that the substance of the advances are equity, the specific rights attached to the investment must be respected in characterizing the equity.

In our facts, the advances to and

were made in exchange for promissory notes which provided a fixed rate of interest. Although the advances may contain more characteristics of equity than debt[6], the terms of the notes must be respected if the notes are properly executed and enforceable under local law.

In cases under subchapter S of the Code, courts have addressed whether intercompany debt reclassified as equity constitutes a second class of stock; thereby, resulting in the inability to elect subchapter S treatment. See Gamman v. Commissioner, 46 T.C. 1 (1966); Portage Plastics Company, Inc. v. United States, 470 F.2d 308 (7th Cir. 1972). Section 1362(a) provides that a “small business corporation” may elect to be treated as an S corporation. In order to constitute a “small business corporation”, a corporation cannot have more than one class of stock. Section 1361(b).

In Gamman, the Service reclassified as equity intercompany loans made by the shareholder to its wholly owned subsidiary. The Court held that the reclassified debt did not constitute a second class of stock since it did not give the shareholder any additional rights and interests in the income and assets of the corporation. Although Gamman addresses the issue in our case, i.e., whether intercompany debt reclassified as equity constitutes a second class of stock, the holding in Gamman has no application since it is a decision under subchapter S of the code and was decided by taking into account the legislative history and purpose of subchapter S.

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[6] We are not offering an opinion of whether the advances should be classified as equity. For purposes of this discussion we assume that the facts support the position that all or a portion of the intercompany debt should be treated as equity.

As discussed above, in H.K.Porter Company, the Court rejected respondent's argument that the preferred stock should be treated as common stock. The Court disagreed with respondent's assertion that the preferred stock did not provide the shareholder with any additional rights as to the profit and assets of the company. The court cited the fact that the preferred stock was in existence for 10 years in rejecting respondent's substance over form argument.

In our case, unlike H.K. Porter Company, neither nor had any preferred stock outstanding at the time of the deemed liquidations. However, like the preferred stock in H.K. Porter Company, the promissory notes issued by and were in existence prior to the year of the liquidation.[7] Where the Service reclassifies debt as equity, the terms of any legally enforceable promissory notes must be respected in determining the rights attached to the equity interest. If the promissory notes in our case are properly executed and enforceable, taxpayer must be treated as holding a class of stock which has a preference to the earnings and assets of and .

Where a taxpayer advances loans to a subsidiary and/or the subsidiary issues preferred stock as part of a plan to generate a worthless stock loss under section 165(g), a substance over form argument may permit the Service to disregard the existence of the intercompany loans or preferred stock. However, where, as in our case, the promissory notes and/or preferred stock were in existence for several years prior to a claimed loss, any enforceable rights attached to such loans and/or stock must be respected for tax purposes. The fact that the parties did not comply with the terms of the notes is of no consequence if the instruments were legally enforceable.

Assuming the notes are properly executed and enforceable, any reclassified intercompany loans should be treated as preferred stock of and . In the liquidation, and would be treated as distributing its assets with respect to the preferred shares (the reclassified intercompany debt) before the common shares. Pursuant to Spaulding Bakeries and H.K. Porter Company, section 332 would apply with respect to the common shares only if there is sufficient property remaining to

[7] The notes were issued beginning in pursuant to the .

distribute on the common shares after the distribution with respect to the deemed preferred shares.

Please contact Attorney Anthony Ammirato at (917)421-4641 with any questions or comments.

DISCLOSURE STATEMENT

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ROLAND BARRAL
Area Counsel, LMSB
(Financial Services)

By: ______________________________

ANTHONY AMMIRATO
Attorney (LMSB)