IVINS, PHILLIPS & BARKER

CHARTERED

1700 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006-4723

TELEPHONE (202) 393-7600

FACSIMILE (202) 393-7601
IPB @IPBTAX.COM
WWW.IPBTAX.COM

H. STEWART DUNN, JR.
CARROLL J. SAVAGE
ERIC R. FOX
CAROL K. NICKEL
ALAN WINSTON GRANWELL
LESLIE JAY SCHNEIDER
ROBERT H. WELLEN
KEVIN P. O'BRIEN
JOSEPH DECARLO, JR.*
PATRICK J. SMITH
MICHAEL R. HUFFSTETLER
LAURIE E. KEENAN
JEFFREY E. MOELLER
STEVEN H. WITMER
ROSINA B. BARKER
WILLIAM L. SOLLEE, JR.
JODI H. EPSTEIN
DEAN R. MORLEY
ROBIN M. SOLOMON
DIRK J. J. SURINGA
ROBERT G. LORNDALE, JR.

DAVID D. SHERWOOD
AMY D. HEALY
STEFAN PRENTISS SMITH*
H. CARTER HOOD
JENNIFER J. FINN
DANIELLE E. ROLFES*
LISA MILOT
SARAH S. MCGONIGLE*
VICTOR S. CHANG*
JAMES E. BROWN*

JAMES S.Y. IVINS (1885-1960)
PERCY W. PHILLIPS (1892-1969)
RICHARD B. BARKER (1906-1988)

OF COUNSEL
JAY W. GLASMANN
WILLIAM L. SOLLEE
DANIEL B. STONE
CLIFTON B. CATES III
ERIC D. CHASON

LOS ANGELES OFFICE
1925 CENTURY PARK EAST
SUITE 2140
LOS ANGELES, CALIFORNIA 90067
TELEPHONE (310) 551-6633
FACSIMILE (310) 551-1188

*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

OCTOBER 8, 2004

To: Our Clients and Friends

A recent memorandum from Area Counsel LMSB (Financial Services) in New York should allow more corporations to claim section 165(g)(3) worthless stock deductions for their subsidiaries. FAA 20040301F (Sept. 22, 2004).

In the memo, a parent corporation (P) filed an election to treat its wholly owned foreign subsidiary (S) as a disregarded entity, and this election caused a deemed liquidation of S. Several years earlier, P had made loans to S, which had issued notes to P. These intercompany notes rendered S insolvent at the time of the deemed liquidation.

Generally, section 332 prevents P from recognizing a loss on such a deemed liquidation. But because S was insolvent, P received nothing for its S stock, and section 332 did not apply. Thus, P claimed an ordinary worthless stock deduction under section 165(g)(3). The IRS audit team, however, argued that the notes should be treated as equity of S, and that, as a result, P's deduction was not allowed under section 332.

Section 332 does not apply to a liquidation of S if the liquidation proceeds pay off S's debts and some of its preferred stock but pay nothing on its common stock (even if P holds all the preferred and common stock). *Commissioner v. Spaulding Bakeries, Inc.*, 252 F.2d 693 (2d Cir. 1958); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986). P argued that, even if S's notes were equity, the equity was *preferred stock*, so that section 332 did not apply. Thus, P argued that it was entitled to its worthless stock deduction.

Counsel agreed with P that, even if the S notes were equity, they were preferred stock. Counsel reasoned that "the specific rights attached to the investment must be respected in characterizing the equity." The intercompany notes were legally enforceable with a fixed interest rate, and there was no indication that the notes were part of a plan to generate a worthless stock deduction. Therefore Counsel concluded that, regardless of whether the notes were debt or equity, section 332 did not bar P's worthless stock deduction.

There are some cautions:

1. Availability of the deduction still depends on several factors, including absence of going concern value and past conduct of an active business by S. Rev. Rul. 2003-125, 2003-52 I.R.B. 1243.

2. It is not clear whether the rationale in the memo would extend to open account intercompany debt, especially if no interest accrues.

3. The memo preserves P's ordinary loss on the S *common stock*, regardless of whether the intercompany notes are debt or equity (preferred stock). But there is still a difference. If the notes are treated as debt, loss on the notes themselves would be an ordinary deduction. But, if the notes are treated as preferred stock, loss on the notes would be capital loss.

4. If P and S are members of a consolidated group, a worthless stock deduction for P may be delayed under Reg. § 1.1502-80(c) and, if the deduction allowed, losses attributable to S are not allowed to the group. Reg. § 1.1502-35T(f).

Nevertheless, the memo supports the conclusion that intercompany debt does not pose a barrier to a worthless stock deduction. We recommend that our clients consider whether any candidates for section 165(g)(3) deductions have been rejected because of intercompany debt and revisit these decisions.

If you would like to discuss this issue, please contact Bob Wellen or Dirk Suringa by phone ((202) 393-7600) or email. Bob is at rwellen@ipbtax.com, and Dirk is at dsuringa@ipbtax.com.