Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:5:SF:2:POSTF:116413-02
PKWebb

VIA U.S. MAIL

date: JUL 02 2002

to: Internal Revenue Service
Large and Mid-Size Business Division
Attn: David Campbell, International Examiner
450 Golden Gate Ave.
San Francisco, CA 94102

from: Paul K. Webb, Attorney (LMSB)

---

subject: [redacted]
Check-the-box worthless stock loss

U.I.L. #: 165.06-00
7701.00-00

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, is subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This advice relies on facts provided by you to our office. If you find that any facts are incorrect, please advise us immediately so that we may modify and correct this advice. This advice is subject to 10-day post review by the National Office. CCDM 35.3.19.4. Accordingly, we request that you do not act on

this advice until we have advised you of the National Office's comments, if any, concerning this advice.

Issues

You requested our advice on the following three issues. According to our prior conversation, you intend to use the advice to develop your case.

1. Is the issue of "future potential value" critical in determining whether the stock of [redacted] ("[redacted]") is worthless under the "Check-the-box" rules?

2. If the company has "future potential value," do we need to quantify it in order to disallow the losses?

3. Because of its relationship to [redacted]'s (the parent's) business prospects in [redacted], it appears that [redacted] was more valuable as part of [redacted]'s business than it would have been to an unrelated third party. Can we use this relationship in determining that [redacted] has a positive value and that the losses are not allowable?

Brief Answers

1. Yes. A stock must cease to have both (1) liquidating value, i.e., an excess of liabilities over assets, and (2) potential value, to qualify for a worthless stock loss deduction.

2. We could find no cases requiring the Service to quantify future potential value. However, factual development of any determination on potential value is extremely important. If you attack a particular aspect of the taxpayer's valuation you must be prepared to provide factual support for your position.

3. The standard requires asking whether a prudent businessperson would have concluded that the stock was worthless. To the extent that you can show that [redacted] valued [redacted], we believe you support your position that [redacted] had some intangible value.

Facts

[redacted] is the parent of a consolidated group of corporations. [redacted] owns [redacted]% of the stock of [redacted] ("[redacted]"), a U.S. subsidiary. [redacted] owns [redacted]% of a [redacted] corporation, [redacted].

In fiscal year [redacted]-06, pursuant to Treas. Reg. § 301.7701-3, [redacted] elected to be treated as a disregarded entity for U.S. tax purposes. As a result, for tax purposes, [redacted] treated [redacted] as being liquidated into its U.S. parent, [redacted].

[redacted] ("[redacted]") performed a valuation of [redacted] as of the election date. It concluded that [redacted] had a negative net worth using both an income approach and underlying assets approach. As a result of this valuation and in connection with the check-the-box event, [redacted] claimed a worthless stock loss of $[redacted] and a bad debt deduction of $[redacted].

[redacted] continues to function as an ongoing business as a branch operation. You state that the only changes occurring to [redacted] relate to its tax treatment for purposes of U.S. taxation.

You stated in our prior meeting that you obtained marketing materials from [redacted] relative to its business in [redacted]. You state that such materials refer to [redacted] as [redacted]'s gateway to the [redacted] markets for [redacted] products.

The following set of facts are summarized from the [redacted] valuation of [redacted] and should be considered in that light. [redacted] first invested in [redacted] in [redacted] when, through [redacted], it acquired [redacted]% of [redacted], a [redacted] corporation. At the time the laws of [redacted] prohibited greater ownership by a non-[redacted] entity. Through [redacted]'s subsidiaries, [redacted] engaged in the manufacture and sale of [redacted] and [redacted] products in [redacted]. In [redacted], the [redacted] subsidiary [redacted] ("[redacted]"), currently known as [redacted], entered into a joint venture ("[redacted]" or "[redacted]") with [redacted] ("[redacted]"). The [redacted] provided that [redacted] was responsible for selling, warehousing, distributing, advertising and promoting all [redacted] products. [redacted] was a silent partner in the agreement. In [redacted], [redacted] exited the [redacted] business in [redacted]. In [redacted], as part of a liquidation, [redacted] shares were transferred directly to [redacted] and the company was renamed [redacted]. After the liquidation, [redacted] was directly controlled by [redacted] and was the sole [redacted] entity controlled by [redacted] (through [redacted]).

The [redacted] proved unprofitable to [redacted] as the two companies were competitors in the [redacted] [redacted] market. [redacted] had little incentive to promote [redacted] products and had

pricing authority over said products, which prevented [redacted] from passing manufacturing cost increases on to customers. Additionally, [redacted] sought a high pricing strategy for [redacted] products which resulted in low sales and a profit squeeze.[1]

In [redacted], [redacted] management decided to exit the [redacted]. The [redacted] had two termination options: (1) give notice of termination without cause, which required a [redacted] day written notice and payment of [redacted] times sales of the aggregated [redacted] month period before the date of the notice of termination, or (2) refrain from selling in [redacted], either directly or indirectly, products covered by the [redacted] for [redacted] years after the termination date. On [redacted], [redacted] gave [redacted] notice to terminate without cause.

As a result of the termination, [redacted] expected to pay [redacted], in local currency, N$[redacted] (pesos), which [redacted] management expected would translate into US$[redacted] (dollars) at the spot exchange rate of approximately [redacted]N$/US$. [redacted], on the other hand, contended that the termination payment should be denominated in US dollars at an exchange rate prior to the [redacted] peso devaluation (approximately [redacted]N$/US$), which resulted in a demand for US$[redacted]. The demand was arbitrated and [redacted] was ordered to pay $US[redacted], plus interest, to [redacted]. This finding was appealed and ultimately upheld on [redacted] ([redacted] days after [redacted] checked the box to disregard [redacted]). For valuation purposes, since [redacted] viewed the judgment amount as contingent on appeal as of the check-the-box date, [redacted] assigned various probabilities to the litigation results. For valuation purposes it assigned [redacted] an expected liability from the litigation (including interest) in the amount of US$[redacted].

In [redacted], [redacted] established an escrow account to pay the [redacted] dissolution fee. The account was funded with a $US[redacted] loan from [redacted]. The loan balance at the time of the election was $US[redacted].

In [redacted], [redacted] signed a distribution contract with [redacted], a major [redacted] distributor of [redacted] products. The [redacted] valuation document notes that [redacted] does not have a

---

[1] We note that the [redacted] valuation memorandum seems internally inconsistent on this point. It argues that the [redacted] was detrimental since (1) [redacted] could not pass on manufacturing cost increases to customers, but (2) that [redacted] pursued a "high pricing strategy" with [redacted] products, which resulted in low sales volume and an eventual profit squeeze. Thus, it complains that [redacted] could not raise prices but that the prices set by [redacted] were already too high.

distribution contract with [redacted] and thus, potentially, [redacted] could sell its products through a different [redacted] entity.

[redacted] has been historically unprofitable. [redacted] periodically provided funds and equipment to [redacted] and has generally capitalized said contributions. [redacted]'s financial results improved considerably in [redacted] due to the dissolution of the [redacted]. [redacted]'s cost of goods sold decreased to [redacted] percent of sales, from a range of [redacted] to [redacted] percent of sales in [redacted]-[redacted]. According to the [redacted] report, the [redacted] forecast indicates a drastic reduction in cost of goods sold, which reflects a full year of using the new distributor. However, even given these improved prospects, using the income approach, [redacted] valued [redacted] at (US$[redacted]). This amount is reached by taking a US$3.3 Indicated Business Enterprise Value, adding US$[redacted] for the [redacted] escrow balance, subtracting the (US$[redacted]) owed to [redacted] as a loan for the [redacted] payment and subtracting the (US$[redacted]) estimated as the final [redacted] liability.

The [redacted] valuation paints a brighter picture using the underlying asset approach for valuation. It provides a US$[redacted] Indicated Business Enterprise Value. This amount is arrived at by valuing [redacted]'s: (1) fixed assets at US$[redacted], (2) other non-current assets at US$[redacted], (3) intangible assets at zero, and (4) adjusted net working capital of US$[redacted]. Intangible assets are valued at zero since [redacted] owns all patents, trade names and trademarks of the products sold by [redacted] and [redacted] has no distribution agreement with [redacted]. [redacted]'s bottom line valuation for [redacted] using the underlying assets approach, after incorporating the escrow account, loan to [redacted] and [redacted] judgment, is (US$[redacted]).

Analysis

The following is our analysis regarding worthless stock losses generated by check-the-box events. As will be clear below, we believe this case requires extensive factual development. Where appropriate, we recommend areas for developing required facts.

I. Is the issue of "future potential value" critical in determining whether the stock of [redacted] is worthless under the "Check-the-box" rules?

[redacted] elected to be treated as a disregarded entity for tax purposes in its fiscal tax year ending June 30, [redacted]. See Treas. Reg. § 301.7701-3(c). For Federal tax purposes, [redacted] was considered to distribute all of its assets and liabilities to its owner upon making the election. See Treas. Reg. § 301.7701-3(g). Section 332 provides generally that no gain or loss shall be

recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.[2] I.R.C. § 332(a). However, Section 332(a) only applies when the recipient corporation receives at least partial payment for its stock, i.e., it does not apply if the dissolving corporation is insolvent. Treas. Reg. 1.332-2(b). In such cases, Section 165(g) allows a deduction for any security (stock) which is a capital asset becoming worthless during the taxable year.

A determination of the worthlessness of stock is "purely a question of fact." Boehm v. Commissioner, 326 U.S. 287, 293 (1945). "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." Boehm, 326 U.S. at 292-93. The standard is 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 Indus. Inc. v. Commissioner, T.C. Memo. 2001-276.

There is a two-part test for determining worthlessness of stock. See 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). First, the stock must cease to have liquidating value, i.e., the corporation has an excess of liabilities over assets (referred to as "insolvency" for purposes of this memorandum). 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 v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986).

A. Applying the two-part test

1. Insolvency

We use the [redacted] valuation of [redacted] as a baseline for reviewing the company's solvency.[3] We believe this is appropriate because it is the opinion upon which the taxpayer relies for its worthless stock loss deduction. If you find the [redacted] valuation unimpeachable, a finding of insolvency would be appropriate. However, there are several items in the valuation which we

---

[2] All citations herein are to U.S.C., Title 26, the Internal Revenue Code, unless otherwise noted.

[3] Although we use [redacted]'s valuation document as a baseline, we recommend that you secure [redacted]'s book values for its various assets and liabilities.

believe require closer analysis. In particular, we believe you must take a closer look at the "debt" from [redacted] to [redacted] to fund the [redacted] judgment payment and whether or not [redacted] has any intangible assets ([redacted] determined a zero value for [redacted]'s intangibles). If, for example, you find that the US$[redacted] "loan" balance from [redacted] to [redacted] for the [redacted] payment should be viewed as a capital contribution, the [redacted] valuation is incorrect.[4]

a. The [redacted] "loan" debt

In finding whether the subsidiary is in fact insolvent, any loans from the taxpayer to the subsidiary must be bona fide and not in substance equity. See Leuthold v. Commissioner, T.C. Memo. 1987-610; Wildes v. Commissioner, T.C. Memo. 1980-298.[5] For a debt to be bona fide there must be "a genuine intention to create a debt, with a reasonable expectation of repayment" and the intention must be consistent with the "economic reality of creating a debtor-creditor relationship." See Litton Bus. Sys., Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

Whether the requisite intention to create a true debtor-creditor relationship existed is a question of fact to be determined from a review of all the evidence. Litton Bus. Sys., Inc., 61 T.C. at 377. Factors ordinarily considered in such analysis include, but are not limited to: (1) the name given to the certificate evidencing the indebtedness, (2) the presence or absence of a fixed maturity date, (3) the source of payments, (4) the right to enforce repayment, (5) any increase in management participation as a result of the advances, (6) the status of the advances in relation to debts owed to regular corporate creditors, (7) the intent of the parties, (8) thin or adequate capitalization, (9) the identity of interest between creditor and stockholder, (10) payment of interest only out of profits, (11) the ability to obtain loans from outside lending institutions, (12) the extent to which the advance was used to acquire capital assets, and (13) the failure of the corporation to repay on the

---

[4]The [redacted] valuation document is unclear as to whether the "loan" was in the amount of US$[redacted] or US$[redacted]. It states a US$[redacted] escrow account as a non-operating asset and a US$[redacted] "inter-company loan" as of the valuation date, used to fund the escrow account.

[5]Any bad debt deduction claimed by a taxpayer under I.R.C. § 166(a) must likewise be shown to involve bona fide debt. Treas. Reg. § 1.166-1(c). Thus, your factual development and analysis of this issue will be applicable to both the worthless stock loss and bad debt deductions claimed by [redacted].

due date. American Offshore, Inc. v. Commissioner, 97 T.C. 579, 602-606 (1991); see also Calumet Indus., Inc. v. Commissioner, 95 T.C. 257, 285 (1990); Anchor Natl. Life Ins. Co. v. Commissioner, 93 T.C. 382, 400 (1989)(11 factors); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980)(13 factors). No single factor is determinative, and not all factors are applicable in each case. Dixie Dairies Corp., 74 T.C. at 493-494. "The various factors . . . are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968).

In addressing the above-stated factors, you should obtain the loan document(s) establishing the "loan" from [redacted] to [redacted]. Likewise, you should obtain any letters, memoranda, e-mails, notes, meeting minutes, etc. from [redacted], [redacted] and [redacted] relating to the "loan" and its approval to discover the actual intent of the parties. Although the "loan" may appear as a debt on [redacted]'s books, [redacted] or [redacted] may simply have viewed it as a necessary capital cost for exiting the [redacted] and continuing its [redacted] business (see below). You should determine whether there were any pre-loan discussions or agreements that the "loan" would be subsequently capitalized. You should determine if there was a fixed date for repayment of the "loan." Similarly, you should seek loan payment history to verify if [redacted] made timely payments and, if not, whether [redacted] enforced the terms of the loan agreement. If the source of [redacted]'s repayment of the "loan" is contingent upon its earnings, an equity investment, rather than a loan is indicated. Likewise, if [redacted] became more involved in [redacted]'s daily operations after the "loan" an equity investment is indicated. If [redacted] subordinated repayment of the "loan" by directing [redacted] to pay other creditors prior to itself, an equity investment would likewise be indicated. If [redacted] already had a high debt to equity ratio prior to the "loan" it is more likely considered an equity investment than a bona fide loan because of the likelihood of loan default. You should keep in mind that advances made by sole shareholders to a corporation are more likely to be for equity than debt. See Flint Indus., Inc., T.C. Memo. 2001-276. Also, keep in mind that "[T]he touchstone of economic reality is whether an outside lender would have made the same payments in the same form and on the same terms." Segel v. Commisioner, 89 T.C. 816, 828 (1987). Finally, we believe it would be helpful to show the history of all prior [redacted] advances which have been capitalized.

According to the [redacted] valuation, there were only 2 termination options for the [redacted]: (1) pay [redacted] times sales of the aggregated [redacted] month period before the date of notice of

termination, or (2) refrain from selling in [redacted], either directly or indirectly, products covered under the [redacted] agreement for a period of [redacted] years from the termination date. We need to review the [redacted] to determine whether or not the agreement would have barred [redacted] from selling its [redacted] in [redacted] for a period of [redacted] years if the first option termination payment was not paid. If so, [redacted]'s capital investment in [redacted] would be lost or severely damaged after [redacted] years of inactivity. In essence, [redacted] may have been forced to fund the [redacted] exit payment in order to continue business in [redacted], whether directly, through [redacted] or another entity. This would indicate an equity investment rather than a bona fide loan to [redacted].

We recommend that you obtain a copy of the [redacted] agreement and all documents, memoranda, meeting minutes, etc. from [redacted] addressing the decision to exit the [redacted] and discussions on who would ultimately pay the [redacted] exit fee. You should also secure all documents reflecting how the [redacted] payment was to be made. If by [redacted], request an explanation as to how this company with little or no historical profits would afford the payment. We recommend that you inquire whether or not [redacted] sought loans from third parties or considered selling assets to raise the money to pay the [redacted] exit fee and that you request all documentation to substantiate such actions. We imagine that [redacted] management did not make this decision on its own and surmise that [redacted] and/or [redacted] were directly involved in the decision making process. Obtaining documents from this decision making process should be useful to your debt/equity analysis.

Once you obtain the above documents, you should determine whether or not the "loan" from [redacted] to [redacted] was rather an equity investment. If so, it should be disregarded in determining solvency. If you determine that the US$[redacted] "loan" balance owed to [redacted] is actually an equity investment, rather than a loan, [redacted] would have a negative net worth of (US$[redacted]) by [redacted]'s valuation, rather than (US$[redacted]). If such a determination is made, you should take a closer look at other value determinations, such as asset values, to determine whether [redacted] was in fact insolvent. You should also determine how the remainder of the [redacted] payment was funded, i.e., whether from an additional loan or equity investment. If, for example, [redacted] or [redacted] was pre-committed to funding the entire [redacted] payment, the remaining liability might properly be disregarded. If you conclude that the entire [redacted] liability should be disregarded because [redacted] had previously committed to invest the necessary funds to exit the [redacted], then [redacted] would be considered solvent as of the election date, even under [redacted]'s analysis.

b. Intangible assets

The fact that [redacted] continues the business of [redacted] after the liquidation indicates that [redacted] had some going concern value that should be considered in determining the value of [redacted]'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 be some value attached to intangible assets which were ignored in the [redacted] valuation. See Wally Findlay Galleries Int'l, Inc. v. Commissioner, T.C. Memo. 1996-293. In Wally Findlay Galleries Int'l, Inc., T.C. Memo. 1996-293, the taxpayer argued that its French subsidiary had no goodwill or other intangible assets because the parent corporation owned the trade name. The court rejected this argument, in part because promotional marketing materials, prepared at a time when the taxpayer claimed the subsidiary was worthless, declared the importance of the subsidiary to the French art market. The court also found that "[t]he fact that WFGI prolonged the subsidiaries existence . . . then took over its facilities to use them for some of the same functions for 8 more years, testifies to the importance that WFGI attached to the image and customer relations that were associated with the Paris operations." Id.

Proper development of this case will require securing all agreements between [redacted] and [redacted] to verify whether or not [redacted] had some enforceable right to market, manufacture and sell [redacted] products. Additionally, we recommend requesting a list of all intangible assets held by [redacted] as of the deemed liquidation date. We also recommend that you secure all marketing and other promotional materials that reflect [redacted]'s value to [redacted] and its global business plan.

2. Loss of potential value

In Morton, 38 B.T.A. at 1278-79, the court set the standard adopted by most courts facing worthless stock loss issues. In Morton, 38 B.T.A. at 1278-79, the court stated:

> 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 is sustained, that stock may not be considered as 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 the 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 assets of the corporation exceed its liabilities, the stock has a liquidating value. If its 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 can not be said to be worthless. The loss of potential value, if its 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.

a. Worthlessness without an identifiable event

Under Morton, 38 B.T.A. at 1278-79, 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. The [redacted] valuation does not indicate whether or not [redacted] was considered so insolvent that there was no hope of recovery. See Steadman, 50 T.C. at 376-77; Corona v. Commissioner, T.C. Memo. 1992-406.

[redacted], , (b)(5)(AC), (b)(7)a

[redacted]

[redacted], (b)(5)(AC), (b)(7)a

b. Identifiable events in general

Since the [redacted] valuation upon which the taxpayer bases worthlessness does not address insolvency beyond hope for recovery, the question arises as to whether the liquidation under Treas. Reg. § 301.7701-3(g)(1) is an 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. See Steadman, 50 T.C. at 376-77; Corona, T.C. Memo. 1992-406.

A review of relevant case law demonstrates that a single identifiable event is rarely sufficient to conclude that stock is worthless. 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, 38 B.T.A. at 1278-79, are not conclusive of worthlessness in and of themselves.

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 in Dittmar v. Commissioner, 23 T.C. 789 (1955). 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, 38 B.T.A. at 1278-79. 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." Dittmar, 23 T.C. at 798. See also Reese Blizzard v. Commissioner, 16 B.T.A. 242 (1929)(no recognition event until the final disposition of property by trustees).

As demonstrated by Dittmar, 23 T.C. at 798, 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 the Boehm, 326 U.S. at 326, requirement that the standard for when stock is worthless is a "flexible, practical one, varying with the circumstances." Thus, courts will also consider the possibility and ease of reversing what would otherwise be an identifiable event. For example, in Slater, T.C. Memo. 1989-35, the Tax Court found that the stock of a corporation was not worthless in the year the business ceased but in 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 v. Commissioner, T.C. Memo. 1988-284, the court considered the possibility of a corporation undoing the surrender of a corporate charter, which caused a dissolution.

i. Liquidation as an identifiable event

That liquidation is included in the list provided in Morton, 38 B.T.A. at 1278, does not in itself mean that a liquidation, including a deemed liquidation under the check-the-box regulations, necessarily leads to a 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, 412 F.2d 556 (5th Cir. 1969); Saylor Elec. & Mfg. 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 a failing corporation. See e.g., Smith v. Helvering, 141 F.2d 529 (D.C. Cir. 1944); Nelson v. United States, 131 F.2d 301 (8th Cir. 1942). As discussed below, the nature of the liquidation, not just its occurrence, is generally reviewed by the court. See A.S. Genecov v. United States, 412 F.2d 556, 561 (5th Cir. 1969); Greenberg v. Commissioner, T.C. Memo. 1971-220.

ii. Liquidation as evidence of worthlessness

As indicated in the above quote from Morton, 38 B.T.A. at 1278-79, 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 v. Commissioner, 71 T.C. 955, 970 (1979). As also stated in Morton, 38 B.T.A. at 1278-79, an identifiable event should evidence the worthlessness of the corporation to others besides the shareholders. See Tippen, T.C. Memo. 1988-284 (where court applied this principle in finding stock worthless).

In the present case, [redacted] apparently continues to operate under foreign law in the same manner that it did prior to the election and there is no known indication to outsiders that [redacted] stock is worthless. [redacted]. (b)(5)(AC), (b)(7)a

[redacted]

[redacted]. (b)(5)(AC), (b)(7)a

[redacted]

[redacted]

iii. Liquidation as destroying potential worth

Morton, 38 B.T.A. at 1278-79, 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. A liquidation would limit or destroy potential worth 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. See A.S. Genecov v. United States, 412 F.2d 556, 561 (5th Cir. 1969), and cases cited therein. The court in A.S. Genecov, 412 F.2d at 561, stated:

> 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."

A.S. Genecov v. United States, 412 F.2d 556, 561 (5th Cir. 1969) quoting Kennemer v. Commissioner, 96 F.2d 177, 178 (5th Cir. 1937). That 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 [redacted] 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 v. Commissioner, T.C. Memo. 1990-644. 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, citing Steadman, 424 F.2d at 4, and Boehm, 326 U.S. at 293. See Continental Ill. Nat'l 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. [redacted] is apparently continuing in business because of reasonable expectations of future value and not for reasons that would be consistent with the worthlessness of the stock.

Greenberg, T.C. Memo. 1971-220, 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, T.C. Memo. 1995-353, refused to find a bankruptcy under Chapter 11 to be a recognition event, 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 appear to involve a liquidation that would in itself be an identifiable event for a worthless stock loss. The liquidation itself in this case does not destroy the potential worth of [redacted]'s stock. It does not end [redacted]'s

ability to recover its investment in [redacted] through continued operations or sale of its interest in [redacted]. There is no ultimate disposition of the assets that requires the ending of the business of [redacted]. Rather it appears to be a manufactured event to generate recognition of a tax loss. These factors all support a finding of potential value.

, (b)(7)a

[redacted]

II. If the company has "future potential value," do we need to quantify it in order to disallow the losses?

As stated above, the standard is whether or not a prudent businessperson would have considered [redacted]'s 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 Indus. Inc. v. Commissioner, T.C. Memo. 2001-276. As part of this analysis, a court is inclined to inquire whether a prudent businessperson would have determined that [redacted] lacked potential value because it liabilities far exceeded its assets' fair market value and whether its assets could reasonably be expected to exceed its liabilities in the future. See Flint Indus. Inc. v. Commissioner, T.C. Memo. 2001-276 (using prudent businessperson test for future potential value).

In at least one case we reviewed, Flint Indus. Inc. v. Commissioner, T.C. Memo. 2001-276, the Court considered expert testimony from two expert witnesses hired by the taxpayer. The experts opined that the subject company was finished as a going concern and that its stock was worthless as of a particular date. The government did not offer expert testimony in rebuttal. The court commented:

> [A]lthough respondent argues that certain assets were not listed in Gunther's FYE April 30, 1992, commercial report, he offered no evidence to rebut the testimony of petitioner's witnesses that the assets in question had no value. Given the overwhelming evidence of financial catastrophe introduced by petitioner, respondent would have been wise to offer some affirmative evidence to demonstrate Gunther's potential value. Respondent failed to do so.

Flint Indus. Inc. v. Commissioner, T.C. Memo. 2001-276.

[redacted], (b)(5)(AC), (b)(7)a

III. Because of its relationship to [redacted]'s (the parent's) business prospects in Latin America, it appears that [redacted] was more valuable as part of [redacted]'s business that it would have been to an unrelated third party. Can we use this relationship in determining that [redacted] has a positive value and that the losses are not allowable?

In short, yes. However, this is only one of several elements you should develop in determining potential value. The standard is whether a prudent businessperson would have determined that the stock in question was worthless. See Flint Indus. Inc. v. Commissioner, T.C. Memo. 2001-276 (using prudent businessperson test for future potential value). Cases such as Wally Findlay Galleries Int'l, Inc., T.C. Memo. 1996-293, which analyze the value of a subsidiary company to its parent, generally do so to determine whether the subsidiary owned goodwill or some other intangible asset that did not appear on the subsidiary's books. To the extent that you can develop facts showing that [redacted] had some intangible value to [redacted], you support the general conclusion that the company had potential value.

Conclusion

, (b)(7)a [redacted]

We provide this analysis solely for your assistance in factually developing the issues. We believe the substantive basis of this analysis will be supported by the Office of Chief Counsel. Ultimately, once factual development is complete, we believe that these issues should be addressed by formal Chief Counsel advice.

Please feel free to contact me, attorney Paul K. Webb, at (415)744-9217, if you have any questions about this memorandum.

LAUREL M. ROBINSON
Associate Area Counsel (LMSB)

PAUL K. WEBB
Attorney (LMSB)

cc:

✓Technical Services Section,
Associate Chief Counsel (P&A)
Internal Revenue Service,
1111 Constitution Avenue, N.W., CC:PA:TSS,
Room 4510,
Washington, D.C. 20224
(via e-mail to TSS4510)
*NSAR 10 day post-review.

Joseph Ravicini
Economist
Internal Revenue Service
Large and Mid-Size Business Division
450 Golden Gate Ave.
San Francisco, CA 94102

[redacted]
Team Manager
Internal Revenue Service
Large and Mid-Size Business Division
[redacted]

William Sabin
Senior Legal Counsel
Office of Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224
(via e-mail)

James W. Clark
Area Counsel, Area 5
1301 Clay St., Stop 1600S
Oakland, CA 94612
(via e-mail)