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subject: Treatment of Check-the-Box Election by a Corporation to be Classified as a Partnership

This memorandum addresses the tax consequences when an insolvent foreign subsidiary of a domestic corporation makes a check-the-box election to be classified as a partnership under § 301.7701-3(c)(1)(i) of the Procedure and Administration Regulations. This memorandum may not be used or cited as precedent.

Issues

- (1) Is a shareholder of an insolvent corporation that elects to be a partnership under § 301.7701-3 allowed a worthless security deduction under § 165(g) of the Internal Revenue Code?
- (2) How are liabilities treated for federal tax purposes in transactions that are deemed to occur under § 301.7701-3(g)(1)(ii)?
- (3) Is a creditor of the insolvent corporation entitled to a bad debt deduction under § 166?

- (4) What is the basis of each partner's interest in the partnership deemed formed under § 301.7701-3(g)(1)(ii)?
- (5) What is the newly-formed partnership's basis in the assets deemed contributed to it under § 301.7701-3(g)(1)(ii)?

Conclusions

- (1) The deemed distribution of assets and liabilities in liquidation of an insolvent corporation does not constitute payment for stock in the liquidating corporation. Therefore, the former shareholders in Situations 1 and 2 (described below) are entitled to a worthless security deduction under § 165(g) if they meet the other requirements of that section.
- (2) The election under § 301.7701-3(c)(1)(i) by the insolvent corporation does not affect the liabilities of the corporation with respect to its creditors under local law, and those liabilities survive the deemed liquidation under § 301.7701-3(g)(1)(ii).¹ The distribution of the electing corporation's liabilities followed by the contribution of the liabilities to the new partnership is not a significant modification of the liabilities for purposes of § 1001. Therefore, the liabilities are not treated under § 1001 as exchanged for new debt of the partnership as a result of the corporation's § 301.7701-3(c)(1)(i) election.
- (3) Because the liabilities survive the deemed liquidation, the insolvent corporation's creditors in Situations 1 and 2 are not entitled to a bad debt deduction under § 166 based solely on the § 301.7701-3(c)(1)(i) election.
- (4) In Situation 1, X's basis in its partnership interest is \$108 and Y's basis in its partnership interest is \$2. In Situation 2, X's basis in its partnership interest is \$88 and Y's basis in its partnership interest is \$22.
- (5) In Situations 1 and 2, the partnership's basis in its assets is \$110.

Facts

Situation 1

U.S. Corporation X owns 100% of foreign corporation Y. X also owns 80% of Z, a foreign corporation, and Y owns 20% of Z. X's ownership of the Z stock satisfies the stock ownership test of § 1504(a)(2). Z is an eligible entity for purposes of the entity classification rules of § 301.7701-3.

¹ This conclusion would be different in Situation 1 if Z had elected to be treated as a disregarded entity rather than a partnership under § 301.7701-3(c)(1)(i). Cf. Rev. Rul. 2003-125, 2003-2 C.B. 1243.

The fair market value of Z's assets is \$100. The adjusted basis of Z's assets is \$120. Z has \$110 of liabilities, all of which are owed to X. The liabilities are not securities within the meaning of § 165(g)(2). At the time the liabilities were incurred, they constituted genuine indebtedness that Z expected to repay in full.² X's adjusted basis in the Z stock is \$100. Y's adjusted basis in the Z stock is \$30.

Z properly elects to change its classification from a corporation to a partnership under § 301.7701-3(c)(1)(i).

Situation 2

The facts are the same as in Situation 1, except that all of Z's liabilities are owed to U, an unrelated foreign corporation.

Law and Analysis

Issue 1: Is a shareholder of an insolvent corporation that elects to be a partnership under § 301.7701-3 allowed a worthless security deduction under § 165(g)?

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3. Under § 301.7701-3, an eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership. Section 301.7701-3(g)(1)(ii) provides that if an eligible entity classified as an association elects under § 301.7701-3(c)(1)(i) to be classified as a partnership, the following is deemed to occur:

The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

Section 301.7701-3(g)(2) provides that the tax treatment of a change in the classification of an entity for federal tax purposes by election under § 301.7701-3(c)(1)(i) is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. The preamble to the 1997 proposed regulations explained that § 301.7701-3(g)(2) "is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations." Prop. Treas. Reg. § 301.7701-3(g)(2), 62 FR 55768, 55769 (Oct. 28, 1997); accord. Dover Corp. and Subs. v. Commissioner, 122 T.C. 324, 334, 348

² Cf. Est. of Franklin v. Comm'r, 544 F.2d 1045 (9th Cir. 1976).

(2004) (acknowledging and not disagreeing with the Service's position that a deemed liquidation under the check-the-box regulations is treated as an actual liquidation).

Section 331(a) provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

Section 332(a), however, provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

Section 332(b) provides, in part, that a distribution shall be considered to be in complete liquidation only if the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock that meets the requirements of § 1504(a)(2) and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation.

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

Section 165(a) allows as a deduction any loss sustained during the year and not compensated for by insurance or otherwise. Under § 1.165-1(b) and (d), to be allowable as a deduction under § 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, with certain exceptions, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form governs in determining a deductible loss.

Under § 165(g)(1), if any security which is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2)(A) provides that for purposes of a worthless security deduction, the term "security" includes a share of stock in a corporation.

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

Rev. Rul. 2003-125, 2003-2 C.B. 1243, addresses the application of §§ 332 and 165 when an eligible corporation elects under § 301.7701-3(c)(1)(i) to be classified as a disregarded entity. Rev. Rul. 2003-125 provides that neither §§ 331 nor 332 applies to a liquidation if a shareholder does not receive payment for its stock. In addition, Rev. Rul. 2003-125 provides that a shareholder does not receive payment for its stock in a liquidation if, at the time of liquidation, the fair market value of the corporation's assets, including goodwill and going concern value, is less than the corporation's liabilities. Rev. Rul. 2003-125 concludes that if § 332 does not apply to the deemed liquidation because the shareholder does not receive payment for its stock, then the deemed liquidation is an identifiable event that fixes the shareholder's loss with respect to the liquidating corporation's stock in the amount of the shareholder's basis in the stock, thus entitling its shareholder to a worthless security deduction under § 165(g)(3).

When Z elects under § 301.7701-3(c)(1)(i) to be classified as a partnership, its liabilities are \$110 and its assets have a fair market value of \$100. Under § 301.7701-3(g)(1)(ii), Z is deemed to distribute its assets and liabilities to X and Y in liquidation of Z. Because the fair market value of Z's assets is less than its liabilities, Z's shareholders do not receive payment for their stock. Under § 165(g), in Situations 1 and 2, X is entitled to a worthless security deduction of \$100 and Y is entitled to a worthless security deduction of \$30, if they satisfy the other requirements of that section.

Issue 2: How are liabilities treated for federal tax purposes in transactions that are deemed to occur under § 301.7701-3(g)(1)(ii)?

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis over the amount realized. Section 1.1001-1(a) provides that gain or loss is realized from the exchange of property for other property differing materially either in kind or in extent.

Section 1.1001-3(b) provides that a debt instrument differs materially in kind or in extent if it has undergone a significant modification. Section 1.1001-3 applies to both actual exchanges of debt (*e.g.*, a corporate issuer exchanges an existing debt instrument for a new debt instrument) and to amendments to existing debt instruments (*e.g.*, an issuer seeks to alter the collateral that secures a debt instrument). Thus, an exchange of debt instruments, whether actual or deemed, is taxable only if the differences between the new and old debt constitute a significant modification.

Section 1.1001-3(c) provides rules for determining whether a change in the legal rights or obligations of a debt instrument is a modification. Pursuant to § 1.1001-3(c)(1)(i), a modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

Section 1.1001-3(c)(1)(ii) provides that, except as provided in § 1.1001-3(c)(2), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification.

Section 1.1001-3(c)(2)(i) provides that an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the debt instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification, even if the alteration occurs by operation of the terms of a debt instrument.

Section 1.1001-3(e) provides rules for determining whether a modification is significant. Section 1.1001-3(e)(4)(ii) provides that the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

Section 1.1001-3(e)(4) also provides that, except for certain exceptions, the substitution of a new obligor on a recourse debt instrument is a significant modification. One of these exceptions is set forth in § 1.1001-3(e)(4)(i)(C) and provides that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration.

A change in payment expectations occurs if either of the following occurs: (1) there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or (2) there is substantial impairment of the obligor's capacity to meet the payment obligations under the debt instrument that was adequate before the modification and is primarily speculative after the modification. Section 1.1001-3(e)(4)(vi). The preamble to final regulations under § 1001 further clarifies that "there is no change in payment expectations . . . if the obligor has at least an adequate capacity to meet its payment expectations both before and after the modification." T.D. 8675, 1996-2 C.B. 60, 63.

A corporation's change in entity classification to a partnership under § 301.7701-3 results in a substitution of a new obligor under § 1.1001-3. However, even if a modification has occurred in Situations 1 and 2 because the partnership is treated as a new obligor, the modification will not be viewed as significant regardless of whether the liabilities are nonrecourse or recourse. With respect to nonrecourse debt, § 1.1001-3 clearly provides that a change in obligor is not a significant modification. With respect to recourse debt, § 1.1001-3(e)(4)(i)(C) provides that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration. In Situations 1 and 2, the new obligor (the partnership) acquires substantially all of the insolvent corporation's assets and liabilities because, under § 301.7701-3(g)(1)(ii), Z is deemed to have distributed all its assets and liabilities to X and Y, who then contribute them to the newly

formed partnership. In addition, though more factual development may be necessary, the change in entity classification from a corporation to a partnership is not likely to result in a change in payment expectations. Also, no significant alteration occurs as a result of the deemed liquidation in Situations 1 and 2. The deemed distribution of assets will not satisfy, in whole or in part, the \$110 liability because under local law, Z's \$110 liability to X in Situation 1 and to U in Situation 2 survives the deemed liquidation and continues in identical form as an obligation of Z, now operating in partnership form for federal tax purposes. As a result, neither recourse nor nonrecourse debt of the corporation would be treated as exchanged for new debt of the partnership based on the corporation's change in entity classification to a partnership under § 301.7701-3.

The tax consequences of the insolvent corporation's debt with respect to an elective change under § 301.7701-3(c)(1)(i), as described above, are the same as the tax consequences that occur if Z actually liquidates, shareholders of Z immediately form a new partnership, Z's debt remains outstanding and unchanged under local law, and interest payments continue to be made on the debt following the entity change (*i.e.*, Z's debt survives the liquidation and becomes an obligation of the partnership). Therefore, if Z had actually taken the steps described in § 301.7701-3(g)(1)(ii), neither recourse nor nonrecourse debt of Z would be treated as exchanged for new debt of the partnership under § 1.1001-3. In Situations 1 and 2, the analysis under § 1.1001-3 with respect to an actual liquidation applies equally to an insolvent corporation's debt owed to a shareholder/creditor and to an insolvent corporation's debt owed to a third-party creditor.

Issue 3: Is a creditor of the insolvent corporation entitled to a bad debt deduction under § 166?

Section 166(a)(1) allows as a deduction any debt which becomes worthless within a taxable year. Section 166(a)(2) provides that the Secretary, when satisfied that a debt is only recoverable in part, may allow such debt as a deduction in an amount not in excess of the part charged off within the taxable year.

Section 1.166-2(a) provides that in determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

Because the full amount of the liability is treated as surviving the liquidation and as being contributed to the newly formed partnership (except to the extent limited by § 752(c), as discussed below), Z's creditors, X and U, are not entitled to a deduction for a partially or wholly worthless debt under § 166 based solely on the § 301.7701-3(c)(1)(i) election.

Issues 4 and 5: What is the basis of each partner's interest in the partnership deemed formed under § 301.7701-3(g)(1)(ii) and what is the newly-formed

partnership's basis in the assets deemed contributed to it under § 301.7701-3(g)(1)(ii)?

Section 334(a) provides that if property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value of such property at the time of the distribution.

Section 334(b)(1) provides that if property is received by a corporate distributee in a distribution in a complete liquidation to which § 332 applies (or in a transfer described in § 337(b)(1)), the basis of such property in the hands of such distributee shall be the same as it would be in the hands of the transferor; except that, in the hands of such distributee, (A) the basis of such property shall be the fair market value of the property at the time of the distribution in any case in which gain or loss is recognized by the liquidating corporation with respect to such property, and (B) the basis of any property described in § 362(e)(1)(B) shall be the fair market value of the property at the time of the distribution in any case in which such distributee's aggregate adjusted basis of such property would (but for § 334(b)(1)) exceed the fair market value of such property immediately after such liquidation.

Section 334(b)(2) provides that, for purposes of § 334, the term "corporate distributee" means only the corporation which meets the stock ownership requirements specified in § 332(b).

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership is the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, is considered a contribution of money by such partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, is considered a distribution of money to the partner by the partnership.

Section 752(c) provides that, for purposes of § 752, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered a liability of the owner of such property.

Section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner bears the economic risk of loss under § 1.752-2.

Section 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under § 1.752-2.

Section 1.752-1(e) provides that if property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.

Section 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.

Section 1.752-2(c)(1) provides that a partner bears the economic risk of loss for a partnership liability to the extent that the partner or related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.

Section 1012 provides that the basis of property shall be the cost of the property, except as otherwise provided in subchapter O and subchapter C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).

Section 1.1012-1(a) provides that the cost of property is the amount paid for such property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d. Cir. 1952) (basis of purchased plant includes assumed lease obligation); *Consolidated Coke Co. v. Commissioner*, 70 F.2d 446 (3d Cir. 1934) (basis of purchased plant includes debt

assumed by taxpayer). Under Crane v. Commissioner, 331 U.S. 1 (1947), a taxpayer's basis in property includes both recourse and nonrecourse liabilities. However, Crane did not address the extent to which debt that exceeds the fair market value of property is included in basis. Where an asset subject to a nonrecourse liability is received in an exchange, the seller must include the amount of the nonrecourse debt assumed by the buyer in the seller's amount realized. Tufts v. Commissioner, 461 U.S. 300 (1983). Likewise, a buyer that takes an asset subject to the seller's liability is entitled to include the amount of the liability in computing the basis of the asset under § 1012. Id. at 307.

Under § 301.7701-3(g)(1)(ii), Z is deemed to distribute its assets and liabilities to X and Y in liquidation of Z. X and Y are deemed to receive Z's assets in exchange for assuming or taking the assets subject to Z's liabilities, pro rata. In Situation 1, X is deemed to assume a portion of Z's liabilities in X's capacity as a shareholder, even though X is the creditor with respect to the liabilities. As discussed in Issue 1, because Z's liabilities exceed the fair market value of its assets, X and Y do not receive any of Z's assets in "payment" for their stock, and thus, neither §§ 331 nor 332 applies to the deemed liquidation. Because neither §§ 331 nor 332 applies to the deemed liquidation, the basis computation rules contained in § 334 do not apply to determine the basis of the assets X and Y are deemed to receive in the liquidation of Z. Instead, the basis of the assets that X and Y are deemed to receive is determined under § 1012 to be the cost of the assets. As described above, the cost to X and Y of the assets of Z is the full amount of the liabilities of Z assumed by X and Y, or \$110. Accordingly, in Situations 1 and 2, because X is deemed to assume liabilities of \$88 in the deemed liquidation of Z, X is deemed to receive assets with a basis of \$88. Similarly, because Y is deemed to assume liabilities of \$22 in the deemed liquidation of Z, Y is deemed to receive assets with a basis of \$22.

In Situations 1 and 2, § 301.7701-3(g)(1)(ii) treats X and Y as contributing assets with a basis in the hands of X and Y of \$110, and a fair market value of \$100 and \$110 of liabilities, pro rata, to the newly formed partnership. Under § 752(c), the amount of the liabilities treated as assumed by the partnership is limited to the fair market value of the assets at the time of the deemed contribution, or \$100. Accordingly, X is deemed to contribute assets with a basis to X of \$88 and liabilities of \$80. Y is deemed to contribute assets with a basis to Y of \$22 and liabilities of \$20. Under § 721, no gain or loss is recognized to the partnership or X and Y on the deemed contribution. Under §§ 722 and 723, respectively, the aggregate basis of X and Y in their partnership interests, and the partnership's basis in the assets deemed contributed, is \$110 (the adjusted basis of the assets to X and Y at the time of the deemed contribution).

In Situation 1, X is the deemed lender of the partnership's \$100 liability. As a result, X bears the economic risk of loss for that liability to the extent the risk of loss is not borne by another partner under § 1.752-2(c). Thus, the \$100 liability is treated as a recourse liability. Under § 1.752-1(e), the partnership is deemed to assume \$100 of the liabilities deemed contributed by X and Y (\$80 and \$20, respectively). As a result, the liabilities of X and Y decrease by \$80 and \$20, respectively. Because X bears the economic risk

of loss for the liability, X's share of the liability is increased by \$100. Under § 1.752-1(f), the net increase in X's share of liabilities, or \$20 (decrease in X's share of liabilities of \$80 plus increase in X's share of liabilities of \$100) is treated as a deemed contribution of money to the partnership by X. Accordingly, X's basis in its partnership interest is \$108 (adjusted basis in assets deemed contributed (\$88) under § 722 increased by the deemed contribution of money (\$20) under § 752(a)). Y's basis in its partnership interest is \$2 (adjusted basis in assets deemed contributed (\$22) under § 722 decreased by a deemed distribution of \$20 under § 752(b)).

In Situation 2, no partner bears the economic risk of loss with respect to the liabilities contributed to the partnership. As a result, the liability contributed is nonrecourse under § 1.752-1(a)(2). For purposes of § 1.752-3, it is assumed that X and Y share nonrecourse liabilities in accordance with the partner's share of partnership profits, which is pro rata. Because the partnership is deemed to assume \$100 of liabilities deemed contributed by X and Y (\$80 and \$20, respectively), the liabilities of X and Y decrease by \$80 and \$20, respectively. At the same time, however, X's share of the liability increases by \$80 and Y's share of the liability increases by \$20. As a result, there is no net change in the partners' share of liabilities under § 1.752-1(f) and, thus, no deemed contributions or distributions under §§ 752(a) and (b). Therefore, X's basis in its partnership interest is \$88 (adjusted basis in assets deemed contributed (\$88) under § 722) and Y's basis in its partnership interest is \$22 (adjusted basis in assets deemed contributed (\$22) under § 722).

If you have any additional questions about this matter, please contact Charles Wien at (202) 622-3070.

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