

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

Number: **AM2012-003**

Release Date: 5/4/2012

CC:CORP:B04:MCMilnes-Vasquez  
POSTN-102978-12

UILC: 1502.19-00, 1502.32-00, 1502.80-00

date: April 10, 2012

to: Cheryl Claybough  
(Director, Pre-filing and Technical Guidance, LB&I)

from: William D. Alexander  
Associate Chief Counsel  
(Corporate)

---

subject: Worthless stock loss on consolidated group subsidiary stock

This memorandum responds to your request for legal advice concerning the application of §§ 1.1502-19(c) and -80(c) with respect to claims for worthless stock losses on stock of consolidated group subsidiaries.

ISSUE

May a consolidated group meet the standard of worthlessness under §1.1502-19(c)(1)(iii)(A) with regard to the stock of a subsidiary that remains a member of the group if that subsidiary holds tax refund claims or other legal claims at the end of the taxable year?

CONCLUSION

A tax refund or other legal claim constitutes an asset in the hands of the subsidiary. Therefore, to the extent that the value of that claim exceeds state law minimum capital requirements, the stock cannot meet the requirements for worthlessness under §1.1502-19(c)(1)(iii)(A).

GENERIC FACT PATTERN

M is a holding company and is the common parent of a consolidated group, which includes member S1. In Year A, the M group incurs a large consolidated net operating loss, all of which is attributable to S1. The group had significant consolidated taxable income in the two consolidated return years prior to Year A. Before the end of Year A,

S1 ceases operation of its business, disposes of its operating assets, and uses the proceeds to satisfy certain of its liabilities. However, at the end of Year A, S1 continues to hold certain assets, including legal claims against its directors and officers, and a right to a portion of the M group's claims for refund of Federal income taxes. The total value of the legal and refund claims is less than S1's remaining outstanding liabilities. The stock of S1 meets the requirements for treatment as worthless under section 165(g), applied without consideration of the consolidated return regulations.

### LAW

Under §1.1502-80(c), a subsidiary's stock is not treated as worthless under section 165 until immediately before the earlier of the time:

- (i) The stock is worthless within the meaning of § 1.1502-19(c)(1)(iii); or
- (ii) The subsidiary for any reason ceases to be a member of the group.

Under §1.1502-19(c)(1)(iii)(A),<sup>1</sup> stock is treated as disposed of by virtue of worthlessness at the time:

All of S's assets (other than its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence) are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (for example, under section 165(a) or § 1.1502-80(c) \* \* \*). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S under section 332 or is in exchange for consideration (other than relief from indebtedness) \* \* \*.

### ANALYSIS

Under the facts presented, the stock of S1 held by M has satisfied the statutory requirements for worthlessness under section 165(g) during Year A. Thus, M would be able to claim its loss on the stock in Year A if M and S1 were not members of the same consolidated group. However, because S1 is a subsidiary in the M group at the end of the taxable Year A, the consolidated return regulations impose additional requirements that must be satisfied before the loss can be claimed.

Section 1.1502-80(c) provides that, if a subsidiary continues to be a member of a consolidated group, that subsidiary's stock may not be treated by the group as

---

<sup>1</sup> Section 1.1502-19(c)(1)(iii)(A) as quoted above is applicable to determinations and transactions occurring on or after September 17, 2008. During earlier periods, the previous version of §1.1502-19(c)(1)(iii)(A) is applicable, which requires disposition of "substantially all" of the assets of the subsidiary. See §1.1502-19(c)(1)(iii)(A) as contained in 26 CFR part 1 in effect on April 1, 2008.

worthless under section 165 until immediately before the stock is worthless within the meaning of § 1.1502-19(c)(1)(iii). Under § 1.1502-19(c)(1)(iii)(A), stock is treated as disposed of by virtue of worthlessness at the time:

All of S's assets (other than its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence) are treated as disposed of, abandoned, or destroyed for Federal income tax purposes \* \* \*.

In this case, there is consolidated taxable income in carryback years of the M group, which is available for offset by Year A consolidated net operating losses attributable to S1. Thus, S1 holds a claim for some portion of the group's income tax refund (which will eventually be converted to cash), which constitutes property. In addition, the director/officer claims held by S1 at the end of Year A constitute property. The plain language of §1.1502-19(c)(1)(iii)(A) requires disposition of all assets (other than corporate charter and state law minimum capitalization) before a subsidiary's stock may be treated as worthless. Therefore, the S1 stock does not qualify as worthless in Year A.<sup>2</sup>

Prior to the amendment of §1.1502-19(c)(1)(iii)(A) in 2008, that section required only that "substantially all" of the assets of the subsidiary be disposed of before a shareholder member could claim a worthless stock deduction. See §1.1502-19(c)(1)(iii)(A) as contained in 26 CFR part 1 in effect on April 1, 2008. The preamble to the Notice of Proposed Rulemaking containing the applicable amendments to §1.1502-19(c)(1)(iii)(A) makes clear that the purpose of the amendment was to tighten the requirements for claiming worthlessness. REG-157711-02, 72 FR 2964, 2985 (January 23, 2007).

In addition, as the preamble to the NPRM explains, §1.1502-19(c)(1)(iii)(A) was intended to prevent gain or loss on stock from being taken into account by the group until after items flowing from the subsidiary's activities are taken into account by the group. Treasury and the IRS concluded that deferring a worthless stock loss deduction until all of the subsidiary's assets had been disposed of would result in clear reflection of the group's income and the promotion of single entity treatment.<sup>3</sup>

---

<sup>2</sup> The fact that the value of the assets of the worthless entity will inure to the benefit of its creditors is of no import. A rule requiring that a worthlessness loss is delayed only to the extent that the value of assets inures to the subsidiary and its shareholders would never have application; by definition, the subsidiary (and its stock) would not be worthless.

<sup>3</sup>The preamble to the current version of section 1.1502-19(c)(1)(iii)(A) provides:

[Former] Section 1.1502-19(c)(1)(iii)(A) generally provides that a share of subsidiary stock will be treated as worthless when substantially all the subsidiary's assets are treated as disposed of, abandoned, or destroyed for federal tax purposes. This provision prevents an excess loss account from being included in income (and a worthless stock

Deferring claims for worthlessness until after a subsidiary's assets have been completely disposed of harmonizes with the intended application of single entity principles in other areas of the consolidated return regulations. For example, under §1.1502-32(b), positive and negative adjustments are made to the basis of subsidiary stock that members hold. Positive adjustments are made to reflect taxable income of subsidiaries, and negative adjustments are made to reflect loss and deduction items of subsidiaries, to the extent that those items are offset against group income. See §1.1502-32(b)(2) and (3)(i). These adjustments ensure that an economic loss incurred in a consolidated group will be taken into account a single time.<sup>4</sup> The shareholder member's amount of gain or loss on the disposition of subsidiary stock rises or falls as a result of these basis adjustments. The preamble to the stock basis adjustments regulations explains the system's preference for the use of the subsidiary's operating loss before the shareholder member's stock loss:

---

deduction from being taken) until the subsidiary's activities have been taken into account by the group. As a result, the group's income is clearly reflected and single entity treatment is promoted.

The current regulations do not, however, define the term "substantially all" for purposes of § 1.1502-19(c)(1)(iii)(A). Particular concerns have arisen because the term is used in many other areas of tax law, most notably in the area of corporate reorganizations. Because different policies are operative in those areas, the thresholds appropriate in those areas are not necessarily appropriate for purposes of § 1.1502-19(c)(1)(iii)(A) and the consolidated return provisions that incorporate it.

The IRS and Treasury Department believe that the single entity purpose of these consolidated return provisions is best effected by treating a subsidiary's stock as worthless only once the subsidiary has recognized all items of income, gain, deduction, and loss attributable to its assets and operations. Accordingly, these proposed regulations clarify § 1.1502-19(c)(1)(iii)(A) by providing that stock of a subsidiary will be treated as worthless when the subsidiary has disposed of, abandoned, or destroyed (for Federal tax purposes) all its assets other than its corporate charter and those assets, if any, that are necessary to satisfy state law minimum capital requirements to maintain corporate existence.

[72 FR at 2985]

<sup>4</sup> One commentator explains the purpose of the investment adjustment rules as follows:

The investment adjustment system is a comprehensive system for adjusting the basis of the stock of a subsidiary held by other members of a consolidated group. Its general effect is to increase or decrease the basis of the subsidiary's stock in tandem with increases or decreases in its adjusted income or loss. As a result, the subsidiary's income and deductions already taken into account in determining consolidated taxable income are not taken into account a second time as gain or loss on the sale or other disposition of the subsidiary's stock. [Dubroff, et al., *Taxation Of Corps Filing Consolidated Returns* § 51.01]

[T]he proposed rules adopt a single entity view of consolidated groups by generally deferring the worthlessness of S's stock until after S recognizes any corresponding loss with respect to its assets. Under the investment adjustment system, if S's loss is absorbed by the group, P's corresponding loss in S's stock is eliminated. [57 Fed. Reg. 53634, 53646 (Nov. 12, 1992).]

In the current case, after the stock of S1 meets the requirements of §1.1502-19(c)(1)(iii)(A), the stock basis that may be recovered by M through a worthless stock loss claim will be that stock basis remaining after adjustments to the basis of the S1 stock under §1.1502-32, including negative basis adjustments to reflect the group's use of S1's losses in current and carryback years, to offset income of any member of the M group. See §1.1502-32(b)(2) and (b)(5), Example 2.

Please call Marie Milnes-Vasquez at (202) 622-7530 if you have further questions.

---

William D. Alexander  
Associate Chief Counsel  
(Corporate)

cc: Lisa Shuman  
Senior Level Counsel  
(Large Business & International)