

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

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to: Case Coordinator  
Large & Mid-Size Business

from: Senior Technician Reviewer, Branch 4  
Associate Chief Counsel (Corporate)

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subject: Application of Section 332 of the Internal Revenue Code to a Deemed Liquidation

This Chief Counsel Advice responds to your request for assistance. In accordance with section 6110(k)(3), this advice may not be used or cited as precedent.

LEGEND

Parent =

Sub 1 =

Sub 2 =

FSub =

Month A =

Month B =

Date C =

Month D =

Country X =

Appraiser =

a =

b =

c =

d =

e =

f =

### ISSUE

Whether section 332 of the Internal Revenue Code applies to the deemed liquidation of FSub upon a change in entity classification under § 301.7701-3 of the Procedure and Administration Regulations resulting in the disallowance to the taxpayer of a worthless security deduction under section 165(g) and a bad debt deduction under section 166(a).

### CONCLUSION

Based on the information provided to us, section 332 does not apply to the deemed liquidation of FSub because FSub was insolvent at the time of the deemed liquidation. Thus, the taxpayer is allowed a worthless security deduction under section 165(g) and a bad debt deduction under section 166(a).

### FACTS

Parent is the common parent of a consolidated group that includes Sub 1 and Sub 2.

In Month A, Sub 1 formed FSub to operate a business in Country X, and FSub issued (i) one share of common stock to Sub 1 in exchange for \$a and (ii) one share of common stock to Sub 2, as nominee for Sub 1, in exchange for \$a.

Sub 1 filed a valid Form 8832, *Entity Classification Election*, changing the classification of FSub from a corporation to a disregarded entity for federal tax purposes effective Date C.<sup>1</sup>

The taxpayer represents that on Date C the fair market value of FSub's assets was less than zero. The taxpayer also represents that as of Date C FSub was indebted to Sub 1 in the amount of \$b (the "Sub 1 Debt") and was indebted to a local bank in the amount of \$c (the "Bank Debt"), which debt was guaranteed by Parent. In Month D (on a date after Date C), Parent transferred funds in the amount of \$d to FSub, which FSub used (along with other funds) to pay off the Bank Debt.

Sub 1 hired Appraiser to determine the fair market value of FSub. In early Month B, Appraiser indicated that FSub's assets had a negative liquidation value and that FSub's business had a negative going concern value. The audit team has determined that as of Date C, the business enterprise value of FSub was in the range of \$e to \$f.

For the group's taxable year that included Date C, the taxpayer claimed under section 166(a)(1) a bad debt deduction for both the Sub 1 Debt and for the portion of the Bank Debt satisfied with the funds transferred by Parent to FSub in Month D. The group also claimed under section 165(g)(3) a worthless security deduction for Sub 1's investment in FSub.

## LAW AND ANALYSIS

### A. Legal Authority

Section 301.7701-3 allows an "eligible entity" to elect its classification for federal tax purposes. An eligible entity with a single owner can elect to be classified as an association (taxed as a corporation) or to be disregarded as an entity separate from its owner. Treas. Reg. § 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. § 301.7701-3(g)(1)(iii). The tax treatment of a change in entity classification is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Treas. Reg. § 301.7701-3(g)(2).

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

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<sup>1</sup> We assume for purposes of this memorandum that FSub was an eligible entity within the meaning of § 301.7701-3 and that, prior to Date C, FSub was treated as a corporation for federal tax purposes.

for the stock. Section 331(c) cites section 1001 for the determination of the amount of gain or loss recognized on such exchange.

Section 332 provides that a corporation recognizes no gain or loss on the receipt of property distributed in complete liquidation of another corporation, provided (1) the distributee owns stock of the liquidating corporation meeting the requirements of section 1504(a)(2), (2) the distribution results in the complete cancellation or redemption of all of the liquidating corporation's stock, and (3) the property transfers occur within a prescribed period of time.

Section 1.332-2(b) of the Income Tax Regulations provides that section 332 does not apply to a liquidating distribution unless the 80 percent shareholder receives at least partial payment for the stock it owns in the liquidating corporation. A shareholder receives no payment for its stock of a liquidating corporation if that corporation is insolvent on the date of the liquidation (i.e., the corporation's liabilities exceed the fair market value of its assets). Rev. Rul. 2003-125, 2003-2 C.B. 1243. If section 332 does not apply to a liquidating distribution, then the shareholder may deduct its loss on the worthless security provided that the requirements of section 165 are met. Treas. Reg. § 1.332-2(b).

Furthermore, if a shareholder owns both common and preferred shares of a liquidating corporation's stock, section 332 applies only if the 80-percent shareholder receives property in exchange for its common stock after the corporation has transferred property to its creditors in satisfaction of any indebtedness and to its preferred shareholders in satisfaction of the liquidation preference of such stock. Commissioner v. Spaulding Bakeries Inc., 252 F.2d 693 (2<sup>nd</sup> Cir. 1958), aff'g, 27 T.C. 684 (1957); and H.K. Porter Co., Inc. and Subsidiaries, 87 T.C. 689 (1986).

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Under section 165(g)(1), a worthless stock loss is generally treated as a capital loss. However, section 165(g)(3) provides that a loss on worthless stock of a corporation that is affiliated with a taxpayer which is a domestic corporation is treated as an ordinary loss. Affiliation for this purpose means the ownership of stock meeting the requirements of section 1504(a)(2) and the satisfaction of a gross receipts test. Section 165(g)(3)(A) and (B).

Section 166(a)(1) allows a deduction for any debt that becomes worthless within the taxable year. In addition, payments made by a guarantor in discharge of part or all of its obligation as a guarantor are allowed as bad debt losses under section 166. Treas. Reg. § 1.166-9.

Section 1.166-9(a) provides that a payment made in discharge of part or all of a taxpayer's obligation as a guarantor is treated as a business debt becoming worthless in the taxable year in which the payment is made or, where the agreement provides for a right of subrogation against the issuer, in the taxable year in which the subrogation

right becomes totally worthless. Treas. Reg. § 1.166-9(a) and (e)(2). However, such a payment is treated as a worthless debt only if: (1) the guarantee agreement was entered into in the course of the taxpayer's trade or business or a transaction for profit; (2) there was an enforceable legal duty upon the taxpayer to make the payment (except that legal action need not have been brought against the taxpayer); and (3) the agreement was entered into before the obligation became worthless. For this purpose, an agreement is considered as entered into before the obligation became worthless if the taxpayer at the time the agreement was made had a reasonable expectation that it would not be required to pay the debt without full reimbursement from the issuer. Treas. Reg. § 1.166-9(d)(3). In addition, § 1.166-9(e)(1) requires a guarantor of an obligation to have received reasonable consideration for entering into the guarantee agreement. A guarantor can demonstrate that it received reasonable consideration if it can demonstrate that the agreement was given in accordance with normal business practice or for a good faith business purpose. Treas. Reg. § 1.166-9(e)(1).

### B. Analysis

The change in FSub's entity classification from a corporation to a disregarded entity is treated as a deemed liquidation of FSub for federal tax purposes. See Treas. Reg. § 301.7701-3(g)(1). The taxpayer took the position that FSub was insolvent at the time of the deemed liquidation and therefore claimed a bad debt deduction under section 166(a)(1) for the Sub 1 Debt and a worthless security deduction under section 165(g)(3) for Sub 1's investment in the stock of FSub. In addition, the taxpayer claimed under section 166(a)(1) a bad debt deduction for the \$d amount transferred in Month D by Parent to FSub and by FSub to the local bank in satisfaction of the Bank Debt.

The audit team questioned the taxpayer's valuation of FSub on Date C. The audit team has determined that as of Date C the business enterprise value of FSub was in the range of \$e to \$f. However, even under the audit team's valuation, FSub would have had insufficient assets to satisfy its obligations.<sup>2</sup> Because FSub was insolvent at the time of the deemed liquidation, section 332 does not apply, and the taxpayer is allowed under section 165(g)(3) a worthless security deduction with respect to the common stock of FSub held by Sub 1.<sup>3</sup> In addition, the taxpayer is allowed a bad debt deduction under section 166(a)(1) in an amount equal to the total outstanding indebtedness of FSub minus the fair market value of FSub.<sup>4</sup> In sum, FSub's insolvency

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<sup>2</sup> The audit team's highest valuation for FSub was \$f, which is less than the amount of FSub's liabilities (i.e., the Sub 1 Debt of \$b plus the Bank Debt of \$c).

<sup>3</sup> This memorandum assumes that FSub meets the gross receipts test described in section 165(g)(3)(B).

<sup>4</sup> This analysis assumes that the payment made by Parent in satisfaction of its guaranty of the Bank Debt meets the requirements of § 1.166-9. If those requirements are not met, the payment made by Parent on the guaranty would be treated as a contribution to the capital of FSub and give rise to a worthless security deduction under section 165(g)(3). Thus, whether or not the guaranty payment satisfies the requirements of § 1.166-9, a loss results either under section 166 or section 165(g)(3).

precludes the deemed liquidation from qualifying as a complete liquidation under section 332 and allows the taxpayer to claim a worthless security and bad debt deductions.

The audit team has proposed, as one way to make section 332 applicable to the deemed liquidation, to recharacterize some or all of the Sub 1 Debt as an equity investment in FSub for federal tax purposes. Treating a threshold amount of Sub 1 Debt as equity, rather than debt, would make FSub solvent at the time of the deemed liquidation. However, for the reasons discussed below, section 332 would still not apply to the deemed liquidation because FSub would not be treated as distributing property in complete cancellation or redemption of all its stock on its deemed liquidation. See section 332(b)(2).

A liquidating corporation is deemed to distribute its property in the following order: (1) to creditors in satisfaction of indebtedness, (2) to preferred stock shareholders, and (3) to common stock shareholders. Commissioner v. Spaulding Bakeries Inc., 252 F.2d 693 (2<sup>nd</sup> Cir. 1958), aff'd, 27 T.C. 684 (1957); and H.K. Porter Co., Inc. and Subsidiaries, 87 T.C. 689 (1986). Section 332 applies to a liquidation only if the liquidating corporation has property remaining for distribution on its common stock after satisfying its indebtedness and the prior claim of its preferred stock. Id.

In this case, if the Sub 1 Debt were recharacterized as equity of FSub, it would be treated as a preferred class of FSub stock.<sup>5</sup> On the date of the deemed liquidation, the total amount of the Bank Debt and the Sub 1 Debt exceeded the audit team's highest estimate of FSub's business enterprise value. Therefore, treating the Sub 1 Debt as equity would not make section 332 applicable to the deemed liquidation because FSub would have no assets to distribute on its common stock. The taxpayer would be allowed a worthless security deduction under section 165(g) for the common stock of FSub held by Sub 1 and a capital loss under sections 331(a) and 1001 for the portion of the Sub 1 Debt recharacterized as equity.

In addition to treating a portion of the Sub 1 Debt as equity of FSub, the audit team has also proposed to treat the Bank Debt as debt of Parent and then as a capital contribution by Parent to FSub. For the reasons that follow, such recharacterization

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<sup>5</sup> 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 (3<sup>rd</sup> Cir. 1968); Estate of Mixon v. United States, 464 F.2d 394 (5<sup>th</sup> Cir. 1972); and Bauer v. Commissioner, 748 F.2d 1365 (9<sup>th</sup> 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.

The intercompany advances that constitute the Sub 1 Debt were in form term loans embodied in promissory notes that bore fixed rates of interest and were treated by the parties as debt for tax and accounting purposes. Because the Sub 1 Debt had all the formal indicia of indebtedness and because interest payments were made on the obligation, the Sub 1 Debt, if recharacterized as equity, should be treated as preferred stock.

would not cause the deemed liquidation to qualify as a complete liquidation under section 332.

As discussed above, in the deemed liquidation, FSub is treated as paying off its indebtedness and the prior claims of its preferred stock before distributing property with respect to its common stock. Section 332 will apply to the deemed liquidation only if FSub has property remaining for distribution on its common stock. Treating the Bank Debt as a contribution by Parent to the capital of FSub would not make section 332 applicable even if Parent's equity interest in FSub were treated as common stock because FSub would have insufficient assets to satisfy the Sub 1 Debt (whether respected as debt or treated as preferred stock) and thus would have nothing to distribute to its common stock shareholders. Thus, the taxpayer would be allowed a worthless security deduction under section 165(g) for Sub 1's investment in the common stock of FSub and a capital loss under section 331(a) for the portion of the Sub 1 Debt treated as preferred stock of FSub that is not satisfied in the liquidation. The character of the loss recognized on the Bank Debt would depend on whether that amount was recast as preferred or common stock of FSub. The exact deduction and loss amounts depend on the final valuation of FSub.

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