Roberts & Holland LLP

December 18, 2003

New Guidance Regarding Tax Treatment of Deemed Liquidations

By: Elliot Pisem and David E. Kahen

Corporate tax practitioners frequently encounter questions relating to the tax consequences of the liquidation of a corporate subsidiary that is insolvent or approaching insolvency. More specifically, questions often arise as to whether and to what extent the basis of a parent corporation in the stock and debt of its subsidiary, typically attributable to capital contributions and loans made by the parent corporation, may result in a tax benefit to the parent at the time of liquidation of the subsidiary.

A ruling recently published by the Internal Revenue Service reviews these consequences, and provides some insight as to the thinking of the IRS, particularly regarding the valuation issues that may arise in this context, in two situations where there is no actual dissolution of an entity but rather only a deemed liquidation under the so-called "check- the-box" rules described below.

Background

In general, if a corporation owns 80% or more (by vote and by value) of the stock of a subsidiary and receives property distributed in complete liquidation of the stock of the subsidiary, no gain or loss is recognized by the corporate shareholder.

This is generally a helpful rule from the shareholder's perspective where the basis of the stock of the subsidiary is less than the cash and the value of the other property distributed. If, however, the amount received on liquidation is less than the basis of the parent in the stock of the subsidiary, this rule prevents the loss with respect to the stock from being recognized at the time of liquidation or thereafter.

By contrast, if no property at all is received in liquidation of the stock of the subsidiary, for example because the assets of the subsidiary are insufficient to pay its liabilities, and if the terms of the liquidation establish that the stock is worthless, then a worthless security loss is allowable to the parent corporation under Internal Revenue Code ("IRC") section 165(g); this loss will generally be an ordinary loss if the parent owns 80% or more of the stock of the subsidiary and the subsidiary has not derived 10% or more of its gross receipts from the types of passive and investment income described in section 165(g)(3)(B).

Rev. Rul. 2003-125

The revenue ruling describes two situations. In the first situation, P, a domestic corporation and calendar year taxpayer, owns all of the equity interests of FS, a foreign entity engaged in a manufacturing business. FS owes money to P and other creditors; however, as of December 31, 2002, its stock is not worthless.

FS is an "eligible entity" within the meaning of section 301.7701-3(a) of the Regulations, meaning that it may change its classification for federal income tax purposes – for example, from a corporation to an entity that is disregarded for federal tax purposes – simply by making an election under the entity classification regulations that is commonly referred to as a "check-the-box" election and without the need to engage in an actual transaction of any kind. Until such an election is made, however, FS is treated as a corporation for federal tax purposes.

On July 1, 2003, an IRS Form 8832 is filed to change the classification of FS for federal tax purposes, as of that date, from a corporation to a disregarded entity. After the election, FS continues its manufacturing operations. As of the end of the day immediately preceding the effective date of the election, the fair market value of the assets of FS exceed the sum of its liabilities if the intangible assets of FS, such as goodwill and going concern value, are taken into account. If intangible assets such as goodwill and going concern value are excluded, however, the fair market value of the assets of FS does not exceed the sum of its liabilities.

In the second situation described in the ruling, the facts are the same as in situation 1 except that the fair market value of the assets of FS, including its intangible assets, does not exceed the sum of its liabilities.

Discussion

If an eligible entity classified as an association (taxed as a corporation) elects to be classified as a disregarded entity, then, under the entity classification regulations, the entity is deemed to distribute all of its assets and liabilities to its owner in liquidation of the entity.

Case law and regulations under IRC section 332 provide that the general rule of nonrecognition of gain or loss to the corporate shareholder owning 80% or more of the stock of the liquidating subsidiary applies only if there is some distribution with respect to the stock of the subsidiary. Where, as in the situations described in the ruling, the liquidation is solely a "deemed" event under the check-the-box rules and there is no actual distribution with respect to stock, the ruling indicates that a distribution "with respect to stock" will be deemed to occur only if the value of the assets of the entity exceeds the sum of its liabilities at the time of the deemed distribution.

To start with perhaps the most obvious point, the ruling notes that the fair market value of the assets of the subsidiary may differ from the amounts shown for those assets on the subsidiary's balance sheet. For the purposes described in the ruling, the fair market value of the subsidiary's assets, rather than their basis or other carrying value, will be controlling.

The ruling then refers to federal estate tax regulations that provide that the fair market value of property is the price at which property would change hands between a willing buyer and a willing seller, neither being compelled to buy or sell and both having knowledge of the relevant facts. The ruling notes that "[t]he Service and the courts regularly apply the valuation standards in the estate tax regulations for purposes of determining the value of property for income tax purposes" (citations omitted).

The ruling then discusses factors relating to the determination of the value of the intangible assets of a corporation. Facts and circumstances relevant to the determination of the value of such assets include the corporation's economic outlook, the demand for its products, the efficiency of its operations, and the size of its customer base. Other factors that may be relevant, according to the ruling, include whether a substantial addition to capital is necessary to continue operations, whether an impairment loss is reported for financial statement purposes, and whether the operations are treated as discontinued operations for financial reporting purposes.

The ruling further observes that, if the business continues after the liquidation of the corporate owner without a substantial addition to capital, and the revenues of the continuing business are sufficient to service its pre-liquidation debts, these circumstances may indicate that the value of the assets of the subsidiary exceeds the sum of the liabilities, and therefore that an entity reclassification from a corporation to a disregarded entity will result in a deemed distribution with respect to the stock of the subsidiary.

In situation 1 of the ruling, the fair market value of the assets of FS, including its intangible assets, exceeds its liabilities as of the close of the day before the check-the-box election was effective. Accordingly, P is deemed to receive a distribution with respect to its stock in FS. Therefore, IRC section 332 applies, and no loss is allowable to P with respect to its stock in FS upon the deemed liquidation.

In situation 2, the assets of FS, including its intangible assets, do not exceed the sum of its liabilities. Therefore, P is not considered to receive anything upon the deemed liquidation with respect to its stock in FS.

The deemed liquidation is considered to be an identifiable event that fixes (for tax purposes) the loss of P with respect to the stock of FS. Accordingly, on the assumed facts for situation 2 of the ruling, P is allowed a worthless security deduction in 2003 with respect to the stock in FS.

The ruling also notes that P and other creditors of FS may be entitled to deductions for partially or wholly worthless debt with respect to obligations of FS.

Conclusions

Revenue Ruling 2003-125 does not appear to contain any startling conclusions in its analysis of the tax treatment of liquidation of near-insolvent subsidiaries by reason of an entity classification election. It does offer potentially useful guidance, however, as to factors the IRS will consider in determining the value of the assets of the liquidating entity in the context of determining the tax consequences of actual and deemed liquidations, and perhaps in other income tax contexts as well.

The analysis in the ruling also offers something of a road map as to factors that should be considered by practitioners in appropriate circumstances before a check-the-box election is made to determine whether a resulting deemed liquidation will facilitate or preclude the recognition of a loss.

The ruling does not, at least in any explicit manner, address the thorny issues that may arise where circumstances suggest that it may be appropriate to take liabilities into account at more or less than the face amount thereof, for example, because it appears likely that creditors of the subsidiary will be prepared to accept less than the full amounts of their claims in the interest of obtaining an accelerated or more certain recovery. The repeated references to "the sum of [FS'] liabilities," without any specifics as to the nature of those liabilities, may imply that such potential discounts should be disregarded in this context so long as the claims are not actually settled for reduced amounts before the deemed liquidation; or, alternatively, that the IRS simply chose not to address that issue here.