Claiming a Worthless Stock Deduction May Have Become a Little Easier

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As uncertainty in the current economy continues to grow, corporations may have some opportunities to take worthless stock deductions in subsidiaries whose business have become worthless. The ability to claim the deduction as an ordinary loss on affiliates has been a challenge because the worthless company must meet certain requirements. Recent guidance, however, may give some relief and present some interesting planning opportunities for corporate taxpayers.

Worthless Stock Deduction Generally

A taxpayer is permitted to report a loss in a security equal to its tax basis when the security becomes completely worthless during a tax year under Section 165.¹ Treas. Reg. Section 1.165-1(b) provides that in order to take a deduction, the loss must be (a) evidenced by a closed and completed transaction, (b) fixed by identifiable events, and (c) actually sustained during the taxable year. The Code, however, does not define “worthlessness.” Judicial decisions have generally focused on a taxpayer’s facts and circumstances to determine whether the security has become worthless.² A single event will not generally satisfy the worthlessness test in the absence of other factors that indicate that no value remains in the security, thereby making this a difficult hurdle.

Even if a taxpayer can determine worthlessness, it must also prove that the recognition of the loss in a particular taxable year is appropriate. A loss for worthlessness generally can be claimed in a year in which a security is abandoned by a taxpayer. In order for a security to be considered abandoned, a taxpayer must permanently surrender and relinquish all rights in a security and receive no consideration in exchange for the security.³ Again, this is a facts and circumstances test, and taxpayers must ensure the transaction is properly characterized as an abandonment rather than another type of transaction, such as an actual sale or exchange, contribution to capital, or a dividend. The

¹ Unless otherwise stated, all references to “Section” are to the Internal Revenue Code of 1986, as amended, and all references to “Treas. Reg. Section” are to the Treasury Regulations promulgated thereunder.

² The consolidated return Regulations provide a test for the worthlessness of a subsidiary as when substantially all of the subsidiary’s assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes. See Treas. Reg. 1.1502-19(c)(1)(iii)(A).

³ See Treas. Reg. Section 1.165-5(i)(2) (effective for abandonment of stock or securities after March 12, 2008).
year of worthlessness and the character of the loss, as described below, are often the
cause of controversy between taxpayers and the IRS.

**Capital Versus Ordinary**

If a taxpayer can establish that a security has become worthless and that the timing is
correct, then it must be determined whether the character of the loss is ordinary or capital.
The general rule is that a worthless stock loss is characterized as a capital loss. Since a
capital loss can only be utilized against capital gain income, taxpayers without current
capital gain income or capital gain income in an applicable carryback or carryforward
period generally will be unable to utilize a worthless stock loss. Section 165(g)(3)
provides an exception to the general rule by characterizing a worthless stock loss as
ordinary if the security owned was stock in an affiliate. For the worthless company to
qualify as an affiliate, the taxpayer must meet two requirements. First, it must own
directly stock meeting the requirements of Section 1504(a)(2), which is generally 80
percent or more of the voting power and 80 percent of the value of the corporation’s
stock. The second requirement, subject to some exceptions, is that 90 percent or more of
the affiliate’s aggregate gross receipts for all taxable years be from sources other than
royalties, rents, dividends, interest, annuities and gains from sales or exchanges of stocks
and securities.

**Look Through Approach**

An issue that many taxpayers face in claiming an ordinary loss under Section 165(g)(3) is
passing the 90 percent gross receipts test, particularly where the relevant subsidiary had
either dividend income from lower tier subsidiaries (possibly non-qualifying gross
receipts) or no gross receipts at all. This issue was addressed in each of PLR 200710004
and TAM 200727016.4

In PLR 200710004, the IRS permitted a parent corporation to claim an ordinary worthless
stock loss under Section 165(g)(3) with respect to stock of a domestic subsidiary holding
company. In the PLR, the holding company operated businesses through subsidiaries
from which the holding company had previously received dividends. The subsidiaries
were ultimately liquidated into the holding company in what were termed Section
381transactions i.e., transactions in which the tax attributes of the liquidated subsidiaries
“carried over” to the holding company. Under these facts, the IRS ruled that the holding
company must take into account the historic gross receipts of the liquidated subsidiaries
for purposes of the 90 percent gross receipts test under Section 165(g)(3).5 Additionally,
the IRS ruled that the holding company must include in its gross receipts all dividends

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4 PLR 200710004 (March 9, 2007); TAM 200727016 (July 6, 2007). While neither a private letter ruling
(“PLR”) nor a technical advice memorandum (“TAM”) may be cited as authority by a taxpayer other than
taxpayer addressed in the PLR or TAM, it may evidence the IRS’s position on an issue.

5 An additional question that has arisen is whether all Section 381 transactions qualify for this test and not
just the ones mentioned in the PLR.
received from lower-tier subsidiary members of its consolidated group and to treat such dividends as “gross receipts from passive sources” to the extent they are attributable to the respective distributing member’s “gross receipts from passive sources.” Thus, in the PLR, only dividends that were attributable to gross receipts from passive sources were counted as dividends for the gross receipts test under Section 165(g)(3). Importantly, the IRS appears to have adopted a look through method in the ruling in determining which gross receipts qualified under Section 165(g)(3).

In contrast to PLR 200710004, in TAM 200727016, the IRS denied a corporate taxpayer’s ordinary loss deduction of a worthless foreign subsidiary where all of the worthless foreign subsidiaries’ income was from dividends received from its subsidiaries that operated active businesses. In the TAM, the IRS did not apply the look through approach as it did in PLR 200710004 in determining the origin of the dividend income. In the TAM, it is unclear if the dividends were included because the worthless corporation was a foreign holding company. Also, there was no mention of Section 381 transactions in the TAM.

Planning Opportunities

By aggregating historic gross receipts received in liquidations and looking to the underlying character of the dividend, the IRS may have presented taxpayers holding worthless subsidiaries with some potential planning opportunities in the PLR. Taxpayers holding worthless subsidiaries, for example, may explore liquidating or merging other subsidiaries into the worthless affiliate to transfer active gross receipts history to a worthless holding company.

Since the TAM did not mention Section 381 transactions, one question that has arisen is whether a foreign holding company could inherit the gross receipts of its foreign subsidiaries through a check the box election that would trigger the look through rules and thus, qualify the entity for an ordinary worthless loss. In comparing the PLR 200710004 and the TAM 200727016, it is not certain how the IRS would view this type of transaction. Taxpayer’s who may be eligible for an ordinary worthless stock deduction in an affiliate might want to take a hard look at this opportunity since it could create a large permanent difference.

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6 The ruling was silent as to how the dividends are traced back to active sources of income. One issue is whether a distribution will follow a “last-in-first-out” type of approach used in the earnings and profits context for determining qualifying gross receipts.

7 Of note, taxpayers attempting this are advised to review all the tax consequences of the transaction as this might not be appropriate for all taxpayers. See CCA 200706011 (February 9, 2007) (Section 332 liquidation does not apply to a deemed liquidation of a foreign subsidiary because the subsidiary was insolvent at the time of the deemed liquidation. Taxpayer was allowed a worthless stock deduction under 165(g)(3)).
One key to claiming this type of loss is making sure the taxpayer has contemporaneously documented the key components of the deduction. For example, corporate taxpayers need to document their tax basis in the worthless subsidiary, which typically requires a study under Treas. Reg. Section 1.1502-32 to determine the amount of the deduction. Second, they need to document the worthlessness of the subsidiary. Third, such taxpayers need to document the gross receipts history of the subsidiary to qualify under Section 165(g)(3) to claim the deduction as ordinary. Finally, a ruling from the IRS might be required to obtain certainty if any type of planning or structuring is involved or if an ambiguity exists as to whether or not each component of the worthlessness test have been met.