

SECTION 332 LIQUIDATION OF INSOLVENT SUBSIDIARY VIA CONVERSION TO DISREGARDED ENTITY

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A corporation converted its wholly owned subsidiary to a disregarded entity via a check-the-box election. At the time, the subsidiary was insolvent. The parent corporation sought a worthless stock loss under Code §165(g)(1).

At issue is Code §332 which will not allow a parent corporation shareholder to recognize gain or loss on liquidating distributions of an 80%-or-more owned subsidiary. The corporation sought a private letter ruling to the effect that Code §332 did not apply.

A necessary requirement for Code §332 to apply is that the parent must receive at least partial payment for the stock it owns. Since a check-the-box election to be treated as a disregarded entity treats the electing corporation as liquidating, at least in normal circumstances it would appear that this constructive liquidation would result in the requisite partial payment for the stock and Code §332 would apply to disallow the loss.

However, in this case the subsidiary was insolvent. The taxpayer sought to apply Rev.Rul. 2003-125 in context of this constructive liquidation. In that Ruling, the IRS concluded that when the fair market value of the subsidiary's assets, including intangible assets such as goodwill and going concern value, is less than the sum of the subsidiary's liabilities, including bona fide liabilities owed to the parent, no part of the transfer is attributable to the parent's stock ownership and the above payment -for-stock requirement isn't satisfied. Accordingly, the Code Sec. 332 nonrecognition rules didn't apply.

On a constructive liquidation of an insolvent subsidiary, the same effect should occur, even though no physical movement of assets occurs. Thus, in theory, Rev.Rul. 2003-125 should apply.

Theory does not always apply when dealing with the IRS. However, in this situation, it did, and the IRS acknowledged that Rev.Rul. 3002-125 could apply to a constructive liquidation under a check-the-box election. Thus, the parent corporation obtained the worthless stock deduction.

As an aside, note that the parent corporation was able to receive an ordinary loss instead of a capital loss, by reason of the application of the affiliation exception under Code §165(g)(3).

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