DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated November 10, 1999. This Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Parent =

DSub1 =

DSub2 =

DSub3 =

FSub1 =

FSub2 =

FSub3 =

Corp A =

Corp B	=
Corp C	=
Acquisition Co	=
Merger Sub	=
Newco	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=

f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
0	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=
y	=
z	=

aa =

bb =

cc =

dd =

ee =

ff =

gg = __________

hh = ________

ii = _________

jj = __________

kk = __________

ll =

Country Z =

Accounting Firm =

ISSUES

1. What is the initial basis in the FSub1 preferred and common stock?

2. How are the October 5, Year 7 contributions, which consisted of contributions by DSub1 to FSub1 of cash and intercompany notes and financing fees in an amount totaling a, reflected in the basis of the common and preferred stock of FSub1?

3. Should the cash merger of FSub1 into Newco (characterized by taxpayer under Rev. Rul. 69-6 as a sale of FSub1's assets to Newco for cash followed by the distribution of that cash to the FSub1 shareholders in exchange for the FSub1 stock) be recast as a sale of stock by the FSub1 shareholders to Newco followed by the liquidation of FSub1?

4. Should DSub3 be allowed an ordinary loss deduction for the common stock of FSub1, its wholly owned subsidiary, under § 165(g)(3)?

CONCLUSIONS

1. The initial basis in the FSub1 preferred and common stock should reflect the FSub1 and DSub1 subscription agreement and the December 16, Year 1 exchange of cash by DSub1 for additional FSub1 preferred stock. However, a court might give weight to an accurate appraisal, even if conducted after the fact.

2. The October 5, Year 7 contributions by DSub1, which consisted of contributions to FSub1 of cash and intercompany notes and financing fees in an amount totaling a should be reflected solely in the basis of the common stock of FSub1.

3. The cash merger of FSub1 into Newco (characterized by Rev. Rul. 69-6 as a sale of FSub1's assets to Newco for cash followed by the distribution of that cash to the FSub1 shareholders in exchange for the FSub1 stock) should not be recast as a sale of stock by the FSub1 shareholders to Newco followed by the liquidation of FSub1.

4. DSub3 is allowed an ordinary loss deduction for the common stock of FSub1, its wholly-owned subsidiary, under § 165(g)(3).

FACTS

Both DSub1 and DSub2 were wholly owned subsidiaries of Parent which was the common parent of a consolidated group.

On or about February 16, Year 1, DSub1 incorporated FSub1 in Country Z with b cash, for which it received c shares of FSub1 common stock, and d shares of FSub1 preferred stock. FSub1 at the same time also borrowed e from DSub2. These funds (f) were immediately contributed to FSub2, a Country Z corporation, in exchange for g-percent of its stock. FSub2 also immediately borrowed h from DSub2.

FSub2 used the foregoing cash to acquire most of the shares of FSub3, an unrelated Country Z corporation whose shares were publicly traded. FSub2 subsequently merged with FSub3 under Country Z law (the merger transaction is referred to as an i thereunder), and the merged entity (referred to hereinafter as FSub2) continued the name previously used by FSub3.

On or about December 12, Year 1, FSub2 was liquidated into FSub1, and FSub1 changed its name to the name previously used by FSub3.

On or about December 13, Year 1, FSub1 issued another j shares of preferred stock to DSub1 in exchange for k, which funds were employed to acquire another unrelated company.

On or about October 5, Year 7, DSub1 contributed cash in the amount of l and an intercompany note in the amount of m as a contribution to the capital of FSub1. DSub1 or Parent also contributed an additional intercompany note in the amount of n and paid financing fees of 0. No additional stock was issued for these contributions.

Also on or about October 5, Year 7, Corp A, the common parent of a consolidated group not related to the Parent consolidated group acquired, through its indirect wholly-owned subsidiary, Corp C, all the outstanding stock of Parent. Parent owned all of the stock of DSub3 at this time.

On or about December 31, Year 8, DSub1 and DSub2 were merged upstream into Parent, which received all the assets (p) and assumed all of the liabilities (q) of those entities.

Also on or about December 31, Year 8, Parent merged downstream into DSub3, which received all the assets (r) and assumed all of the liabilities (s) of Parent. Immediately following this transaction, Corp A was the common parent of a consolidated group and owned all of the outstanding stock of Corp B, which owned all of the outstanding stock of Corp C, which owned all of the outstanding stock of DSub3, which owned all of the outstanding stock of FSub1.

On May 14, Year 9, DSub3 sold both the preferred and common stock of FSub1 to an unrelated party (Acquisition Co). This sale was structured in multiple steps. First, Acquisition Co formed Merger Sub and funded it with t. Second, Acquisition Co formed Newco. Third, Merger Sub and FSub1 entered into an agreement to merge into a new Country Z entity (Newco). Third, DSub3 received u in cash and v shares of Newco stock in exchange for the w shares of FSub1 preferred stock. These v shares of Newco stock represented less than x-percent of the stock of Newco. DSub3 also transferred the c shares of common stock of FSub1 to Newco, but allegedly received ee in exchange for those shares. The U.S. tax treatment of this transaction is the same as a forward cash merger. The transaction will be treated as if FSub1 sold all of its assets for cash and then distributed the cash in complete liquidation of its stock. Fourth, Newco wired y of the aforementioned proceeds to pay off unrelated loans of FSub1, and wired DSub3 the net proceeds of z. Fifth, on May 14, Year 9, the liquidation preference of the preferred shares of FSub1, received by DSub3 in exchange for w shares of FSub1 preferred stock, exceeded the net proceeds of z. Sixth, on May 16, Year 9, DSub3 sold the v shares of Newco stock back to Acquisition Co for aa.

DSub3 reported a capital gain on the sale of the w shares of FSub1 preferred stock in the amount of bb on the consolidated return filed by Corp A for the tax year ended on December 31, Year 9. This gain represented the difference between the net basis it determined for this stock (cc) and the net proceeds of z. DSub3 also reported an ordinary loss on the sale of the common stock of FSub1 in the amount of dd. This loss represented the difference between the amount DSub3 received for the common stock of FSub1 (ee) and the amount of basis it determined for this stock (dd).

LAW AND ANALYSIS

1. Initial basis in the FSub1 preferred and common stock.

On Form 5471 (Information Return of U.S. Person With Respect to Certain Foreign Corporations) and on its balance sheet included with Form 1120 for the tax years Year 2 through Year 6, DSub1 (collectively, DSub1 and DSub3 are referred to herein as the “Taxpayer”) allocated kk to the FSub1 preferred stock and ll to the FSub1 common stock. However, on its Form 1120 for Year 9, the year of the sale of the FSub1 assets, Taxpayer reported the basis as cc on the FSub1 preferred stock and dd on the FSub1 common stock. These amounts were the results of an appraisal made in Year 9 by Accounting Firm, Taxpayer’s representative, using a so-called “income approach” looking back to Year 1. Under the appraisal, the February Year 1 contribution was allocated ff to the FSub1 preferred stock and gg to the FSub1 common stock. The December Year 1 contribution was allocated hh to the FSub1 preferred stock and ii was allocated to the FSub1 common stock. Thus, under Taxpayer’s valuation, in Year 1, the FSub1 preferred stock had a basis of cc and the FSub1 common stock had a basis of jj.

Examination disagreed with the method of valuing the stock and used the more contemporaneous allocations reported by Taxpayer on the balance sheet attached to Form 1120 for tax years Year 2 through Year 6 of kk to the FSub1 preferred stock and ll to the FSub1 common stock. Examination has not attempted to verify the accuracy of the Year 9 appraisal. These contemporaneous allocation amounts were also reported in records received from Taxpayer pursuant to an information document request for workpapers and other records that would show the basis of the common and preferred stock.

We agree that the "income approach" appraisal was constructed as an after the fact attempt to shift basis from preferred stock to common stock in order to increase the ordinary loss on the common stock for the purpose of creating or increasing a net operating loss carryback for DSub3. We also agree that the best evidence of the basis in the common stock and preferred stock, resulting from the original formation of FSub1 is reflected in the subscription agreement, the December Year 1 exchange of cash by DSub1 for preferred stock of FSub1, and the basis allocations consistently stated on the corporation's books from Year 1 to Year 9. However, to the extent that the appraisal is accurate, even if done after the fact, a court may give weight to the Taxpayer's position.

We note that the duty of consistency may apply. See, e.g., Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988), cert. denied, 490 U.S. 1065 (1989); Beltzer v United States, 495 F.2d 211 (8th Cir. 1974). The duty of consistency has been applied to prevent taxpayers from taking inconsistent positions in order to improperly inflate the basis of an asset. Coldiron v. Commissioner, 54 T.C.M. (CCH) 1084 (1987). In determining basis, the principles of estoppel may also apply. Treas. Reg. § 1.1016-6(b). For example, if Year 1 is closed to assessment, Taxpayer's reallocation of basis to the common stock should be estopped as inconsistent with its prior reported positions to the extent the Service has acquiesced in or relied upon those reported facts for those years. Further factual development would be appropriate.

2. October 5, Year 7 contributions by DSub1.

Taxpayer allocated the entire amount of the October 5 Year 7 contributions by DSub1, which consisted of contributions to FSub1 of cash and intercompany notes and financing fees in an amount totaling a, to DSub1's basis in the common stock of FSub1. The examiner asserts that the amount should be allocated between the FSub1 common stock and the FSub1 preferred stock based on the relative tax basis of the stock at the time of the Year 7 contributions.

Treas. Reg. § 1.358-2(a)(4) provides that in every case in which, before the transaction, a person owned more than one class of stock, a determination must be made (upon the basis of all of the facts) of the stock received with respect to the stock of each class held (whether or not surrendered).

Treas. Reg. § 1.358-2(b)(2) provides that, if a transferor in a § 351 exchange receives stock of more than one class, then the basis of the property transferred shall be allocated among all of the stock received in proportion to the fair market values of the stock of each class. However, that regulation only provides a method for allocating basis when stock of two classes is actually received. In a case in which no stock is received, all of the facts must be examined to make the determination of what stock is received with respect to the common stock and the preferred stock.

The suggested allocation of basis between preferred and common appears to be based on the meaningless gesture theory as expressed, for example, in Lessinger v. Commissioner, 85 T.C. 824 (1985), aff'd, 872 F.2d. 519 (2d. Cir. 1989). In Lessinger, both the Tax Court and the Circuit Court held that, because C (an individual shareholder) is the sole shareholder of S, the issuance of stock would be a meaningless gesture. Under that rationale, it could be argued that common and preferred stock would be deemed issued in exchange for the new contributions. While the examiner allocated the contributions between common and preferred in accordance with their respective tax basis, apparently to preserve the proportion of Taxpayer's initial investment in common and preferred stock, it could also be argued that the appropriate allocation is in proportion to their fair market values.

The meaningless gesture rule has been applied to allocate basis to existing stock when contributions were made, but no stock was issued. It deems stock issued to satisfy the exchange requirement of § 351, and for purposes of determining basis. The rule does not provide the same rights under corporate law that would be attached to the stock if the stock were actually issued.

It is our view that the meaningless gesture rule should be applied only in the cases in which the issuance or non issuance of stock is truly meaningless. In the simple case of a corporation with only one class of stock owned by a single shareholder, any contribution to capital generally increases the value of the stock by the amount of the contribution. In that case, there really is no difference between issuing stock or not issuing stock. Because the common stock is a residual class that receives what is left upon liquidation of the corporation, the issuance or non issuance of common stock does not make a difference. There would similarly be no change in either voting or dividend rights. Accordingly, it is easy to conclude that it would be a meaningless gesture to issue additional shares of common stock because the issuance does not affect the rights of any other class of stock.

On the other hand, when a corporation has preferred stock, the issue is more complicated. For example, whatever rights attach to the preferred stock do so on a share by share basis, meaning that there is a difference in rights, depending on whether stock is issued. In this case, the only preference is a liquidation preference attached to the preferred stock. If more shares are actually issued, then the preferred shareholders will have a greater claim on the assets of the corporation in liquidation than they would have assuming that no stock were actually issued.

For example, if there are insufficient assets to cover the liquidation preference at the time of the contribution, the actual issuance of preferred stock would change the relationship between the common and preferred shareholders. If no preferred stock were actually issued, the new funds would be allocated to satisfy the amount of the already existing liquidation preference, and the common shareholders would be closer to reaching the point where they would participate in the liquidation proceeds. If the corporation actually issued the preferred stock at the time of the contribution, the common shareholders would be disadvantaged because the amount of the liquidation preference would be increased.

Thus, the focus would not be on the relationship between the shareholder and its corporation, but between the various classes of stock. Whether the meaningless gesture rule applies should be determined by the rights attaching to that stock. The inquiry should be whether the issuance or non issuance of stock makes a difference as between the classes of stock. Because the issuance or non issuance of preferred stock makes a difference in this case, it would not be a meaningless gesture to issue preferred stock. Accordingly, the October 5, Year 7 contributions by DSub1, consisting of contributions to FSub1 of cash and intercompany notes and financing fees in an amount totaling a, should be reflected solely in the basis of the common stock of FSub1.

3. Liquidation versus sale of stock.

Taxpayer reported the transaction as a sale of assets by FSub1 followed by the liquidation of FSub1, based on an analysis of Rev. Rul. 69-6, 1969-1 C.B. 104 and H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986). Because the liquidation preference was greater than the proceeds, none of the proceeds were attributable to the common stock. Therefore, Taxpayer reported that the liquidation of FSub1 was not within § 332. Consequently, taxpayer reported that the liquidation proceeds in excess of its basis in the FSub1 preferred stock would result in capital gain under § 331. Because the common shareholders received nothing, they reported an ordinary loss on the common stock under § 165(g).

Because the v shares of Newco stock were de minimis in value and because they were redeemed only two days after issuance, it has been suggested that the transaction be recast. Presumably the recast is as a stock sale. The result of this stock sale would be that the z purchase price would be allocated between the common and preferred in accordance with their respective fair market values. Capital gain or capital loss would result depending upon the basis in each of the preferred and common stock. The basis determinations would be the same as discussed above.

The suggested recast is too far from the facts of the case as presented. Because Newco received the assets of FSub1, the recast would require the stock sale to be followed by a liquidation of FSub1 by Newco. This is not what happened. Newco paid cash and received assets.

4. Ordinary loss versus capital loss.

Section 165(a) allows as a deduction any loss sustained during the year and not compensated by insurance or otherwise. Under § 165(g)(1), if any security, which is a capital asset, becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a sale or exchange of a capital asset on the last day of the taxable year. Section 165(g)(2)(A) defines the term "security" to include a share of stock in a corporation. Section 165(g)(3) is an exception to the foregoing capital gain treatment that provides ordinary loss treatment for stock in certain affiliated corporations even if the stock is a capital asset. To qualify, DSub3 must meet the requirements set forth in § 165(g)(3). See also Treas. Reg. § 1.165-5(d). We assume that DSub3 meets these requirements.

Under Treas. Reg. § 1.165-1(d)(1), a loss is allowable under § 165(c) only for the taxable year in which the loss is sustained. See, Boehm v. Commissioner, 326 U.S. 287, 291 (1945). For this purpose, a loss is sustained during the taxable year in which the loss is evidenced by closed and completed transactions and fixed by identifiable events occurring in the taxable year. Treas. Reg. § 1.165-1(d)(1); Boehm, 326 U.S. at 291.

Under Treas. Reg. § 1.165-5(c) and (d), no loss is allowed unless the stock is wholly worthless. See also Treas. Reg. § 1.165-5(f). A determination of worthlessness of stock is "purely a question of fact." Boehm v. Commissioner, 326 U.S. 287, 293 (1945); Klepetko v. Commissioner, T.C. Memo. 1990-644, aff'd., 967 F.2d 159 (2d. Cir. 1972). Whether worthlessness occurs in a particular year is also a question of fact. Boehm, 326 U.S. at 293; Shvetz v. Commissioner, T.C. Memo. 1979-298. The burden of showing worthlessness is on the taxpayer. Boehm, 326 U.S. at 294; Figgie Int'l, Inc. v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986).

The essential standards for a determination of worthlessness are set forth in Morton v. Commissioner, 38 B.T.A. 1270 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940).

> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some "identifiable event"

in the corporation's life which puts an end to such hope and expectation.

Morton, 38 B.T.A. at 1278-79. This language is often relied upon by courts. See, e.g., Figgie Int'l, Inc. 807 F.2d at 62; Corona v. Commissioner, T.C. Memo. 1992-406, aff'd, 33 F.3d 1381 (11th Cir. 1994); Garner v. Commissioner, T.C. Memo. 1991-569, aff'd, 987 F.2d 267 (5th Cir. 1993); Post v. Commissioner, T.C. Memo. 1975-419.

"Identifiable events" are events that "limit or destroy the potential value of stock" such as (a) the cessation of a business, (b) the sale of all of the assets of the corporation, (c) the surrender or revocation of the corporate charter, (d) the commencement of a plan of liquidation, sale of assets and distribution in liquidation to creditors, or (e) bankruptcy and receivership. See Morton, 38 B.T.A. at 1278; Steadman v. Commissioner, 50 T.C. 369, 376-77 (1968), aff'd, 424 F.2d 1 (6th Cir. 1970), cert. denied, 400 U.S. 869 (1970).

In order to show that the FSub1 common stock was worthless, DSub3 must show that its common stock in FSub1 ceased to have both liquidating value and potential value. The FSub1 common stock had no liquidating value in Year 9 because the entire amount of the proceeds DSub3 received from Newco did not exceed the liquidation preference on the preferred stock. FSub1's cash merger with Newco is treated for tax purposes under Rev. Rul. 69-6 as a sale of FSub1's assets to Newco followed by the distribution of that cash to the FSub1 shareholders in exchange for the FSub1 stock. Thus, the forward cash merger is an "identifiable event" that ends the hope or expectation of some value with respect to the FSub1 stock. Therefore, DSub3 should be allowed a worthless stock, ordinary loss deduction for the FSub1 common stock under § 165(g)(3). The amount of the ordinary loss will depend upon the amount of basis allocated to the preferred and common stock.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Part of DSub3's basis in FSub1 stems from a $[redacted] dollar note contributed on October 5, Year 7. Under the facts presented it appears that DSub3 inherits the liability (and the accompanying basis), but the facts do not reflect the note's ultimate disposition. If the liability was genuine enough for basis, it should be genuine enough for repayment (or at the very least, forgiveness of indebtedness income). [redacted]

In addition, additional facts are required to determine whether [redacted]

[redacted].

For additional information, please contact Aaron Farmer of CC:INTL:Br4 at (202) 622-3860 or Daniel Heins of CC:DOM:FS:CORP at (202) 622-8406.

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