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Person to Contact:

Telephone Number:

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September 17, 1999

PLR-106089-99

In Re:

Legend

Parent	=	
Sub 1	=	
Sub 2	=	
Sub 3	=	
Sub 4	=	
Sub 5	=	
Fiscal Year	=	
Foreign Country	=	
Individual	=	

Products	=	
Purchaser	=	
A	=	
B	=	
C	=	
D	=	
E	=	

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This responds to your letter dated March 12, 1999, in which you requested a ruling that Sub 1 and Sub 2, indirectly wholly owned domestic subsidiaries of Parent, may claim worthless securities deductions under section 165(g)(3) of the Internal Revenue Code of 1986 (Code) with respect to their investments in Sub 3 upon the disposition by Sub 3 of its manufacturing business.

Facts:

The information submitted states that Parent is a multinational manufacturing and marketing company. It is the common parent of a consolidated group that files a consolidated return for its Fiscal Year. Its overall method of accounting for maintaining its books and records and filing its federal income tax returns is the accrual method of accounting.

Sub 1 is an indirectly wholly owned domestic subsidiary of Parent. Sub 2 is a wholly owned domestic subsidiary of Sub 1. Sub 1 and Sub 2 are holding companies for certain Parent subsidiaries and engage in certain intercompany financing transactions. Together, Sub 1 and Sub 2 own 100 percent of the outstanding shares in Sub 3. Sub 2 owns A percent of the outstanding shares in Sub 3, and Sub 1 owns the remaining B percent of the shares in Sub 3.

Sub 3 is organized under the laws of Foreign Country and is an association taxable as a corporation for U.S. tax purposes within the meaning of section 7701(a)(3). Sub 3 is engaged in the business of manufacturing Products, which it sells to Sub 4, an indirectly wholly owned subsidiary of Parent. Sub 4 is organized under the laws of Foreign Country as an association taxable as a corporation for U.S. tax purposes within the meaning of section 7701(a)(3). Sub 4 is engaged in the business of marketing the Products produced by Sub 3.

As part of a global restructuring program, the assets comprising the manufacturing business of Sub 3 will be sold to Purchaser, an entity to be organized under the laws of Foreign Country. Purchaser will be controlled by Individual, the current Chief Executive Officer of Sub 4. Purchaser will enter into an agreement with Sub 4 (Supply Agreement) to produce Products for Sub 4.

In connection with the proposed sale to Purchaser, appraisals were made of Sub 3’s real estate, machinery, and equipment. Based on the appraised values of the assets, Sub 3’s liabilities, including debt owed to banks and a significant pension liability that will be retained by Sub 3 following the sale of its assets, exceed the fair market value of its assets.

Purchaser and Sub 3 will enter into a purchase agreement under which Purchaser will acquire the operating assets of Sub 3 and assume certain of its liabilities. The purchase price will be a fixed price negotiated at arm’s length and will be based in part on the recent appraisals of the value of Sub 3's real estate, machinery, and equipment. The purchase price will be payable by the assumption of liabilities and a cash payment at closing. Sub 3's remaining liabilities will be substantially in excess of the cash proceeds from the sale, which will be Sub 3’s only significant asset, leaving Sub 3 insolvent following the disposition of its operating assets.

Purchaser will also enter into a purchase agreement with Sub 4 under which Purchaser will acquire that portion of the business of Sub 4 that relates to the manufacture of Products distributed by Sub 4. Purchaser will purchase Sub 4's manufacturing assets for a fixed price, negotiated at arm’s length. The purchase price will be payable by an assumption of certain liabilities and a cash payment at closing.

The Supply Agreement will have an initial term of 10 years. Beginning in year four, and in each year thereafter, the parties can mutually agree to extend the contract for one or more additional years. The Supply Agreement is also subject to termination by Sub 4 for cause, which generally relates to breaches by Purchaser in the performance of its obligations as supplier, certain bankruptcy type events affecting Purchaser, or its unauthorized transfer of its business. Purchaser may terminate the agreement due to certain payment defaults by Sub 4 or certain bankruptcy type events affecting Sub 4.

Products are to be sold to Sub 4 for a price equal to the base cost of the item plus C percent. The base cost is comprised of a fixed cost component and a variable cost component. The base cost of each Product initially subject to the Supply Agreement will be contained in an attachment to the Supply Agreement. The base cost is subject to adjustment every six months commencing with the six-month period beginning January 1, 2000, as provided in the Supply Agreement. The Supply Agreement also provides for the payment of variance adjustment payments from Sub 4 to Purchaser or from Purchaser to Sub 4 on a quarterly basis to adjust for variances between actual and budgeted costs. Sub 4 has also agreed to pay Purchaser an annual discretionary bonus related to the overall performance of Purchaser under the Supply Agreement.

Under the terms of the Supply Agreement, Sub 4's purchase orders will be made six months in advance and its only obligation under the Supply Agreement will be to accept delivery of, and pay for, this six-month supply of Products. Except for this six-month supply, Sub 4 will not be required to purchase any minimum volume of Products for any period. In addition, Purchaser will grant a right of first refusal to Sub 4 to acquire assets which Purchaser agrees to sell to a third party. Purchaser may not transfer its rights under the Supply Agreement without Sub 4's prior written consent.

Sub 5 will contribute D to the capital of Purchaser in return for certain preferred shares of Purchaser that will entitle Sub 5 to an E percent voting interest. The preferred shares held by Sub 5 will be entitled to a cumulative, preferred dividend of a percentage rate of return on the nominal value of the shares. The Articles of Association of Purchaser will provide that resolutions of the shareholders will generally be enacted with a majority of the votes cast. However, unanimous shareholder consent will be required for a number of major actions that could jeopardize Purchaser's ability to fulfill its obligations under the Supply Agreement. Parent has represented that the primary purpose in owning the preferred shares is to provide Parent with an effective means under Foreign Country law to prevent Purchaser from engaging in activities that might jeopardize its ability to perform under the Supply Agreement. The preferred shares will be redeemable by Purchaser on the termination of Supply Agreement.

Sub 5 and Individual will enter into a shareholders' agreement (Shareholders' Agreement) under which certain put and call options will be granted with respect to Sub 5's interest in Purchaser. Under the Shareholder's Agreement, Sub 5 will have the right to put its preferred shares to Individual upon the expiration of the Supply Agreement, and Individual will have a call option on the preferred shares exercisable on the expiration of the Supply Agreement, provided the Supply Agreement is not terminated pursuant to Sub 4's right to terminate the agreement due to a breach by Purchaser. In both cases, the price for the preferred shares will be the amount contributed by Sub 5 to the capital of Purchaser plus accrued but unpaid dividends. Because the put and call options are both at a price equal to the amount contributed by Sub 5, there is no possibility for appreciation in value of Sub 5's interest in Purchaser or any risk of loss to Sub 5 on its investment, other than the risk of loss associated with Individual's inability to perform its purchase obligation.

Law and Analysis:

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2) defines security to include a share of stock in a corporation. Treasury Regulation § 1.165-5(b) provides that if any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

Section 165(g)(3) provides that for purposes of section 165(g)(1), any security in a corporation affiliated with a domestic corporate taxpayer shall not be treated as a capital asset. For purposes of section 165(g)(1), section 165(g)(3) provides that a corporation which has issued a security is treated as affiliated with the taxpayer only if: (A) stock possessing at least 80 percent of the voting power of all classes of the issuing corporations's stock and at least 80 percent of each class of its nonvoting stock is owned directly by the taxpayer and (B) more than 90 percent of the aggregate of the issuing corporation's gross receipts for all taxable years has been from sources other than royalties, rents (excepts rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

Section 1.165-5(d) provides that if a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of § 1.165-5(d)(2) and the security becomes wholly worthless during the tax year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with § 1.165-5(b). The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, because section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1).

Section 1.1502-34 provides, in part, that for purposes of §§ 1.1502-1 through 1.1502-80, in determining the stock ownership of a member of the affiliated group in another corporation for purposes of determining the application of section 165(g)(3)(A), in a consolidated return year, there shall be included stock owned by all other members of the group in the corporation. Parent has represented that more than 90 percent of the Sub 3's aggregate receipts for all taxable years has been from sources other than royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stocks and securities, as required in section 165(g)(3)(B). Thus, Sub 3 meets the affiliation requirements of section 165(g)(3) with respect to Sub 1 and Sub 2.

Accordingly, if Sub 3's stock becomes worthless, Sub 1 and Sub 2's losses will be ordinary rather than capital.

No deduction is allowed for the partial worthlessness of stock. Section 1.165-4(a) provides that a mere shrinkage in the value of stock, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as of the date of the loss. Section 1.165-4(a) further provides that a loss due to a decline in value of stock will not be allowed as a deduction under section 165(a), except insofar as the loss is recognized upon a sale or exchange of the stock or the loss is otherwise permitted under § 1.165-5, which permits the deduction of losses for wholly worthless securities.

The courts have adopted a two pronged test for determining whether stock is worthless. Stock which is wholly worthless is devoid of any present and potential value. Morton v. Commissioner, 38 B.T.A. 1270 (1938), *aff'd,* 112 F.2d 320 (7th Cir. 1940). This determination is based on all of the surrounding facts and circumstances. There is no present value when the liabilities (including contingent liabilities) of the company exceed the fair market value of its assets. There is no potential value when the facts and circumstances indicate that there is no potential for the shareholders to receive any return on their investment.

After examining the decisions concerning a deduction for worthlessness of stock which the taxpayer continues to hold, the Board of Tax Appeals in Morton summarized the test as follows:

> [I]t is apparent that a loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss is sustained, that stock may not be considered as worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time, and that such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver for it. Such events are called "identifiable" in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock.
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> 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. If the assets of the corporation exceed its liabilities, the stock has a liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and can not be said to be worthless. 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.

38 B.T.A. 1278-79.

The general requirement of the case law that an identifiable event fix the date of worthlessness is also found in the regulations. Section 1.165-1(b) states that a loss deductible under section 165(a) “must be evidenced by closed and completed transactions, fixed by identifiable events.” The court in Morton noted, however, that in exceptional cases a worthless stock loss will be allowed in the absence of an identifiable event, but only “where the liabilities of a corporation are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders.” 38 B.T.A. at 1279.

All losses, whether capital or ordinary, must be recognized in the year in which they are sustained. The determination of when the loss is sustained “calls for a practical, not a legal test.” Boehm v. Commissioner, 326 U.S. 287, 293 (1945)(quoting Lucas v. American Code Co., Inc., 280 U.S. 445, 449 (1930)). Section 1.165-1(b) provides that the claim of worthlessness should be established by an identifiable event that fixes the year of worthlessness.

Numerous cases hold that the sale of operating assets and the cessation of operations establish the worthlessness of stock. U.S. v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927) (German government’s seizure of the assets of a German subsidiary in World War I was an identifiable event justifying a worthless stock deduction); Genecov v. U. S., 412 F.2d 556 (5th Cir. 1969) (sale of operating assets in 1957 followed by placing the remaining assets in trust and the dissolution of the corporation in 1958 all were identifiable events evidencing worthless in those years and not in 1963 when the taxpayer sold his stock for nominal consideration); Dunbar v. Commissioner, 119 F.2d 367 (7th Cir. 1941) (worthlessness established in year corporation’s charter was revoked and all assets disposed of); De Loss v. Commissioner, 28 F.2d 803 (2d Cir. 1928)(the sale of assets and cessation of operations were the identifiable events that established a lack of future value); and

Watson v. Commissioner, 38 B.T.A. 1026 (1938)(forced sale of almost all assets, which secured corporate notes, was the event that "fixed" the worthlessness of the taxpayer's stock).

By selling all of the operating assets of a business, there remains nothing to generate income which could be distributed to the shareholders, thereby foreclosing any potential value. No actual liquidation is required, as long as operations have ceased. McGlynn v. Commissioner, 4 B.T.A. 1005 (1926)(stock becomes worthless in the year the company became insolvent and assets were disposed of in consideration of the assumption of the corporation's liabilities). A binding contract for the sale of the assets of a business, based on independently appraised values, may fix the liquidating value of the assets sold. The Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979). In Austin, the court held that there was no liquidating value since liabilities exceeded assets when sold. The lack of potential value was established by the fact that the corporation had ceased operations and was winding up its affairs.

CONCLUSION

Based on the information submitted and the above representations, we rule as follows:

(1) Sub 1 and Sub 2 may each claim a worthless securities deduction under section 165(a) with respect to their investments in the Sub 3 stock upon the closing of the sale of Sub 3's operating assets to Purchaser, and

(2) Such loss will be treated as an ordinary loss because Sub 3 is affiliated with Sub 1 and Sub 2 within the meaning of section 165(g)(3).

No opinion is expressed as to the accuracy of factual representations, or as to the tax treatment of the proposed transaction under the provisions of any other section of the Code and regulations that may be applicable. In particular, no opinion is expressed as to whether Sub 1 and Sub 2 sustained a loss with respect to the stock of Sub 3 entitling them to a worthless securities deduction under section 165 in a year prior to the year in which the sale of the operating assets of Sub 3 is made and whether more than 90 percent of Sub 3's gross receipts for all of its tax years has been from sources other than those specified in section 165(g)(3)(B).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/ William A. Jackson

William A. Jackson
Chief, Branch 6, Income Tax & Accounting