OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
SPECIAL LITIGATION ASSISTANT CC:

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated January 25, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:
Parent =
Subsidiary 1 =
Subsidiary 2 =
Corporation =
Agreement =
Appraisal =
Special =
Disease =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
$a =
$b =
$c =
$d =

$e =
$f =
$g =
$h =
$i =
$j =
$k =
x =
y =
Surgical Device 1 =
Surgical Device 2 =

ISSUE(S):

1. Whether securities in Subsidiary 1, Parent's wholly-owned subsidiary, become wholly worthless in the tax Year 4 such that Parent may claim an ordinary loss pursuant to I.R.C. § 165(g).

2. Whether Treas. Reg. § 1.1502-80(c) precludes Parent from taking a worthless stock loss under I.R.C. § 165(g)(1) for the tax year Year 4 with respect to the stock of Subsidiary 1?

3. Whether the loss disallowance rules of Treas. Reg. § 1.1502-20 limit the amount of any worthless stock loss to which Parent would otherwise be allowed for the tax year Year 4 with respect to the stock of Subsidiary 1?

CONCLUSION:

1. At this point, we cannot say that Parent has sustained its burden of proving that the stock did not have "any recognizable value" at the time worthlessness is claimed. Treas. Reg. § 1.165-4(a). At the end of the tax year, Subsidiary 1 continued to hold patents which are not conclusively proved to be without demonstrable value.

2. Treas. Reg. § 1.1502-80(c) does not preclude Parent from taking a worthless stock loss under I.R.C. § 165(g)(1) for the tax year Year 4 with respect to the stock of Subsidiary 1.

3. Under the loss disallowance rules of Treas. Reg. § 1.1502-20, Parent's worthless stock loss is disallowed to the extent of $i, the duplicated loss amount.

FACTS:

Parent corporation (Parent) is the common parent of the Parent consolidated group, which includes Subsidiary 2 and, up until April of Year 4, had included Subsidiary 1.

Parent manufactures various types of surgical devices. With and through Subsidiary 1 and Subsidiary 2, Parent manufactured and marketed Special coated surgical devices known as "Surgical Device 1" and "Surgical Device 2."

In Year 1, Parent had acquired most of the assets of Corporation, a corporation engaged in the research, development and production of medical devices. Parent then transferred these assets to a new corporation, Subsidiary 1, as a capital contribution.

Concurrently, Subsidiary 1 entered into a License Agreement whereby Corporation granted Subsidiary 1 a worldwide licence on its remaining assets, certain patent rights relating to Surgical Device 2 (the Corporation patents). In one of the various side agreements (Agreement) that Parent entered into with Subsidiary 1, Corporation, and their shareholders, Parent agreed that, in the event that it abandoned the manufacture and sale of Surgical Device 2, Parent would notify Corporation or its shareholders, who had the option to acquire all rights to Surgical Device 2 for an x percent royalty, $k in cash and a y-year note. Subsequent amendments to this agreements provided that certain patent rights on the new designs for Surgical Device 2 would be the property of Corporation but that such rights would be included in the rights licenced to Subsidiary 1 pursuant to the License Agreement.

Although Subsidiary 1 was in the business of developing and marketing surgical devices, it also coated surgical devices using a patented Special coating process. Ultimately, Parent acquired full ownership of Subsidiary 1 and became Subsidiary 1's prime (if not only) customer.[1] Parent experienced substantial cost savings in using Subsidiary 1 to coat its surgical devices, rather than contracting with a third party.

Clinical trials of the Special coated Surgical Device 2 were conducted in Europe in Year 2. By early Year 4, Parent determined that Surgical Device 2 caused an unacceptable rate of medical problems in patients. Parent concluded that Surgical Device 2 could not be modified and, therefore, decided not to continue marketing the device.

In the years between its inception and April of Year 4, Subsidiary 1 consistently incurred annual operating losses. For the Year 1 through April of Year 2, Subsidiary 1 incurred a total net operating loss (NOL) of $a. In Year 3,

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[1]The field service advice request does not indicate exactly when Parent acquired control of Subsidiary 1. It does indicate, however, that Parent exercised an option to acquire all of Subsidiary 1's stock on April 30 of Year 2.

Subsidiary 1 incurred a $b NOL, which was utilized on the Year 3 consolidated return. In Year 4, Subsidiary 1 incurred an operating loss of $c. Subsidiary 1 also reported intercompany sales of $d and $e, respectively, of which $f was reported by Subsidiary 1 as an intercompany sale of all of its assets of value to Subsidiary 2.

In connection with the sale to Subsidiary 2, Parent procured the an appraisal (Appraisal) of the assets being sold. The Appraisal estimated the fair market value of the assets as $j. Based on discussions with Parent's personnel, the Appraisal ascribed no value to the intellectual property represented by Surgical Device 2 because, according to the Parent's personnel, Surgical Device 2 was too flawed for any components to be utilized in the future.

Although Parent had decided to abandon commercial development of Surgical Device 2, no notice was provided to Corporation, as required by the Agreement. Section 41(b)(1) of Title 35 of the United States Code provides for the payment of a maintenance fee to the U.S. Patent Office three and one half years after the issuance of a patent. If the fee is not paid, the patent expires following a six month grace period. The maintenance fee came due with respect to four of the Surgical Device 2 patents after Year 4, and in each case the fee was paid.

After the sale of its assets, except certain purportedly worthless patents related to Surgical Device 2, Subsidiary 1 distributed the sales proceeds to Parent as a $g dividend and the remainder as relief of indebtedness. Subsidiary 1 did not liquidate nor did it dissolve. Parent filed a Form 8594 (Asset Acquisition Statement) with respect to Subsidiary 1's April asset sale. On its Year 4 consolidated return, Parent claimed a $h loss on the stock of Subsidiary 1 per section 165(g)(3) and Treas. Reg. § 1.1502-20(c) on the theory that the Surgical Device 2 technology, which was Subsidiary 1's only remaining asset, was worthless. Parent continues to pay the patent registration fees for the Surgical Device 2 technology patents still held by Subsidiary 1.

LAW AND ANALYSIS:

Section 165(a) of the Code 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) of the Code provides that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, 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)(3) of the Code provides that, for purposes of I.R.C. § 165(g)(1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset.

Treas. Reg. § 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.

Under section 382 of the Code, if an ownership change of a loss corporation occurs, the taxable income of the loss corporation for any post-change taxable year can be offset by pre-change NOL carryovers only to the extent of the “section 382" limitation.

Section 382(b)(1) sets forth the 382 limitation amount.

Section 382(g)(4)(D) of the Code automatically triggers a § 382 limitation in the case of worthless stock. This provision limits the amount of post-ownership-change income that can be offset by pre-ownership-change NOL carryovers. Section 382(g)(4)(D) treats a worthless-stock deduction by a 50 percent shareholder as a change-of-ownership event, thus triggering application of the § 382 application.

Section 1.1502-80(c) of the regulations overrides I.R.C. § 165 from the standpoint of the timing of the worthlessness deduction with regard to a consolidated group. This provision delays a worthless stock deduction under I.R.C. § 165 until the stock is deemed disposed of under the principles of § 1.1502-19(c)(1)(iii).

Treas. Reg. § 1.1502-19(c)(1)(iii) (as amended by T.D. 8560 and corrected by Notice 97-25, 1997-16 I.R.B. 8, the regulation as amended and corrected became effective on January 1, 1995) sets forth one of three events that determine when a member is considered to have disposed of all of its shares of stock in a subsidiary for purposes of triggering an Excess Loss Account (ELA). Treas. Reg. § 1.1502-19(c)(1)(iii) provides that P is treated as disposing of a share of S’s stock at the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or § 1.1502-80(c), or, if S's asset is stock of a lower-tier member, the stock is treated as disposed of under this paragraph (c)). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness).

Treas. Reg. § 1.1502-20(a)(1) provides that no deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary.

Treas. Reg. § 1.1502-20(a)(2) defines "disposition" for purposes of -20(a) as any event in which gain or loss is recognized, in whole or in part.

Treas. Reg. § 1.1502-20(a)(3) governs the coordination of the -20 loss disallowance rules with loss deferral provisions of the Code. Treas. Reg. § 1.1502-20(a)(3) provides that if another Code provision defers, rather than disallows, a loss, the general rule of § 1.1502-20(a)(1) does not apply until the loss is taken into account. However, this deferral period will be overridden and the loss will be taken immediately into account upon the happening of one of three events listed in Treas. Reg. § 1.1502-20(a)(3)(iii):

Treas. Reg. § 1.1502-20(a)(3)(iii) lists the following three overriding events:

(A) The stock ceases to be owned by a member of the consolidated group;
(B) The stock is canceled or redeemed;
(C) The stock is treated as disposed of under § 1.1502-19(c)(1)(ii)(B) or (c)(1)(iii).

Treas. Reg. § 1.1502-20(c) limits the amount of loss disallowed under Treas. Reg. § 1.1502-20(a). It provides that the amount of loss disallowed under Treas. Reg. § 1.1502-20(a)(1) with respect to a share of stock shall not exceed the sum of the following amounts:

(i) Extraordinary gain dispositions. The amount of income or gain (or its equivalent), net of directly related expenses, that is allocated to the share from extraordinary gain dispositions.
(ii) Positive investment adjustments. The amount of the positive adjustment (if any) with respect to the share under § 1.1502-32 for each consolidated return year, but only to the extent the amount exceeds the amount described in paragraph (c)(1)(i) of this section for the year.
(iii) Duplicated loss. The amount of duplicated loss with respect to the share.

Treas. Reg. § 1.1502-20(c)(2) defines "extraordinary gain dispositions," "positive investment adjustments," and "duplicated loss" for purposes of applying Treas. Reg. § 1.1502-20(c)(1). For purposes of our analysis here, "extraordinary gain disposition" includes, inter alia, the actual or deemed disposition of (1) capital assets as defined in section 1221, and (2) section 1231 property as defined in section 1231(b). "Positive investment adjustments" for purposes of Treas. Reg. § 1.1502-20(c)(1)(ii) are described as the sum of the amounts under §§ 1.1502-32(b)(2) (i) through (iii) for the consolidated return year (the adjustment determined without taking distributions into account). However, amounts included

in any loss carryover are taken into account in the year they arise rather than the year absorbed.

Treas. Reg. § 1.1502-20(c)(2)(vi) provides that “duplicated loss" is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of--

(A) The sum of--
(1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and
(2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and
(3) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary, over
(B) The sum of--
(1) The value of the subsidiary's stock, and
(2) Any liabilities of the subsidiary, and
(3) Any other relevant items.

The flush language of § 1.1502-20(c)(2)(vi) provides that the amounts determined under this paragraph (c)(2)(vi) with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower tier subsidiaries. If 80 percent or more in value of the stock of a subsidiary is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), substituting "10 percent" for "50 percent" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

Of particular relevance in this case is the portion of the duplicated loss formula concerning “losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition.” Treas. Reg. § 1.1502-20(c)(2)(vi)(A)(2).

Treas. Reg. § 1.1502-20(c)(2)(iii) provides that amounts are described in paragraphs (c)(1)(i) and (ii) of this section only to the extent they are reflected in the basis of the share, directly or indirectly, immediately before the disposition or deconsolidation. For this purpose, an amount is reflected in the basis of a share if the share's basis would have been different without the amount. However, amounts included in any loss carryover are taken into account in the year they arise rather than the year absorbed.

Treas. Reg. § 1.1502-20(g)(1) provides that, as a general rule, a common parent may reattribute to itself any portion of the net operating loss carryovers and net capital loss carryovers attributable to the subsidiary when a member disposes of stock of the subsidiary and the member's loss would be disallowed under § 1.1502-20(a)(1). The amount reattributed may not exceed the amount of loss that would be disallowed if no election is made under this paragraph (g). For this purpose, the amount of loss that would be disallowed is determined by applying paragraph (c)(1) of this section (without taking into account the requirement in paragraph (c)(3) of this section that a statement be filed) and by not taking reattribution into account.

Treas. Reg. § 1.1502-20(g)(2) provides that if the subsidiary whose losses are to be reattributed, or any higher tier subsidiary, is insolvent within the meaning of section 108(d)(3) at the time of the disposition, losses of the subsidiary may be reattributed only to the extent they exceed the sum of the separate insolvencies of any subsidiaries (taking into account only the subsidiary and its higher tier subsidiaries) that are insolvent. For purposes of determining insolvency, liabilities owed to higher tier members are not taken into account, and stock of a subsidiary that is limited and preferred as to dividends and that is not owned by higher tier members is treated as a liability to the extent of the amount of preferred distributions to which the stock would be entitled if the subsidiary were liquidated on the date of the disposition.

Treas. Reg. § 1.1502-20(g)(5) provides that the election to reattribute losses under § 1.1502-20(g)(1) must be made in a separate statement, signed by the common parent and each subsidiary whose losses are being reattributed, and filed with the group's return for the taxable year of disposition. The statement must be filed with the group's income tax return for the tax year of the disposition.

Treas. Reg. § 1.1502-77(a) provides that the common parent, for all purposes (other than for several purposes not relevant here), shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability of the consolidated return year.

Issue 1: Parent has not sustained its burden of proving the stock was worthless.

Under I.R.C. § 165(a) a taxpayer is allowed a deduction for losses sustained and not compensated for by insurance or otherwise. Section 165(g)(1) and Treas. Reg. § 1.165-5(b) provide that a deduction for worthless securities is only allowable in the year in which the stock becomes wholly worthless. The loss on the sale of the securities of an affiliated corporation shall not be treated as a capital loss if that section's definition of the term “affiliated corporation” is satisfied. I.R.C.

§ 165(g)(3). Because Subsidiary 1 was Parent's wholly-owned corporation, subsections 1.165(g)(3)(A) and (B) of the Regulations are satisfied and the loss on the stock of Subsidiary 1, if allowable pursuant to section 165, would be treated as an ordinary loss.

Worthlessness of a security is a question of fact. All pertinent facts and circumstances, objective and subjective, must be considered. Boehm v. Commissioner, 326 U.S. 287 (1945). The taxpayer may not claim a deduction on account of its value shrinkage. Miami Beach Bay Shore Co. v. Commissioner, 136 F.2d 408 (5th Cir. 1943). In general, worthless of a security is established by some identifiable event. “To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events and actually sustained during the year.” Treas. Reg. § 1.165-1(b). There is no deduction for partial worthlessness. 875 Park Ave. v. Commissioner, 217 F.2d 699 (2d Cir. 1954). The stock must not have "any recognizable value" at the time worthlessness is claimed. Treas. Reg. § 1.165-4(a).

In this case, the issue to be resolved of whether the loss is allowable pursuant to section 165(g) centers on the question of worthlessness. The taxpayer must establish not only that the security had no current liquidation value at the close of year, the taxpayer must also establish that it had no potential value. Morton v. Commissioner, 112 F.2d 320 (7th Cir. 1940). “The petitioner has the burden of proving [that] stock ceased to have both liquidating value...and potential value, a reasonable expectation that the assets would exceed the liabilities in the future.” Steadman v. Commissioner, 50 T.C. 369, 376-370 (1968), aff'd, 424 F.2d 1 (6th Cir. 1970). Generally, this burden is met by showing an "identifiable event" in the corporate life normally considered as effectively destroying the potential value, such as dissolution of the corporation, appointment of a receiver, cessation of normal business operations, bankruptcy or liquidation. United States v. S.S. White Dental Mfg. Co., 274 U.S. 398 (1927); Morton v. Commissioner, 112 F.2d 320 (7th Cir. 1940); Corona v. Commissioner, T.C. Memo. 1992-406, aff’d, 33 F.3d 1381 (11th Cir. 1994). Admittedly, Subsidiary 1 had abandoned commercial development of Surgical Device 2, written-off the total inventory of Surgical Device 2 and sold substantially all of its assets. These events tend to be factors indicative of worthlessness and support the Parent’s claim of the deduction.

However, we point out that after cessation of the business and disposition of most of the corporate assets, Subsidiary 1 continued to hold the Surgical Device 2 patents. As long as the stock has any value, either present or potential, the taxpayer may not claim a deduction. Miami Beach Bay Shore Co. v. Commissioner, 136 F.2d 408 (5th Cir. 1943). If a corporation holds property of uncertain value or liabilities are uncertain, the loss is not determined until the value of the property or

the amount of liabilities is fixed with reasonableness. Commissioner v. Winthrop, 98 F.2d 74 (2d Cir. 1938). At the end of Parent's Year 4 tax year, Subsidiary 1 continued in existence holding several Surgical Device 2 patents. In spite of the Parent's claims regarding the patents, and consequently the stock, we do not believe that worthlessness has been established. First, we point out that since the sale of Subsidiary 1's other assets in Year 4, on more than one occasion Parent has renewed the Surgical Device 2 patents. More importantly, upon abandonment of commercial sale of Surgical Device 2, Parent was required to notify Corporation and its shareholders, who had the option to acquire all rights to Surgical Device 2 for an x percent royalty, $k in cash and a y-year note. Parent has not given the required notice nor does it even appear that it has made any overtures to determine if Corporation has any interest in reacquiring Surgical Device 2. While the value of the Surgical Device 2 patents may not be equal to the full contractual buyback price, it is difficult to dismiss the patents as completely valueless.

According to the Appraisal, in Year 4, prospects for the U.S. medical devices industry were bright, with an expectation that revenues and earnings for the leading manufacturers would accelerate. Appraisal, p.6. Because Disease is still a leading killer in the United States, the Standards and Poor's Industry Survey indicated that the development of new diagnostic and therapeutic tools aimed at this market would remain a high priority for the medical equipment industry. Furthermore, the Appraisal expressed the expectation that the late 1990's and 2000s will emphasize the development of better metals and plastics, new non-metallic plastic and ceramic products, and new synthetics that can be used to create implants. Appraisal, p.8.

Although the conclusions contained in the Appraisal would tend to support the contention that the patents are totally valueless, they are based solely on the appraiser's conversations with Parent employees. Both the economic and marketing outlooks for the medical device industry are strong. It is conceivable that Parent neither transferred the Surgical Device 2 patents nor formally notified Corporation of the cessation of production because of the possibility of future utilization. The fact that the patents have been renewed and the predictions in terms of the evolution of new materials which will advance the medical device industry lend support to such a consideration. At this point the indicators that there is no potential value with respect to the stock rest primarily on the assertions of Parent and its employees. To the extent that Subsidiary 1 still retained several patents with demonstrable value (the repurchase price established by the Agreement) after cessation of business and sale of its other assets, none of the identifying events occurred thereafter to eliminate or reduce the inherent value of the Surgical Device 2 patents. Thus, the facts do not sustain Parent's burden of

showing an "identifiable event" in the corporate life effectively destroying the potential value of the patents and thereby, establish the worthlessness of the stock.

Issue 2: Treas. Reg. § 1.1502-80(c) does not preclude Parent from taking a worthless stock deduction with respect to the stock of Subsidiary 1.

Parent claimed a worthless stock deduction with respect to the stock of Subsidiary 1 on its Year 4 consolidated return. Parent argues that it is entitled to the deduction because its Subsidiary 1 stock is worthless. Subsidiary 1's only assets are worthless patents and, therefore, the requirements of Treas. Reg. § 1.1502-80(c) have been met. Subsidiary 1 has disposed of substantially all of its assets by selling its assets of value to Subsidiary 2, its sister corporation, and distributing the entire sales proceeds to Parent as a $g dividend and the remainder as relief of indebtedness. We agree with Parent that Treas. Reg. § 1.1502-80(c) does not preclude it from taking a Year 4 worthless stock deduction with respect to the stock of Subsidiary 1.

Treas. Reg. § 1.1502-80(c) delays a worthless stock deduction under I.R.C. § 165 until the stock is deemed disposed of under the principles of § 1.1502-19(c)(1)(iii). Treas. Reg. § 1.1502-19(c)(1)(iii) determines the time that the consolidated group may report the company's stock as worthless. Treas. Reg. § 1.1502-19(c)(1)(iii) provides that the stock becomes worthless at the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed under I.R.C. § 165(a) or Treas. Reg. § 1.1502-80(c). In the present case, Subsidiary 1 sold all of its assets, except a few purportedly worthless patents, to Subsidiary 2. Subsidiary 1 then purportedly distributed the sales proceeds to Parent as a $g dividend and the remainder was transferred as relief of indebtedness.

You express concern that the phrase "substantially all" includes the assets of the Special coating business and that those assets were sold for cash. You conclude that the assets should not be considered disposed of under Treas. Reg. § 1.1502-19(c)(1)(iii) "to the extent the disposition ... is in exchange for consideration."[2] As noted in footnote 2, the parenthetical language "other than

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[2] Treas. Reg. § 1.1502-19(c)(1)(iii)(A), which became effective on or after January 1, 1995, initially read as follows:

> Substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or § 1.1502-80(c), or, if S's asset is stock of a lower-tier member, the stock is treated as disposed of under this paragraph (c)). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is

relief from indebtedness," in the regulations after the word "consideration" was added to Treas. Reg. § 1.1502-19(c)(1)(iii)(A) by Notice 97-25, and became effective on January 1, 1995. The parenthetical language is therefore applicable to this case. We believe that the dividend, albeit substantial, is a disposition for purposes of Treas. Reg. § 1.1502-80(c). The distribution in the form of "debt relief" appears to clearly fit the parenthetical language of Treas. Reg. § 1.1502-19(c)(1)(iii), "in exchange for consideration (other than relief from indebtedness)." Likewise, we do not believe that the retention of purportedly "worthless" patents (assuming they are worthless) precludes, for purposes of Treas. Reg. § 1.1502-80(c), Parent from taking a worthless stock loss under I.R.C. § 165(g)(1) for Year 4 with respect to the stock of Subsidiary 1, assuming Parent is entitled to take a worthless stock loss under I.R.C. § 165(g) for this year. Accordingly, we conclude that Subsidiary 1 disposed of substantially all of its assets for consideration, and the sales proceeds, which then represented substantially all of its assets, were disposed of in the form of dividends and relief from indebtedness.

Under Treas. Reg. § 1.1502-19(c)(1)(iii), there can be no disposition of assets when they are sold for consideration because all that has happened is that the assets sold have been replaced with cash.[3] However, here, cash proceeds from the

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> in complete liquidation of S or is in exchange for consideration.

The last sentence of Treas. Reg. § 1.1502-19(c)(1)(iii)(A) was amended by technical correction in Notice 97-25, 1997-16 I.R.B. 8, which revised the last sentence of paragraph (c)(1)(iii)(A) to read:

> An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness).

Id at 9. The effective date of this correction is January 1, 1995. The Notice indicates that the correction was necessary because "the final regulations contain errors and omissions which may prove to be misleading and are in need of clarification." Id at 8.

[3] You appear to indicate that Parent has not satisfied the disposition test under Treas. Reg. § 1.1502-19 with respect to Subsidiary 1's sale of the assets. We agree that such disposition does not satisfy this section because the sale is in exchange for consideration. See discussion in footnote 2. However, we believe that the relevant disposition is the exchange of the cash in satisfaction of its debts and the distribution of the dividend.

sale were distributed to Parent in relief of its indebtedness and as a dividend, leaving Subsidiary 1 solely with purportedly worthless intangible assets. Thus, we agree with Parent that it would now have a worthless stock deduction if Subsidiary 1 is worthless, since the requirements of Treas. Reg. § 1.1502-80(c) appear to have been satisfied.

Issue 3: Treas. Reg. § 1.1502-20 limits the amount of Parent's Year 4 worthless stock loss deduction.

A member's duplicated loss is determined immediately after a disposition. Treas. Reg. § 1.1502-20(c)(2)(vi). Treas. Reg. § 1.1502-20(a)(2) defines "disposition" for purposes of § 1.1502-20(a) as any event in which gain or loss is recognized, in whole or in part. Parent's treatment of Subsidiary 1's stock as worthless is an event in which Parent recognizes loss under I.R.C. § 165. Thus, Parent's treatment of Subsidiary 1's stock as worthless is a disposition as defined in Treas. Reg. § 1.1502-20(a)(2) for purposes of determining loss disallowed under Treas. Reg. § 1.1502-20(a).

Parent asserts that, for purposes of determining the limit of its loss disallowance under Treas. Reg. § 1.1502-20(c), it has an extraordinary gain disposition amount. Parent's position is based on the following view of the facts: Prior to the April Year 4 asset sale, Subsidiary 1 was a wholly-owned subsidiary of Parent, and Parent was the common parent of a consolidated group ("group") whose federal income tax return included Subsidiary 1 and Subsidiary 2.[4] On April 26, Year 4 (a date subject to the present Treas. Reg. § 1.1502-20), Subsidiary 1 sold all of its tangible and intangible assets of value to Subsidiary 2, a member of the Parent consolidated group. Subsidiary 1 realized $12,994,282 gain on the sale, and although this gain was subject to deferral as an intercompany transaction, Parent asserts that this gain was triggered in Year 4, when Subsidiary 1 became worthless and Parent was deemed to dispose of its Subsidiary 1 stock under Treas. Reg. §§ 1.1502-80(c) and 1.1502-19(c)(1)(iii).

We disagree with Parent's legal conclusion that the deferred gain from the sale of Subsidiary 1's assets **was triggered in Year 4** when Subsidiary 1 purportedly became worthless and Parent was deemed to dispose of its Subsidiary 1 stock under Treas. Reg. §§ 1.1502-80(c) and 1.1502-19(c)(1)(iii). Parent's position assumes that a "disposition of the stock" under Treas. Reg. § 1.1502-19(c), which

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[4]There may have been other members of the Parent consolidated group, however, there are insufficient facts to make this determination.

triggers the requirement that the parent corporation take into account its ELA as income, also triggers the subsidiary's deferred gain or loss. It does not necessarily follow that a triggering event for purposes of one section is also a triggering event for another section of the consolidated return regulations. Treas. Reg. § 1.1502-19(c) governs when a corporation's ELA is taken into account, whereas § 1.1502-13 governs when members of a consolidated group take into account deferred gain or loss arising from an intercompany transaction.

Worthlessness of stock is not a restoration event under Treas. Reg. § 1.1502-13. Neither Subsidiary 1's April Year 4 asset sale nor Parent's treatment of Subsidiary 1's stock as worthless caused either the Subsidiary 1 assets to leave the Parent consolidated group or Subsidiary 1 to cease to be a member of the group. Subsidiary 1 remains a member of the Parent consolidated group and the assets are still maintained within the group.

Thus, we conclude that Parent's treatment of Subsidiary 1's stock as worthless did not trigger recognition of Subsidiary 1's gain from the sale of its assets in Year 4. The $12,994,282 deferred gain remains deferred and, therefore, is not includable in the determination of "extraordinary gain dispositions" under Treas. Reg. § 1.1502-20(c). Furthermore, since Subsidiary 1 was not required to take into account in Year 4 the deferred gain, Parent is not entitled to the positive basis adjustment with respect to the gain resulting from the sale because such income is not taxable income for this year. See Treas. Reg. § 1.1502-32(b)(2)(i). Accordingly, based on only those facts presented to us, we believe that both Parent's "extraordinary gain dispositions" and "positive basis adjustments" with respect to this sale are zero for purposes of determining Parent's allowable loss.

We do believe, however, that Parent has duplicated losses for purposes of determining its allowable loss under Treas. Reg. § 1.1502-20(c)(1). Subsidiary 1 had pre-Year 4 NOL carryforwards in the amount of $a and an operating loss of $c in Year 4, which appears to be Subsidiary 1's Year 4 loss **before** taking into account its deferred gain. In Year 4, Subsidiary 1 sold substantially all of its assets to Subsidiary 2 and recognized a deferred gain. Since the gain was not triggered in Year 4 (or anytime thereafter), Subsidiary 1 cannot offset the deferred gain by its Year 4 operating loss.[5] Instead, Subsidiary 1's $a NOL carryover is simply

[5] We assume that Subsidiary 1's Year 4 operating losses could not be used by another member of the group, and that the $a NOL carryforwards would be SRLY'd. If the Year 4 operating loss could be used, Parent would be subject to a basis reduction in the stock of Subsidiary 1.

increased by its Year 4 loss. Subsidiary 1's new NOL carryforward amount appears to thus be $i.[6]

The "duplicated loss" formula set forth in Treas. Reg. § 1.1502-20(c)(2)(vi) includes "[a]ny losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition." Treas. Reg. § 1.1502-20(c)(2)(vi)(A)(2). Under the facts presented to us, after applying the formula as set forth in Treas. Reg. § 1.1502-20(c)(2)(vi), $i is Parent's "duplicated loss" amount for purposes of determining its allowable loss under Treas. Reg. § 1.1502-20(c)(1).

It appears that Subsidiary 1 has unused NOLs of $i. The Parent consolidated group apparently is unable to use the losses, and the losses becomes a consolidated net operating loss carryover attributable to Subsidiary 1. In Year 4, Parent treats the stock of Subsidiary 1 as worthless, recognizing a loss. Under Treas. Reg. § 1.1502-20(a)(1), Parent's worthless stock loss is disallowed to the extent of $i, the duplicated loss amount. See Treas. Reg. § 1.1502-20(a)(5) Example 3.[7]

Assuming proper procedures are met, a taxpayer (with subsidiary's consent) may elect under Treas. Reg. § 1.1502-20(g)(1), to reattribute to itself the subsidiary's share of the unused consolidated NOL carryforwards to the extent of the loss that would otherwise be disallowed. The reattributed losses are deemed absorbed by the subsidiary with the result that the taxpayer's basis is reduced. See § 1.1502-20(g)(3), example 1(iii), for an illustration of how a reattribution of losses reduces the parent corporation's basis in its subsidiary's stock immediately before the disposition and, consequently, prevents the parent from recognizing loss to that

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[6]Subsidiary 1's NOL carryforward of $a and its Year 4 operating loss of $c are numbers apparently provided by Parent. Accordingly, we are using Parent's numbers for illustrative purposes only and we do not know whether these numbers are accurate.

[7]Both Parent and District Counsel assume that Parent's treatment of Subsidiary 1's stock as worthless was a triggering event, thereby requiring Subsidiary 1 to take into account the $f deferred gain on the sale. We believe that the deferred gain was not triggered. However, even if it was triggered, the loss would not have been disallowed as a duplicated loss, but rather it would have been disallowed as an extraordinary gain disposition. The fact that Parent had used the Year 4 operating loss to offset a portion of the gain does not prevent the $f from being an extraordinary gain disposition because Parent received the benefit of a basis increase under Treas. Reg. § 1.1502-32.

extent on the disposition. Note, however, that Treas. Reg. § 1.1502-20(g)(2) limits reattribution of losses from insolvent members.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We are cognizant that there are facts here which support the claim that the stock was worthless. The early failure of the clinical trials and the subsequent sale of the majority of Subsidiary 1's assets tend to weigh in Parent's favor. These factors which usually are considered as "identifying events" for purposes of section 165(g) represent hazards for the Commissioner in litigating this case. However, other factors, while possibly less weighty, tend to cast doubt on the notion that the stock had no value.

Here, although a disposition event has occurred with regard to Subsidiary 1's stock, Subsidiary 1 is still in existence after the event establishing worthlessness; therefore Subsidiary 1's losses do not disappear. Nonetheless, Subsidiary 1's losses are carried forward, but effectively rendered unusable under I.R.C. § 382(g)(4)(D), which prevents Subsidiary 1 from offsetting future income by its loss carryovers because Subsidiary 1's stock is treated as worthless.[8] .[9]

We note that, although the time for filing the election under Treas. Reg. § 1.1502-20(g)(5), which provides that the election to reattribute losses under

[8]Although the losses are effectively rendered unusable, these losses continue to exist and could be used by a taxpayer to offset recognized built-in gain that accrued before the ownership change, assuming the threshold under I.R.C. § 382(h) is met.

[9]See Dubroff et al., Federal Income Taxation of Corporations Filing Consolidated Returns, § 72.02[3], at 72-104 (2nd ed. 1998). Dubroff recommends that taxpayers affected by this rule should consider challenging the validity of the loss duplication rule.

§ 1.1502-20(g)(1) must be filed with the group's return for the taxable year of disposition, has passed, Parent may request relief. The Commissioner has discretionary authority to grant an extension of time for Parent to file the Elections, provided Parent shows it acted reasonably and in good faith, the requirements under the provisions of Treas. Reg. §§ 301.9100 are satisfied, and granting relief will not prejudice the interest of the government.

If you have any further questions, please call (202) 622-7930.

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