Worthless Stock Losses for Foreign Subsidiaries

Sometimes foreign businesses fail. And, worse yet, under certain circumstances, no U.S. tax deduction can be taken for the lost investment. But, proper planning can secure a tax loss.

To illustrate, assume a U.S. company invests $30 million in a foreign subsidiary for common stock. Five years later, it becomes obvious that the subsidiary’s business is not viable, so a decision is made to shut it down. After severing employees, disposing of assets and paying creditors, the foreign subsidiary has $200,000 that it distributes to its U.S. parent in liquidation.

The liquidation of the foreign subsidiary into its U.S. corporate parent would be tax-free under Code Sec. 332. Under these circumstances, the U.S. parent would not obtain any deduction for the $29.8 million it lost on its investment in the foreign subsidiary.

In addition, since the subsidiary is foreign and not subject to U.S. taxation, any operating losses would not have been deductible on a U.S. tax return, and any net operating losses of the subsidiary from its foreign operations would not carry over to the U.S. corporate parent in the tax-free liquidation. Moreover, any net built-in loss with respect to the foreign subsidiary’s assets would not be deductible by the U.S. parent.

Let’s consider a different scenario. This time the U.S. parent funds the foreign subsidiary with $8 million of debt and $22 million of common stock. With this structure, a termination of the business of the foreign subsidiary would result in a tax-deductible loss of $29.8 million. The parent has a $7.8 million deduction resulting from the unpaid portion of the debt and a $22 million worthless stock loss. The liquidation is not tax-free because no amount is distributed with respect to the common stock.

When Code Sec. 332 does not apply, the U.S. parent has a loss on its common stock under Code Sec. 165(a) and (g). Such loss generally is a capital loss, which can offset only capital gains. Nevertheless, Code Sec. 165(g)(3) provides that a worthless stock loss with respect to an 80-percent owned subsidiary is an ordinary loss if the subsidiary generated more than 90 percent of the aggregate of its gross receipts for all tax years from sources other than royalties, certain rents, dividends, certain interest, annuities and gains from the sale of stocks and securities.
Alternatively, the U.S. parent could have invested $8 million in preferred stock and $22 million in common stock. The $200,000 distributed in liquidation of the foreign subsidiary would be with respect to the preferred stock, and there would be no assets available to distribute with respect to the common stock. Cases hold that Code Sec. 332 does not apply in this situation, and that the common shareholder is entitled to a worthless stock loss with respect to its common stock investment as described above. The $7.8 million loss with respect to the preferred stock should be capital under Code Sec. 331. This is the result even though the holder of the common and preferred stock is the same.

Under certain limited circumstances, a loan from a sole corporate shareholder to its subsidiary can be characterized as equity. Debt treated as equity should be considered as preferred stock. As discussed above, treating the debt as preferred stock should not jeopardize the deduction for the loss on the common stock, as long as no amount is distributed with respect to the common stock. Such reclassification, however, may change the character of the loss with respect to the debt from ordinary to capital (but should not change the character of the loss on the common stock).

The determination of when a company becomes worthless is subjective and often uncertain. Also, as long as the company continues in existence and has operations, potential future value must be considered. An actual liquidation of the company, even if the business continues, can provide an identifiable event establishing the date of worthlessness.

When winding down a business, however, sometimes it can be difficult to immediately dissolve a corporation (e.g., local law may require first satisfying all creditors). The IRS has ruled that filing an election to disregard a foreign subsidiary will be treated as a liquidation for this purpose. Also, conversion of a single-member corporation into an entity that is classified as a disregarded entity will be treated as a liquidation.

Despite rosy projections for the business of a foreign subsidiary, it is prudent to capitalize the subsidiary with some debt or preferred stock in order to secure a loss on the common stock in the unfortunate situation where the business later becomes worthless.

ENDNOTES

1 See also Reg. §1.367(b)-3 (foreign subsidiary's E&P, if any, is included in the income of the U.S. parent).
2 Reg. §1.367-3(e); Rev. Rul. 72-421, 1972-2 CB 166.
3 Code Sec. 362(e).
4 If the parent charges off the portion of the debt likely to be unpaid on its books in advance of the liquidation, the $7.8 million loss with respect to the debt generally is deductible as an ordinary loss under Code Sec. 166. Under certain circumstances, such loss might be considered as a capital loss under Code Sec. 165 or 1271. There should be no U.S. tax costs resulting from any cancellation of indebtedness income. See Code Sec. 108(a); Lowell D. Yoder, COD Income Slips Through the Subpart F Net, 12 Tax Magt. Int'l J. 624 (Dec. 12, 1997).
7 It is theoretically possible (although unlikely) that, under certain circumstances, such transaction might qualify as a reorganization under Code Sec. 368(a)(1)(C), which would result in no loss with respect to the preferred stock. However, there should still be a worthless stock loss for the common stock. See Proposed Reg. §1.332-2(e); Ex. 2, supra.
8 Code Sec. 385. Numerous cases have addressed whether an investment in a corporation should be classified as debt or equity. See, e.g., Roth Steel Tube Co., CA-6, 86-2 ustc ¶9676, 800 F2d 625; Fin Hay Realty Co., CA-3, 68-2 ustc ¶9438, 398 F2d 694; J.S. Biritz Construction Co., CA-8, 68-1 ustc ¶9118, 387 F2d 451; Georgia Pacific Corp., 63 TC 790, Dec. 33,118 (1975).
9 The IRS reached this conclusion in CCA 201105011 (Dec. 16, 2003).
10 Rev. Rul. 70-489, 1970-1 CB 53 (loss on stock of an insolvent subsidiary was deductible even though the parent continued the business as a branch).
11 Rev. Rul. 2003-125, IRB 2003-52, 1243 (IRS ruled that a taxpayer may claim a worthless stock loss and bad debt deduction when an insolvent subsidiary elects to be treated as a disregarded entity).
12 See LTR 2011115001 (Jan. 4, 2011) (conversion of a domestic corporation to a limited liability company under state law was treated as a liquidation, and because the subsidiary was insolvent, the U.S. parent was entitled to claim a worthless stock loss); Reg. §301.7701-3(b)(1)(ii).