

Worthless Security Deduction for Intercompany Debt to a Financially-Troubled Subsidiary

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Due to the decrease of security values caused by the current economic environment, the Internal Revenue Code (IRC) §165(g) on worthless-security deductions may be of current interest to parent-corporation creditors, subsidiary-corporation debtors and other interested parties. The Internal Revenue Service (IRS) recently addressed the corporate taxpayer concern that a recharacterization of intercompany debt as common equity may prevent a worthless security deduction. IRS guidance regarding this issue is promulgated in Field Attorney Advice (FAA) 20040301F and other Chief Counsel Advice (CCA) 200706011.



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The IRS guidance concluded that intercompany debt treated as equity for income tax purposes will be recharacterized as preferred stock rather than common stock. This means that a parent corporation that is also a creditor may still access the common-stock tax basis, even if the parent is a lender of last resort and continues to loan money to the debtor subsidiary. This parent loan to a subsidiary subjects the intercompany debt to potential equity recharacterization.

IRS Guidance on Intercompany Debt Recharacterization

FAA 20040301F provides that recharacterized intercompany debt will be treated as a parent corporation's preferred-equity stock in the debtor's subsidiary. However, the worthless-security deduction may only be claimed on the parent corporation's original common-stock investment in the debtor subsidiary.

In the FAA 20040301F fact set, the taxpayer parent corporation owned two controlled foreign corporations (CFCs). The parent corporation lent foreign currency to the two CFCs. When the CFCs failed to make the debt payment, the intercompany loans were restructured into

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new loans issued by the parent corporation. An independent business valuation concluded that the equity of the CFCs had no positive value. The parent corporation then made a check-the-box (CTB) election to treat the CFCs as disregarded entities. This election triggered a worthless-security deduction and a bad-debt deduction under Revenue Rulings 70-489 and 2003-125.

Based on a debt/equity analysis of the two intercompany loans, the IRS audit team determined that a significant portion of the intercompany loans should be reclassified as equity. As a result of this debt-to-equity reclassification, the two CFCs were considered solvent as of the deemed liquidation of the two subsidiaries.

Value & Cents

IRC §332 applies in a complete liquidation of a corporate subsidiary. The tax court decision of *H.K. Porter Co.*, 87 T.C. 689 (1986), concluded that a liquidating corporation is deemed to distribute its property in the following order: (1) to creditors, (2) to preferred stockholders and (3) to common stockholders. Therefore, if a parent corporation common stockholder receives no property in exchange for its ownership interest in the subsidiary's liquidation, then §332 will not apply. Section 332 applies when a parent corporation owning at least 80 percent of the vote and the value of a subsidiary receives property in exchange for all of its equity interest.

In FAA 20040301F, the IRS concluded that the terms of the intercompany notes should be respected for income tax purposes. The intercompany notes provided for a preference to the two subsidiary company's earnings in the form of interest payments. The IRS concluded that the intercompany notes should be recharacterized as preferred stock in the

subsidiaries.

In the CCA 200706011 fact set, the IRS determined that a foreign subsidiary had both a negative liquidation value and a negative going-concern value. These negative equity business values were due, in part, to debt guaranteed by the parent corporation. Since the debt had all of the formal *indicia* of indebtedness and the subsidiary made interest payments on the guaranteed debt, the IRS concluded that the guaranteed subsidiary debt should be recharacterized as preferred equity. The following example illustrates the difference to the parent corporation income tax results by treating intercompany debt as debt, preferred stock or common stock when converting a subsidiary corporation debtor to a disregarded entity.

Assume that a parent corporation owns all of the equity interest in the debtor's subsidiary corporation. The parent equity interest in the debtor's subsidiary has an income tax basis of \$10 million, and both the parent and subsidiary

are eligible entities within the meaning of Treasury Regulations §301.7701-3(a). Neither the parent nor subsidiary files a consolidated income tax return.

The subsidiary's balance sheet lists \$6 million in assets at fair-market value and \$8 million in liabilities from a credit agreement with the parent. That intercompany debt provides for a market interest rate. The subsidiary's gross receipts are all derived from its manufacturing operations. Finally, the parent makes a CTB election to classify the subsidiary as a disregarded entity.

Tax Result with the Intercompany Debt Treated as Debt

Upon its conversion, the subsidiary is deemed to transfer its \$6 million in assets in partial satisfaction of the \$8 million intercompany debt owed to the parent. The subsidiary recognizes gains or losses on the disposition of its assets under IRC §1001 and it also recognizes ordinary cancellation of debt (COD) income of \$2 million under IRC §61(a)(12). The

subsidiary, insolvent by \$2 million, may exclude the \$2 million COD income under IRC §108(a). Of course, the subsidiary must reduce its tax attributes under §108(b).

Assuming that the intercompany debt is excluded from §1271(a), the parent will claim an ordinary bad debt deduction of \$2 million under §166(a). The parent is then entitled to an ordinary worthless security deduction of \$10 million for its equity investment in the subsidiary under IRC §165(g)(3).

Tax Result with the Intercompany Debt Recharacterized as Preferred Stock

As discussed, the terms of the recharacterized intercompany debt are respected by the IRS. The preference to the subsidiary's earnings in the form of interest payments, as well as its legally enforceable liquidation rights, indicate to the IRS that the recharacterized intercompany debt should be treated as preferred stock.

Upon its conversion, the subsidiary is deemed to transfer its \$6 million in assets to the parent, its preferred stockholder, and will recognize gains or losses under §336(a). The parent recognizes a capital loss of \$2 million on its "preferred stock" under §331(a). This tax treatment assumes that the "C" reorganization requirements are not satisfied. As a result, the parent will be entitled to an ordinary worthless security deduction of \$10 million on its common stock investment in the debtor subsidiary under §165(g)(3).

Tax Result with the Intercompany Debt Recharacterized as Common Stock

Upon its conversion, the subsidiary is deemed to transfer its \$6 million in assets to the parent, the subsidiary's common

stockholder. Neither the subsidiary nor parent will recognize gains or losses under §§332(a) and 337(a). The parent's \$10 million basis in its original common-stock investment and its \$8 million tax basis in its recharacterized common stock in the subsidiary will simply disappear. The parent will have a carryover tax basis in the subsidiary's distributed assets of \$6 million under §334(b).

Creditor Parent Corporation Implications

In the parent/subsidiary example, the recharacterization of the intercompany debt to the subsidiary as common stock eliminates all losses otherwise resulting from the debt and the equity. Such a debt recharacterization should obviously be avoided by the parent corporation creditor, which should ensure that the intercompany debt provides for real and enforceable legal entitlements over the subsidiary common stock.

Intercompany debt recharacterized as preferred stock may result in a creditor parent corporation capital loss, as opposed to an ordinary income loss. This treatment would result by creating a second class of equity. This tax disadvantage may be outweighed by the tax benefit of salvaging an otherwise lost worthless-security deduction. Treated as debt, the intercompany debt produces an ordinary bad-debt deduction, assuming the intercompany debt is excluded from §1271(a). The intercompany debt maximizes the benefit of the parent corporation tax basis through a worthless security deduction, and the tax treatment of intercompany debt as debt also produces the best tax result in the above

parent/subsidiary example. Both the relative values of the worthless-security and the bad-debt deductions, and the likelihood of an intercompany debt-to-equity reclassification, may create the need to reevaluate the CTB election. In order to predict the susceptibility of a debt-to-equity reclassification, the creditor parent corporation should perform a debt/equity analysis.

The Debt/Equity Analysis

In determining the true substance of an intercompany funds transfer, the legal rights and obligations of the parties should be considered. One threshold question is addressed in *Scriptomatic Inc.*, 555 F.2d 364 (3d Cir. 1977). In determining whether an equityholder is a lender of last resort, the court considered whether "an outside investor [would] have advanced funds on terms similar to those agreed by the shareholder." A thorough explanation of the debt/equity analysis related to an intercompany investment is beyond the scope of this article.

Conclusion

The reclassification of intercompany debt from debt-to-equity may cause a serious concern to the parent corporation creditor. The IRS positions in FAA 20040301F and CCA 200706011 do provide guidance to the parent corporation creditor that seeks a tax deduction for a worthless security. This worthless-security deduction has become a common tax-planning issue for many creditor parent corporations because the current economic environment has caused the intercompany debt of the debtor subsidiary corporation to become worthless. ■