ANOTHER LOOK THROUGH THE WORTHLESS STOCK DEDUCTION: SECTION 165(g)(3) AS APPLIED TO FOREIGN SUBSIDIARIES

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I. INTRODUCTION

Revenue Ruling 2003-125[1] holds that a domestic parent corporation may claim a worthlessness deduction under Internal Revenue Code section 165(g)(3) in respect of the stock of a foreign subsidiary where the value of the foreign subsidiary's assets does not exceed the foreign subsidiary's liabilities. The ruling was hailed by commentators as it resolved interpretive issues that had been exacerbated by the issuance of an Internal Revenue Service Field Service Advice[2] the year before.[3] But, the ruling reflects a peculiarity in the implementation of the statute that has apparently lain unnoticed by taxpayers, the Internal Revenue Service, and commentators for decades.

Section 165(g)(3) is an exception to the general rule of section 165(g)(1). Section 165(g)(1) provides that worthless stock deductions result in capital loss. Thus, section 165(g)(3) provides an *ordinary* loss if certain requirements are met. Specifically, the shareholder must be a domestic corporation and must directly own stock meeting the requirements of section 1504(a)(2) in the worthless subsidiary. The subsidiary must also satisfy a test relating to the active character of its gross receipts.

Section 165(g)(3) was meant to apply to operating subsidiaries eligible to file consolidated returns with the shareholder parent corporation. The ordinary deduction offered to the parent by section 165(g)(3) is a surrogate for a net operating loss of the subsidiary that a domestic parent and

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1 Rev. Rul. 2003-125, 2003-2 C.B. 1243.

2 I.R.S. Field Serv. Adv. 200226004, 2002 WL 1399055 (June 28, 2002).

3 Debra J. Bennett, *Rev. Rul. 2003-125: Worthlessness and Deemed Liquidations*, 82 TAXES 17, 21 (2004) ("very useful guidance"); Joseph M. Calianno, *When Does a Conversion from a Foreign Corporation to a Foreign Branch Entitle a Domestic Parent to a Worthless Stock Loss?*, 15 J. INT'L TAX'N 22, 25 (2004) (provided "some necessary guidance"); Jasper L. Cummings, Jr., *Foreign Subsidiary Losses Appear Safer*, 105 TAX NOTES 583 (Oct. 25, 2004) (confirmed that deemed liquidations can give rise to ordinary worthless stock deductions); Robert A. Rizzi, *Worthless Stock and Section 332: New Ruling Dulls the Double-Edged Sword*, 31 CORP. TAX'N 24 (2004) ("a Solomonic solution"). *See* Edward J. Schnee & W. Eugene Seago, *The Tax Result of a Subsidiary Becoming Worthless*, 34 CORP. TAX'N 18 (2007) (upstream liquidation of insolvent subsidiary in the ruling was not a reorganization under section 368).

subsidiary filing consolidated returns would deduct.[4]

Foreign subsidiaries are plainly not eligible for filing consolidated returns with a domestic parent. Further, under long-standing authority, a foreign subsidiary is not entitled to any deductions, except those related to a U.S. trade or business of the subsidiary.[5] A foreign subsidiary has no net operating loss under U.S. tax principles and is not able to transfer any losses it may experience to its domestic parent.[6]

Thus, the rationale for permitting an ordinary worthless stock deduction in respect of a foreign subsidiary is open to question. If a foreign subsidiary liquidates into its domestic parent under section 332, no net operating loss flows to the parent. Yet, if the liquidation fails section 332, the parent is entitled to an *ordinary* loss under a statute, section 165(g)(3), intended to give the parent a deduction that is a proxy for the worthless subsidiary's net operating loss. Nowhere has this apparent inconsistency been discussed.

This article traces the evolution of section 165(g)(3), then discusses the doctrine under which foreign corporations have no net operating loss, and finally evaluates arguments favoring application of section 165(g)(3) to foreign corporations. Despite the vast amount of ink that has been spilled on questions of whether subsidiary stock is worthless and when it became so, none of the authorities or commentary in the area question the application of section 165(g)(3) to foreign subsidiaries in the first place. Yet, applying section 165(g)(3) to foreign subsidiaries appears anomalous in light of the intent of section 165(g)(3) and the overall system for taxing foreign corporations that has been in place since 1913.

II. The Worthless Stock Deduction

1913 —"Losses Actually Sustained"

From its inception in 1913, United States federal income tax law imposed tax on corporations organized in the United States[7] and permitted them to deduct "all losses actually sustained within the year . . . and not compensated by insurance or otherwise."[8] Article 141 of Treasury

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[4] *See infra* text accompanying notes 33-38.

[5] I.R.C. § 882(c)(1)(A).

[6] Rev. Rul. 72-421, 1972-2 C.B. 166 (holding that a foreign subsidiary that liquidates into its domestic parent under section 332 has no net operating loss to transfer because a foreign subsidiary not engaged in a trade or business within the United States is not entitled to deductions). *See infra* text accompanying notes 68-75.

[7] Act of Oct. 3, 1913, Pub. L. No. 16, 38 Stat. 114.

[8] *Id.* § II(G)(b), 38 Stat. at 173.

Regulations 45 required that losses "must usually be evidenced by closed and completed transactions."[9] Article 144 of Treasury Regulations 45 explained this language as meaning that "[i]f the stock of a corporation becomes worthless, its cost . . . may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness be made as in the case of bad debts."[10]

1918 —"Closed and Completed Transaction"

United States v. S. S. White Dental Mfg. Co. of Pennsylvania,[11] a Supreme Court case, confirmed that a domestic corporation could take a worthless stock deduction in respect of a foreign subsidiary. A domestic corporation that manufactured and sold dental supplies owned a German subsidiary. The German government confiscated the assets and business of the German subsidiary in 1918 as enemy property. The domestic parent sought a worthlessness deduction for that year, despite the fact that the assets, much impaired, were returned to the German subsidiary after World War I and the Mixed Claims Commission later granted the taxpayer's claim for compensation for the seizure.

The case revolves around whether the loss was "fixed by identifiable events."[12] The Court held that the seizure of the assets was such an event, reasoning that the taxpayer does not have to establish that there is

> no possibility of an eventual recoupment. It would require a high degree of optimism to discern in the seizure of enemy property by the German government in 1918 more than a remote hope of ultimate salvage from the wreck of the war. The taxing act does not require the taxpayer to be an incorrigible optimist.[13]

The case links the "identifiable event" requirement to the realization requirement. A "mere fluctuation in value" does not give rise to a deductible loss,[14] but an identifiable event, such as a sale of property, does. In this case, the seizure was a requisite identifiable event.

The Supreme Court did not consider whether there was anything untoward about giving the domestic parent a loss in respect of a foreign

[9] United States v. S.S. White Dental Mfg. Co. of Pa., 274 U.S. 398, 401 (1927).

[10] *Id.* Article 561 of Treasury Regulation 45 applied the provision to corporations, as Article 144 interpreted the statutory provision applicable to individuals. *Id.*

[11] *Id.* at 403.

[12] *Id.* at 401.

[13] *Id.* at 403.

[14] *Id.* at 401.

subsidiary, as the only ground on which the Commissioner challenged the deduction was whether there had been a "closed and completed transaction."[15] This is not surprising as the domestic parent did experience an economic loss, and the distinction between capital and ordinary losses on worthless stock had not yet been introduced.

The Court did focus on the fact that the "identifiable event" occurred at the subsidiary level but felt that the seizure of the subsidiary's assets "left [the shareholder] without property or assets of any kind."[16] The Court also asserted that the result would be the same if one were to view the assets as property of the domestic parent, "ignoring the entity of the German company."[17] The Court seems to have had an inkling that a look-through principle was at play.

1932 —Wrong Year

Sterling Morton involved an individual taxpayer who claimed a worthless stock deduction in 1932.[18] The Commissioner argued successfully that the stock had become worthless in 1931, or a prior year, and therefore no deduction was allowed for 1932.

In its analysis, the Board of Tax Appeals distinguished between "liquidating value" and "potential value". Under the opinion, stock must lack both in order to be worthless. Liquidating value is simply the excess of the value of a company's assets over its liabilities, while potential value measures the

> value it may acquire in the future through the foreseeable operations of the corporation. . . . 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.[19]

The Board linked potential value with the "identifiable event" requirement, stating that an identifiable event is usually required in order to establish the loss of potential value.[20] However, in certain cases where

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[15] *Id.* at 400.

[16] *Id.* at 402.

[17] *Id.*

[18] Sterling Morton v. Commissioner, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

[19] *Id.* at 1278-79.

[20] *Id.* at 1279.

liabilities are so far in excess of asset value that "no reasonable hope and expectation" of profit to stockholders exists, the stock has no potential value.[21] In such circumstances, an identifiable event, such as a liquidation, in a later taxable year, does not determine worthlessness.[22]

1933 —Tax-Free Liquidation

In the following year, H.G. Hill Stores, Incorporated, ("Hill") liquidated a worthless subsidiary, H.G. Hill & W.E. Penick, Inc. ("Penick").[23] Hill and Penick apparently filed consolidated returns. Hill appears to have recaptured the Penick losses reported on the consolidated returns and instead claimed a bad debt deduction and a worthless stock deduction with respect to Penick debt and stock.[24]

The Commissioner's objection this time was that the liquidation was tax-free under the predecessor of section 332 (old section 112(b)(6)). The Board of Tax Appeals disagreed. It read the liquidation statute to require a distribution in respect of stock, but "Penick distributed nothing to stockholders. It was insolvent, with a very large deficit, and had nothing to distribute to stockholders. It sold its assets to pay a part of its debts."[25] As a result, Hill's worthless stock deduction was sustained.

The case thus equates failure to satisfy the tax-free liquidation statute with eligibility for a worthless stock deduction. That result does not seem inevitable after *Sterling Morton*, however, as the inability to distribute anything to a stockholder in liquidation appears to be a consequence of not having liquidating value (since liabilities exceed asset value), whereas *Sterling Morton* required something more, a lack of potential value, in order for worthlessness to be sustained.

1938 —Worthless Stock Loss is Capital

In 1938, Congress amended the statute to make all worthless stock deductions capital losses. Previously, the regulations, rather than the statute itself, specifically addressed worthless stock. The change in 1938 both elevated the authority for the deduction to a statute and made the deduction a capital loss if the stock was a capital asset in the taxpayer's hands.[26] The

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21 *Id.*

22 *Id.*

23 H. G. Hill Stores, Inc. v. Commissioner, 44 B.T.A. 1182 (1941).

24 *Id.*

25 *Id.* at 1183.

26 Revenue Act of 1938, Pub. L. No. 554, § 23(g)(2), 52 Stat. 447, *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at

House analogized a worthless stock loss to a sale of stock at a loss. A sale would give rise to a capital loss subject to various limitations.

The House was troubled by the "peculiar and anomalous" result that, under prior law, a taxpayer selling stock at a loss was subject to limitations on the use of the capital loss, while a taxpayer who held the same issuer's stock until bankruptcy received an ordinary loss not subject to the restrictive capital loss regime.[27] The House found the distinction in treatment to be "not satisfactory, since, in either case, the loss sustained by the taxpayer is a loss of capital and consequently should be treated similarly for tax purposes."[28]

The Senate proposed that capital loss treatment should not apply to corporations because worthless stock losses of corporations "are customarily a part of their ordinary business expense."[29] Furthermore, the capital loss regime was particularly restrictive in the case of corporations.[30] The Senate eventually capitulated, and the statute was passed, applying capital treatment to worthless stock for all taxpayers.

1942 —Worthless Stock Loss of Affiliated Operating Company is Ordinary

The Senate's discomfort in 1938 with applying capital loss treatment across the board resurfaced in 1942. In that year, Congress carved out an exception to the general rule of capital loss treatment of worthless stock.[31] The exception, contained in section 23(g)(4), was the predecessor to today's section 165(g)(3). Under the amendment, a domestic corporation owning ninety-five percent of a subsidiary in an active business was eligible for ordinary treatment.

Specifically, the exception treated stock in an "affiliated" corporation as a noncapital asset, with the result that a loss on such stock would be ordinary. For this purpose, a corporation was deemed to be affiliated with the taxpayer if (A) the taxpayer directly owned at least ninety-five percent of each class of the corporation's stock (the "Ownership Test"), (B) more

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12 (1938) [hereinafter SEIDMAN I].

27 SEIDMAN I, *supra* note 26, at 12.

28 *Id.* at 13.

29 *Id.* at 14.

30 *Id.* It was also argued that certain types of corporations were required by government regulations to deduct bad debts or worthless stocks and that tax law should conform. *Id.* This argument was persuasive with regard to bad debts, an area where banks were given special treatment. *Id.*

31 Revenue Act of 1942, Pub. L. No. 753, § 123(a)(1), 56 Stat. 798, *reprinted in* 1 J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1953-1939, at 1334 (1954) [hereinafter SEIDMAN II].

than ninety percent of the "aggregate of [the subsidiary's] gross incomes for all taxable years has been from sources other than royalties, rents, dividends, interest, annuities or gains from sales or exchanges of stocks and securities" (the "Operating Company Test"), and (C) the taxpayer was a domestic corporation (the "Parent Test").[32]

The Senate Finance Committee explained the reasoning behind the amendment:

> Under the present law, losses by a parent corporation on the stock or securities of a subsidiary corporation becoming worthless are treated as capital losses in the same manner as in the case of other stock or securities held by the taxpayer. The committee bill would permit such losses to be taken in full as ordinary losses by the parent if it owns directly 95 percent of each class of the stock of the subsidiary. Such a parent and subsidiary corporation may file consolidated returns and to this extent the corporate entity is ignored. Thus the losses of the one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary.[33]

On the one hand, this explanation seems straightforward. Ordinary treatment was meant to apply to corporations eligible for filing a consolidated return. On that theory, it should not apply to foreign subsidiaries since foreign subsidiaries are not (and at the time of enactment were not) eligible to file consolidated returns.

Yet this straightforward explanation requires amplification. For example, it fails to explain why the statute did not simply limit ordinary treatment to corporations eligible to file consolidated returns. Why did it impose the Operating Company Test, and why did it not include any requirements for filing consolidated returns other than the Ownership Test and the Parent Test?

Indeed, one could even take the contrary view — that the statute was aimed at entities *not* filing consolidated returns. For corporations that do file consolidated returns, the subsidiary's losses offset the parent's income under the consolidated return rules, and thus the role of the worthless stock deduction seems limited or even irrelevant. However, a troubled subsidiary's losses would only offset the parent's income in a group filing

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32 SEIDMAN II, supra note 31, at 1334.

33 *Id.*

consolidated returns if the subsidiary's losses were recognized. At the time of worthlessness, the subsidiary may have significant unrealized losses. Thus, the statute does seem to be aimed in large part at groups filing consolidated returns, as an initial reading of the Senate Finance Committee Report would suggest.

The Operating Company Test seems to derive from the look-through principle articulated by the Senate Finance Committee. The Senate Finance Committee's statement, "to this extent the corporate entity is ignored,"[34] echoes the Supreme Court's references in *S. S. White Dental* to looking through the subsidiary entity to its assets.[35] The Operating Company Test may have been intended to ensure that ordinary treatment on worthless subsidiary stock only applies if the subsidiary's losses would have been ordinary. If the subsidiary were a holding company that generated capital gains and losses, then, under a look-through theory, the rationale for ordinary treatment on the subsidiary's stock goes away.

It is not clear why the statute imposed the Ownership Test and the Parent Test but did not simply require that the parent and the subsidiary file consolidated returns. The statute does not require the subsidiary to be an "includible corporation" eligible to file consolidated returns. The Revenue Act of 1942 itself made significant changes in rules governing eligibility of corporations to file consolidated returns.[36] Both before[37] and after[38] the Act, however, foreign corporations were not eligible. It may be that the statute was sufficiently in flux that Congress did not have time to further coordinate eligibility for filing consolidated returns with eligibility for the ordinary worthless stock deduction.

1943 —Refinement of Operating Company Test

The Revenue Act of 1943 refined the Operating Company Test by treating certain rent and interest as "good" income for purposes of that test.[39] The amendments were aimed at ensuring that rent and interest incidental to operating activities would not cause the Operating Company Test to fail. In reference to that test, Senator Davis, advancing the amendment, stated that "[t]he obvious intention of this limitation was to

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[34] *Id.*

[35] *See supra* text accompanying notes 16-17.

[36] *See* SEIDMAN II, *supra* note 31, at 2040-41, 2047-50.

[37] *See* I.R.C. § 141(e)(1939).

[38] *See* Revenue Act of 1942, Pub. L. No. 753, § 159(a), 56 Stat. 798, *reprinted in* SEIDMAN II, *supra* note 31, at 2047.

[39] Revenue Act of 1943, Pub. L. No. 235, 58 Stat. 21 (1944), *reprinted in* SEIDMAN II, *supra* note 31, at 1331.

permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company."[40]

The Senator was concerned with two types of income that could potentially cause the test to be failed: (1) interest income associated with deferred purchase price on the sale of an operating asset and (2) rental income from employee housing, such as housing for employees built by the company in connection with the development of a mine:

> In either of these instances the corporation, although solely an operating corporation, would be denied the benefits of these sections of the existing law because of the all-inclusive scope of the terms "interest" and "rents," even though the income from such sources is incidental to the operating activities of the company and arose as a direct result of its activities as an operating company.[41]

1946 —Business Purpose in Acquiring Minority

Soon after enactment, the ordinary loss statute was applied to a foreign subsidiary. In 1946, Hunter Manufacturing Corporation ("Hunter") purchased the twenty-four percent of its troubled Mexican subsidiary that it did not already own and liquidated the subsidiary.[42] The Tax Court analyzed whether Hunter's worthless stock loss should be capital under the general rule of section 23(g)(2) or ordinary under section 23(g)(4).[43] The Court held that the loss was capital on the basis that the purchase of the minority interest was without any business purpose but rather was made "solely for tax-reducing purposes."[44] This was not "the kind of affiliation that the statute had in mind."[45] Instead the statute "had in mind a true affiliation which would serve a business purpose."[46] The Court did not question whether ordinary treatment could apply in the case of a foreign subsidiary.

1954 — Section 381 Enacted

Section 381, enacted in 1954, provided statutory rules for carrying over

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40 SEIDMAN II, *supra* note 31, at 1332 (statement of Sen. Davis).
41 *Id.* at 1333.
42 Hunter Mfg. Corp. v. Commissioner, 21 T.C. 424 (1953).
43 *Id.*
44 *Id.* at 430-31.
45 *Id.* at 431.
46 *Id*.

attributes from one corporation to another in a corporate reorganization or liquidation of a subsidiary into its parent satisfying section 332.[47] Section 381 was intended to rationalize the court cases addressing carryovers:

> Present law makes no provision for the transfer from one corporation to another, in a tax-free merger or consolidation, of the major tax benefits, privileges, elective rights and obligations which were available to the predecessor . . . . The courts have held, in general, that such tax attributes of a corporation may be preserved only by continuing the corporation's identity. For example, the surviving corporation in a merger is generally entitled only to the tax attributes from its own premerger experience and not from the experience of the other corporations merged. More recently, however, this separate entity rule appears not to have been followed.
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> As a result, present practice rests on court-made law which is uncertain and frequently contradictory.[48]

1956, 1959, and 1960 — Regulatory Application of Ordinary Treatment to Foreign Subsidiaries

The Service made clear in regulations in the 1950s that ordinary treatment of worthless stock could apply to foreign subsidiaries. Presumably, this approach was informed by *S. S. White Dental*(and possibly *Hunter*),but *S. S. White Dental* was decided at a time when all worthless stock deductions were ordinary and therefore should not have been dispositive.

In 1956, the Service proposed regulations confirming that ordinary treatment could apply to worthless stock in foreign subsidiaries. Those proposed regulations defined "security" to include "a share of stock in a domestic or foreign corporation"[49] and provided ordinary treatment to a taxpayer owning a "security" in an affiliated corporation.[50] The Service withdrew the 1956 proposed regulations in 1959[51] and proposed new regulations with the same result: ordinary treatment for worthless stock in a foreign corporation.[52] The new proposed regulations were finalized in 1960

[47] Revenue Act of 1954, Pub. L. No. 83-591, § 381, 68A Stat. 3.
[48] H.R. REP. NO. 83-1337, at 41 (1954).
[49] Prop. Treas. Reg. § 1.165-7(b), 21 Fed. Reg. 4928 (July 3, 1956).
[50] Prop. Treas. Reg. § 1.165-7(c), 21 Fed. Reg. 4928 (July 3, 1956).
[51] Prop. Treas. Reg. § 1.165, 24 Fed. Reg. 8177 (Oct. 8, 1959).
[52] Prop. Treas. Reg. § 1.165-5(d)(1), Fed. Reg. 8180 (Oct. 8, 1959).

and contained the same language as the regulations do today: "If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer . . . and such security becomes wholly worthless during the taxable year, the loss resulting there from may be deducted . . . as an ordinary loss . . . ."[53]

After the promulgation of the regulations, numerous court decisions arose involving a domestic parent claiming an ordinary worthless stock deduction in respect of a foreign subsidiary.[54] In light of the regulations, the IRS did not challenge the application of section 165(g)(3) to foreign subsidiaries. None of the cases questioned whether it should so apply. For example, in one case, a domestic parent claimed that its Canadian subsidiary was worthless in 1954, a year that predated the regulation.[55] The 1960 opinion denied the deduction because the taxpayer did not show that the stock had not become worthless in a prior year.[56] This opinion, like the others, did not question whether a foreign subsidiary could be eligible for ordinary treatment.

1970 — Continuation of the Business

In 1970, the Service ruled that a parent corporation may take an ordinary worthless stock deduction upon the liquidation of an insolvent subsidiary despite the parent continuing the business of the subsidiary as a branch.[57] At first blush, this ruling seems not to square with the requirement in *Sterling Morton* that the subsidiary stock have no "potential value." It would seem that continuing the business would be premised on the possibility that the business will ultimately have equity.

Possibly, the rationale in the ruling relates to the fact that the subsidiary

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[53] T.D. 6445, 1960-1 C.B. 93. Prop. Treas. Reg. § 1.165-5(d)(1), Fed. Reg. 8180 (Oct. 8, 1959).

[54] Flint Indus. Inc. v. Commissioner, 82 T.C.M. (CCH) 778 (2001) (German subsidiary was worthless in 1992); Emhart Corp. v. Commissioner, 75 T.C.M. (CCH) 2231 (1998) (Portuguese subsidiary was worthless in 1984); Wally Findlay Galleries Int'l Inc. v. Commissioner, 71 T.C.M. (CCH) 3214 (1996) (French subsidiary not proven worthless in 1984); Figgie Int'l, Inc. v. Commissioner, 807 F.2d 59 (6th Cir. 1986) (Brazilian subsidiary not worthless in 1968); Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979) (Colombian subsidiary was worthless in 1971).

[55] Brandtjen & Kluge, Inc. v. Commissioner, 34 T.C. 416 (1960).

[56] *Id.* at 444-45.

[57] Rev. Rul. 70-489, 1970-2 C.B. 53. Courts have also held that continuing the business did not preclude a worthless stock deduction. *See*, *e.g.*, Cont'l Ill. Nat'l Bank & Trust Co. of Chicago v. United States, 81-1 USTC 9185 (N.D. Ill. 1981); Frazier v. Commissioner, 34 T.C.M. (CCH) 951 (1975); Steadman v. Commissioner, 50 T.C. 369, 378 (1968).

in that ruling owed debt to the parent. Upon the liquidation, the debt went away. Thus, the theory may have been that post-liquidation continuation of the business was consistent with worthlessness before the liquidation because, before the liquidation the business was heavily leveraged, while afterwards it was not.[58]

The 2002 Field Service Advice

In 2002, the Service grappled with a taxpayer's claimed ordinary worthless stock deductions resulting from check-the-box elections that caused two foreign subsidiaries to be classified as partnerships.[59] The Field Service Advice (FSA) concluded that the taxpayer had not proven worthlessness of the subsidiary stock.

The FSA ranged far and wide and analyzed the relationship between liquidations and the identifiable event requirement. The FSA never squarely addressed the fact that nothing had occurred by reason of the election from a real-world perspective. The FSA stated that the election resulted "in no changes" to the subsidiaries' "operating agreements or business practice."[60] The subsidiaries "continued to . . . maintain their books and records as corporations."[61] The country in which they were incorporated "continued to treat" the subsidiaries "as corporations".[62] In fact, the taxpayer represented that neither subsidiary was "aware of its change in classification from corporation to partnership for U.S. federal tax purposes."[63]

Despite the minimal event that took place in the real world, the FSA presupposes that a check-the-box election has the same stature as a state law liquidation for the purpose of proving worthlessness. Clearly, though, the FSA's writer was troubled by the transaction: "[I]t is possible for stock to be worthless even though the business of the corporation continues. . . . However, continuing to run the business usually indicates that the stock is not worthless . . . ."[64] The FSA led to a stir of commentary.[65]

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[58] *See* Rev. Rul. 59-296, 1959-2 C.B. 87 (merger of insolvent subsidiary into creditor-parent is not covered by section 332 or section 368 so parent is entitled to bad debt deduction); Rev. Rul. 68-602, 1968-2 C.B. 135 (creditor-parent's cancellation of insolvent subsidiary's debt is disregarded in evaluating whether subsequent liquidation qualifies under section 332).

[59] I.R.S. Field Serv. Adv. 200226004, 2002 WL 1399055 (June 28, 2002).

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *See, e.g.*, Debra J. Bennett, *Code Sec. 165(g): Under the Microscope*, 81 TAXES 11,

2003 — Check-the-Box Does the Trick

The taxpayer-friendly result in Revenue Ruling 2003-125 can be explained in part from the history that preceded it. For years, it had been accepted that ordinary worthless stock deductions were permissible for foreign subsidiaries. It also had been established that continuation of the business was not preclusive of the deduction. Thus, from those perspectives, the ruling's grant of ordinary treatment is not surprising.

Nonetheless, other aspects of the ruling do seem surprising. The Service could have distinguished check-the-box elections from legal dissolutions and held that check-the-box elections cannot constitute the requisite identifiable event because they have no real world impact. Further, the Service seems to have conflated the *Sterling Morton* concepts of liquidating value and potential value by emphasizing that worthlessness requires valuing goodwill, going concern value, and other intangibles.[66]

Indeed, the *Sterling Morton* test implies that there could be liquidations that fail section 332 because the subsidiary is insolvent (liabilities equal or exceed value of assets) and also fail the test of worthlessness because the subsidiary has potential value. Revenue Ruling 2003-125 implies that there is no such liquidation.[67]

III. THE "NO DEDUCTIONS" RULE FOR FOREIGN CORPORATIONS

While the parameters of the worthless stock deduction have evolved over time, the rules relating to deductions that may be taken by foreign corporations have remained relatively stable. Since the Revenue Act of 1913, foreign corporations have not been permitted to take deductions

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17 (2003) ("The authoritative merit of the FSA is questionable" and "the FSA does not come to any clear resolution."); Jasper L. Cummings, Jr., *The 2003-2004 Priority Guidance Plan for Chief Counsel (Corporate)*, 100 TAX NOTES 1443, 1444 (Sept. 15, 2003) ("confusion in the law"). *See also* Jerred G. Blanchard, Jr., Debra J. Bennett & Christopher D. Speer, *The Deductibility of Investments in Financially Troubled Subsidiaries and Related Federal Income Tax Considerations*, 80 TAXES 91 (2002) (detailed discussion of worthless stock deduction shortly before the issuance of the FSA).

[66] The ruling posits two scenarios, one in which the value of the assets of the subsidiary exceeds the subsidiary's liabilities and the other in which the assets do not exceed liabilities. In the first, the parent does not get a worthless stock deduction, but in the second it does. Rev. Rul. 2003-125, 2003-2 C.B. 1243. The IRS seems therefore only to be testing for liquidating value. *See* Rizzi, *supra* note 3, at 27 (ruling makes clear that all the subsidiary's property, including intangibles, must be taken into account).

[67] *See* I.R.S. Gen. Legal Adv. Mem. 2011-003 (Aug. 18, 2011) (check the box election on worthless foreign subsidiary, causing it to be a partnership, results in ordinary worthless stock deduction for parent).

unrelated to a U.S. trade or business. Under current law, section 881 imposes a flat thirty percent tax on certain types of U.S.-source income of foreign corporations. The tax is levied on the gross income of the foreign corporation. No deductions are allowed.[68] By contrast, under section 882, deductions are available if they are "connected with income which is effectively connected with the conduct of a trade or business within the United States . . . ."[69]

The non-deductibility of foreign expenses not effectively connected with a U.S. trade or business is well-established. Under the Revenue Act of 1913, foreign corporations could only deduct "ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business within the *United States*" (emphasis added), "losses actually sustained within the year in business conducted by it within the *United States*" (emphasis added), a portion of its interest expense, and U.S. federal and State taxes.[70]

The Revenue Act of 1936 introduced the concept of a flat tax on U.S.-source income of a foreign corporation not engaged in a U.S. trade or business.[71] The relevant Treasury Regulations made clear that "[a] nonresident foreign corporation is not allowed any deductions from gross income from sources within the United States, the tax being imposed upon the amount of gross income received."[72] The Revenue Act of 1936 provided for deductions "only if and to the extent that they are connected with income from sources within the United States."[73]

With this background, in Revenue Ruling 72-421,[74] the Service ruled that a foreign corporation not engaged in a U.S. trade or business may not transfer its losses to its domestic parent in a section 332 liquidation. In the ruling the foreign subsidiary had operated at a loss for several years. If it had been a domestic corporation, it would have had a net operating loss. Citing the section 881 and 882 regulations, the Service held that, as a foreign corporation, the subsidiary had no net operating loss to transfer as it was not entitled to deductions in the first place. From that perspective, the ruling is not surprising. The holding of the ruling has since been reflected in Treasury Regulation § 1.367(b)-(3)(e), which states that "only a net operating loss or capital loss carryover that is effectively connected with the

68 I.R.C § 882(c)(1)(A); Treas. Reg. § 1.881-2(a)(3) (as amended in 2012).
69 I.R.C § 882(c)(1)(A).
70 Act of Oct. 3, 1913, Pub. L. No. 16, § G(b), 38 Stat. 114, 173.
71 Revenue Act of 1936, Pub. L. No. 740, § 231(a), 49 Stat. 1648, 1717.
72 Treas. Reg. § 94, art.232-1 (1936).
73 Revenue Act of 1936, Pub. L. No. 740, § 232(a), 49 Stat. 1648, 1717.
74 Rev. Rul. 72-421, 1972-2 C.B. 166.

conduct of a trade or business within the United States . . . is eligible to be carried over under section 381."[75]

IV. EVALUATION OF ARGUMENTS FAVORING ORDINARY LOSS TREATMENT

The "End of the Road" Argument

One could argue that a domestic parent should be entitled to an ordinary worthless stock deduction in respect of its foreign subsidiary on the theory that the economic downside scenario should be treated the same as the economic upside scenario. That is, at the end of the road, if a foreign subsidiary has been profitable, the domestic parent would ultimately realize ordinary income either under section 1248 (if the foreign subsidiary stock is sold) or section 367(b)[76] (if the foreign subsidiary is liquidated into the domestic parent in a section 332 liquidation). Arguably, section 165(g)(3) is the flip side of those rules. On this argument, parity is served by providing ordinary treatment at the "end of the road" whether the end of the road is an upside or downside scenario.

That argument, however, is not persuasive. To begin with, the rules already do not provide parity in a downside scenario. If the domestic parent sold the foreign subsidiary stock at a loss, the loss would be capital. Recall that the original impetus for making worthless stock deductions capital was a concern over having a disparity between the treatment of sales of stock at a loss and a taxpayer holding stock through bankruptcy of the issuer of the stock.[77] If the downside scenario should be treated the same as the upside scenario, one would have expected that sales of foreign subsidiary stock at a loss would be ordinary, but that is not the case.

Furthermore, worthlessness often is not the end of the road because of the doctrine that allows the parent to continue the business of the subsidiary after taking a worthlessness deduction.[78] Indeed, under Revenue Ruling 2003-125, apparently all that is needed is a check-the-box election with no real world implications at all. The analogy between a disinvestment arising from a sale governed by section 1248 and an identifiable event giving rise to a worthlessness deduction where the parent continues to operate the business seems strained.

As to section 367(b), as discussed above, net operating losses do not

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[75] *Cf.* I.R.C. § 362(e) (limitation on importation of built-in losses).

[76] Treas. Reg. § 1.367(b)-3(b)(3)(i), (ii) (as amended in 2006).

[77] *See supra* text accompanying notes 27-28.

[78] *See supra* text accompanying notes 57-58.

flow up to the parent in a section 332 liquidation.[79] Here, again, the rules do not treat the upside and downside scenarios the same. While the section 367(b) regulations require inclusion of the foreign subsidiary's earnings and profits in a section 332 liquidation, they do not view the foreign subsidiary as having a net operating loss that could flow up to the parent (except insofar as the loss is effectively connected with a U.S. trade or business), as discussed above.[80] If it were apparent that the upside and downside scenarios should be treated the same, one would expect a subsidiary to have a net operating loss and for it to flow up to the parent under section 381.

One could argue that, nonetheless, the upside and downside scenarios should be treated the same. If the subsidiary had been profitable, the United States would eventually have taxed the foreign subsidiary's income, and the income would have been ordinary, and therefore, if the subsidiary is not profitable, the domestic parent should be entitled to an ordinary loss. On this view, not only is ordinary treatment appropriate upon worthlessness, but a foreign subsidiary should be viewed as having net operating losses that can flow up under section 332 and, arguably, a domestic parent should be entitled to an ordinary loss on a stock sale. On this view, Revenue Ruling 72-421 and the related section 367(b) regulation should be conformed to section 165(g)(3), not the other way around.

This argument seems wrongheaded, however, because the United States often does not, currently or eventually, tax a profitable foreign subsidiary's earnings. First, inclusion of those earnings may often be deferred for many years. Further, with the foreign tax credit system, the United States cedes taxing jurisdiction generally to source countries. Thus, if the foreign subsidiary earned income and paid foreign tax on that income, in general, the United States does *not* intend to tax that income even if the income is repatriated to the United States. Ordinary dividend treatment under section 1248 or Treasury Regulation § 1.367(b)-3[81] means, under section 902, that the domestic parent corporation is treated as having paid a portion of the foreign taxes paid by the subsidiary. Such taxes may be creditable. Ordinary dividend treatment under sections 1248 and 367 is therefore a mechanism designed *not* to tax foreign subsidiary earnings, rather than a detriment to the foreign parent that should be balanced by beneficial ordinary deductions if the subsidiary's fortunes decline.

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79 *See supra* text accompanying notes 74-75.

80 *See supra* text accompanying notes 74-75.

81 *See* Treas. Reg. § 1.367(b)-3(b)(3)(ii), Example 1 (as amended in 2006).

The Branch Analogy

Another argument one could make in favor of ordinary treatment for worthless foreign subsidiary stock could be that if the foreign operations had been conducted as a branch of the domestic parent from the beginning, the domestic parent would have been entitled to deduct the losses, subject to certain possible limitations such as the dual consolidated loss limitations. On this view, ordinary treatment for worthless foreign stock appropriately looks through to the subsidiary's ordinary losses. Indeed, this argument echoes the statement in the 1942 legislative history enacting the predecessor to section 165(g)(3) that, where a parent and subsidiary file consolidated returns, "to this extent the corporate entity is ignored. Thus the losses of the one may be offset against the income of the other."[82] While a foreign subsidiary cannot file consolidated returns with its domestic parent, the parent may conduct foreign operations through a branch. To that extent, there is no separate corporate entity, and, as a result, losses and income may be offset.

The branch analogy, however, goes too far. If the analogy to a branch is correct, then all taxpayers, not solely domestic corporations, should be entitled to an ordinary deduction for foreign stock, since all types of taxpayers could have operated the business through a branch and been eligible to offset ordinary losses of the foreign operations against other income of the taxpayer. Indeed, the legislative history itself, in discussing the notion of ignoring a corporate entity, specifically tied that idea to parent and subsidiary corporations eligible to file consolidated returns.

Further, the branch analogy seems like a whipsaw. If the foreign operations had been conducted as a branch, then foreign income would be taxed on a current basis, subject to the foreign tax credit regime. If the taxpayer avails itself of the deferral inherent in conducting a foreign business through a subsidiary, it is unclear why the entity should be disregarded when the taxpayer claims a worthless stock deduction.

No Sale or Exchange; No Inconsistent Treatment Among Shareholders

Another argument that could be made is that there has been no sale or exchange, and so the Internal Revenue Code's general ordinary treatment should apply. The argument could be made that the concern over inconsistent treatment between one taxpayer who sells stock and another who holds stock through a bankruptcy of the issuer is more applicable to publicly traded stock or privately held stock with multiple shareholders than

[82] S. Rep. No. 77-1631, at 47 (1942).

it is to a corporation owning eighty percent of the stock of a subsidiary, as is required by section 165(g)(3). This argument, however, like the previous argument, proves untenable, as it would suggest that a sale of (domestic or foreign) subsidiary stock by a parent corporation should be ordinary as well.

Loss Has Been Sustained

Finally, one could resort to pointing out that the parent corporation has sustained a loss. That is, of course, true, but it does not explain why the loss should be ordinary.

V. CONCLUSION

Revenue Ruling 2003-125 involves a number of well-recognized taxpayer-friendly moves by the Service.[83] None of them, however, are as taxpayer-friendly as the premise that an ordinary deduction could potentially apply with respect to foreign stock. This premise seems questionable in light of the look-through theory behind section 165(g)(3) and the long-standing framework of the Internal Revenue Code in taxing foreign corporations. Even more curious than the merits is the apparent absence of discussion of the merits in cases, legislative materials, regulations, and commentary. Thus, this paper offers two puzzles — should there be ordinary treatment, and why has no one previously analyzed that question? With the centennial of the Act of October 3, 1913 nearly upon us, this paper advances the discussion on both.

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[83] *See supra* text accompanying notes 1-3, 66-67.