

Check The Box Elections By Insolvent Corporations

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When a corporation makes a check the box election, it is treated as having liquidated and then being reestablished as a partnership. In context of an insolvent corporation, this raises questions about worthless stock treatment, bad debts, and other tax consequences. A recent Chief Counsel Memorandum provides the IRS' opinion on these issues.

WORTHLESS SECURITY DEDUCTION. In the deemed liquidation of a solvent corporation, the shareholders realize gain or loss based on the deemed distribution that occurs. However, an insolvent corporation has no net assets to distribute. Therefore, the shareholders do not receive anything and thus there is no sale or exchange to fix gain or loss. See Rev. Rul. 2003 – 125. In this circumstance, however, the shareholders will be entitled to a worthless security deduction in the amount of their basis in their stock pursuant to Code Section 165(g). Code Section 165(g) provides that if any security which is a capital asset (such as a share of stock in a corporation) becomes worthless, a loss from a seller or exchange of that security is deemed to occur.

Note that this result holds even if the shareholder is a corporation owning 80% or more of the stock of the insolvent subsidiary. That is, Code Section 332 (which applies to liquidations of corporate subsidiaries into a parent corporation) will not apply to disallow the loss. This result occurs because Code Section 332 will not generally apply to the liquidation of an insolvent subsidiary when the parent corporation receives no assets as shareholder.

TAXABLE SUBSTITUTION OF LIABILITIES. The substitution of a debt instrument that differs materially in kind or in extent from an existing debt instrument may constitute a sale or exchange of that debt instrument under Code Section 1001. Changes in obligor of the debt instrument can constitute such a taxable substitution.

Since an insolvent corporation will likely have liabilities to its shareholders or third parties, the issue arises whether such a substitution of debt occurs when the debt is deemed transferred and reestablished in the partnership, since at a minimum, there is a new obligor for federal tax purposes. Notwithstanding this new obligor, the Memorandum concludes that there is no such taxable substitution occurring under Code Section 1001.

BAD DEBT DEDUCTION. We noted above that the shareholders of the insolvent corporation are eligible to receive a worthless stock deduction upon the deemed liquidation of the corporation. This might lead you to believe that a creditor of the corporation should likewise receive a bad debt deduction under Code Section 166 since the corporation disappears. Code Section 166 allows as a deduction any debt which becomes worthless within a taxable year. However, you would be wrong in that conclusion (at least according to the Memorandum).

The Memorandum determines that Code Section 166 does not apply because the full amount of the liability is treated as surviving the liquidation and being assumed by the partnership. Thus, the debt was not rendered worthless by reason of the election.

BASIS IN PARTNERSHIP INTEREST AND PARTNERSHIP BASIS IN ASSETS. The Memorandum then addresses various basis issues arising from the deemed liquidation and deemed formation of the partnership. Interested persons should consult the Memorandum – we will not run through them here to avoid the risk of readers never wanting to read this blog again.

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