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SALVAGING TAX BENEFIT FROM LOSSES ON INTERCORPORATE LOANS AND INVESTMENTS

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The 1974 equity market collapse and the general business recession of recent months have combined to highlight a number of unique income tax considerations which relate to losses incurred in intercorporate investment and loan transactions. These matters are complicated by a number of special statutory provisions which apply for corporate income tax purposes both to the so-called ordinary losses and to the contrasting so-called capital losses. Also interesting is the fact that although our federal income tax laws contain a number of provisions to alleviate the pyramiding of the burden of taxes on income passing through several tiers of corporate ownership,[1] there appear to be no comparable statutory provisions restricting or limiting the possible pyramiding of tax benefits from losses passing through several tiers of corporate ownership.[2]

This article will explore some of the areas where tax planning can serve to accelerate, change, expand or even multiply the ultimate tax benefit available from losses incurred by a corporation on investments in, or loans to, other corporations, whether they are wholly owned sub-

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1. For example, INT. REV. CODE OF 1954, § 243 (dividends received deduction); INT. REV. CODE OF 1954, § 332 (tax-free liquidation of subsidiaries).

2. In the case of consolidated tax returns filed by an affiliated group of corporations under sections 1501-1504, provision is made for adjusting the investment in a lower tier corporation for losses utilized in the consolidation in the present regulations. Treas. Reg. 1.1502-32 (1972); *see* National Lead Co., 23 T.C. 988, 996-1000 (1955), where a bad debt loss deduction was reduced for losses taken in a prior consolidated tax return. An unrelated issue was appealed, and the Tax Court reversed on that issue in Commissioner v. National Lead Co., 230 F.2d 161 (2d Cir. 1956), *aff'd*, 352 U.S. 313 (1957).

sidiaries, controlled sudsidiaries, or merely minority-owned subsidiaries. Before beginning such exploration or discussion, however, a brief listing of some of the principal statutory provisions of the Internal Revenue Code which may be involved in corporate loss considerations would seem desirable. These include:

1. Section 165, containing the general rule allowing a deduction for losses not compensated for by insurance or otherwise, but especially section 165(g)(3), which provides that for corporations, a loss from worthless securities in an 80 percent-owned subsidiary, as therein defined, shall be treated as an ordinary loss rather than a capital loss.
2. Section 166 containing the general rules for deduction as ordinary losses of wholly worthless or partially worthless debts and which, by reason of section 166(d) in the case of corporations, eliminates the concept of "nonbusiness" bad debts.
3. Section 172 containing the general rules by which a net operating loss of a taxpayer may be carried back as a deduction to each of the three taxable years preceding the taxable year of such loss and also may be carried over to each of the five taxable years following the taxable year of such loss.
4. Section 269 imposing restrictions on the use of any deduction, credit or other allowance in any acquisition of property of another corporation or in the acquisition of control of a corporation if the principal purpose of such acquisition was the evasion or avoidance of federal income taxes.
5. Section 381 which contains provisions generally relating to the succession by an acquiring corporation of various income tax items of a distributor or transferor corporation in tax-free liquidations of subsidiaries under section 332, and in certain corporate reorganizations under section 368; but particularly section 381(c)(1) and section 381(c)(3), respectively, containing provisions dealing with the succession to net operating loss carryovers and capital loss carryovers.
6. Section 382 and section 383, respectively, which impose special limitations on the use of net operating loss carryovers and unused tax credits and capital loss carry-forwards in certain purchases of a corporation or changes in corporate ownership in a corporate reorganization.
7. Section 1211(a) containing the fundamental limitation which provides that corporations' losses from the sale or exchange of capital assets, that is, capital losses, shall be allowed only to the extent of gains realized from such sales or exchanges.
8. Section 1212(a) containing the general provisions that for corporations, capital losses may be carried back to each of

the three taxable years preceding the loss year, or may be carried over to each of the five taxable years succeeding the loss year.

9. Section 1232(a)(1) containing the general rule that amounts received on retirement of corporate bonds, debentures, notes or certificates or other evidences of indebtedness which are capital assets in the hands of the taxpayer, shall be considered as received in exchange therefor, that is, resulting in a capital gain or capital loss.
10. Sections 1501-1504 which provide that a group of corporations affiliated under a common parent through 80 percent stock ownership, as therein defined, may elect to file consolidated income tax returns in accordance with the very complex Consolidated Return Regulations, as promulgated by the Commissioner of Internal Revenue.

Cataloging these several statutory provisions of the Internal Revenue Code demonstrates the existence of a formidable maze of Code provisions which can greatly complicate the analysis and resolution of problems involving intercorporate losses. This is not to mention the definitional problems and the broad range of interpretive concepts in court decisions spawned by these statutory provisions. It will be readily apparent that a complete discussion of the myriad of special corporate loss situations which could arise range far beyond the reasonable parameters of any article. However, there are a number of selected areas of the topic which can be presented, and which, it is hoped, will demonstrate some of the practical considerations which should be borne in mind when dealing with intercorporate loss matters.

Capital Investment vs. Debt

Perhaps nowhere is the dichotomy between ordinary losses and capital losses found in our income tax laws more noticeable than in its application to corporations. The great majority of corporate taxpayers do not engage with any frequency in significant or major transactions looking toward the realization of capital gains. Accordingly, if and when a major loss occurs which would be classified as a capital loss, the corporate taxpayer may be devoid of any offsetting capital gains, or even the prospect of any such capital gains, with the result that because of the provisions of Section 1211(a) of the Code, there is little likelihood of any tax benefit accruing from such loss.

The threshold question in most intercorporate loss situations involving advances by one corporation to another corporation in which it owns all or a part of the stock, is whether under the "substance vs. form" tests applied in the administration of our income tax laws, such advances should be treated as loans, that is as debts, or should be viewed as a capital contribution, that is, a part of the investment in the stock of such corporation. If the advances are loans and they become worthless, or even partially worthless, the corporate taxpayer is entitled to a deduction against ordinary income.[3] If the advances are capital contributions and a part of the investment if the second corporation's stock, the result will usually be a worthless stock deduction, or a capital loss, if the investment becomes worthless.[4]

The question of whether a corporate shareholder's advance to either a wholly or a partially owned subsidiary is a loan is essentially one of fact turning on the circumstances of each case.[5] The essence of the difference between debt and capital investment is that the latter is intended to be sums placed at risk in the subsidiary's business, while the former is intended to establish a definite liability of the subsidiary, payable in any event.[6] There are a number of factors which the courts have enumerated as indicative of a capital contribution—inadequate capitalization,[7] absence of notes, interest, or security or a fixed maturity,[8] advances in proportion to stock ownership,[9] subordination to other debt,[10] and a failure to treat the advances as a loan on the books and records of the parties.[11] These various factors apply in debt versus equity situations and, to a substantial extent, equally in cases involving corporate shareholders and their subsidiaries and individual share-

3. INT. REV. CODE OF 1954, § 166.

4. *Id.* § 165(g). *But see id.* § 165(g)(3) (80 percent-owned affiliates defined therein).

5. John Kelly Co. v. Commissioner, 326 U.S. 521, 530 (1945); Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 905 (7th Cir. 1959).

6. Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir. 1942).

7. Curry v. United States, 396 F.2d 630, 634 (5th Cir.), *cert. denied*, 393 U.S. 967 (1968); Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695, 698-99 (4th Cir. 1963); Ben P. Gale, 26 P-H Tax Ct. Mem. 413, 418 (1956).

8. Wachovia Bank & Trust Co. v. United States, 288 F.2d 750, 756 (4th Cir. 1961); Max Greenhouse, 23 P-H Tax Ct. Mem. 798, 799-800 (1954). On intercorporate loans, different from individuals operating on a cash basis, where the debt is interest bearing, the creditor usually has accrued the interest as income. *See* Earle v. W.J. Jones & Son, 200 F.2d 846, 851 (9th Cir. 1952).

9. Arlington Park Jockey Club, Inc. v. Sauber, 262 F.2d 902, 905 (7th Cir. 1959); Isidor Dobkin, 15 T.C. 31, 32 (1950).

10. United States v. Henderson, 375 F.2d 36, 40 (5th Cir.), *cert. denied*, 389 U.S. 953 (1967).

11. *Cf.* Cohen v. Commissioner, 148 F.2d 336 (2d Cir. 1945); Los Angeles Shipbuilding & Drydock Corp. v. United States, 166 F. Supp. 914, 919 (S.D. Cal. 1958), *vacated*, 289 F.2d 222 (9th Cir. 1961).

holders and their corporations. It should be noted that the consideration accorded to these factors by the taxpayers at the time the advances are made may vary considerably, depending on whether it is a corporate taxpayer or an individual taxpayer which is involved. Unfortunately, corporate taxpayers tend to be impelled more by the business considerations and frequently do not give a great deal of concern to keeping the tax record. This is due in part to the fact that individual shareholders and their controlled corporations can usually reap more immediate and direct tax benefits in the avoidance of double taxation by reason of the deductibility of the interest on debt and the repayment of debt as a return of the shareholders' capital. In the corporate taxpayer setting, except for foreign subsidiary situations, the dividend received deduction provided for by Section 243 of the Code makes the double taxation problem one of only minor concern; thus the classification as debt becomes of primary importance only if the debtor fails and a loss results. The structuring of intercorporate business arrangements to anticipate a loss is a harder tax discipline to pursue because of the introduction of the human element.

This is particularly true in the case of a parent corporation and its wholly owned subsidiary. It might initially appear that it would make no material difference whether the intercorporate advances are classed as capital investment or as debt. As has already been noted, if the stock of a wholly owned operating subsidiary becomes worthless, the capital investment may, nevertheless, be deductible as an ordinary loss for the parent.[12] Further, such a parent-subsidiary relationship affords the parent the option of filing consolidated income tax returns with the subsidiary[13] so that the parent, on a current basis, can be in a position to obtain the full benefit of any operating losses incurred by its subsidiary as an offset against its operating income; in other words, in the event of the subsidiary's losses, the parent enjoys the equivalent of a current ordinary loss deduction for its advances even if these advances were to be classed as capital investment in the subsidiary.

There are, however, at least two common situations where the classification of advances to a wholly owned subsidiary as debt is important. First, where separate corporate tax returns are, or must, be filed (such as in the case of a foreign subsidiary) but the subsidiary's operations have resulted in losses and such an impairment of assets that, while the investment in the subsidiary could not be written off as totally

12. INT. REV. CODE OF 1954, § 165(g)(3).
13. *Id.* § 1501-1504.

worthless, a write-off of a portion of the debt as "partially worthless" could be justified and some current tax benefit enjoyed by the parent;[14] and second, where such a subsidiary is being closed out, and all of the remaining assets are being transferred to the parent with the knowledge that such assets will only partially cover the total of the advances made to, and the investment in, the subsidiary. In such a case, if the market value of the assets remaining is less than the advances classed as debt, the excess debt may be written off by the parent as an ordinary loss on a worthless debt[15] and the capital investment then can similarly be written off as an ordinary loss on a worthless security in an affiliated corporation.[16] On the other hand, if all of the advances were classified as capital investment, then the transfer of assets would constitute the liquidation of the subsidiary and no gain or loss could be recognized by the parent at the time of such liquidation either on its admitted capital investment or the excess debt.[17]

One of the furthest reaching provisions of the Tax Reform Act of 1969 was the addition of section 385, which delegates extremely broad authority to the Commissioner to determine what should be treated as stock and what should be treated as indebtedness. It has been noted that the Commissioner's power to write the rules in this area seems virtually equivalent to his broad authority to write regulations in the consolidated return area.[18] Despite the considerable time which has elapsed since enactment, no regulations have yet been proposed, and it remains to be seen what impact this provision and such regulations will have in years to come on these "debt vs. equity" classification matters.

Financial Support for the Troubled Subsidiary

Clearly, when a corporate taxpayer sees financial difficulties developing in its wholly or partially owned subsidiary, it should give care-

14. It should be noted that while a deduction for partial worthlessness may be taken, it does not have to be taken even though the extent of partial worthlessness can be ascertained. Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F.2d 222, 228 (9th Cir. 1961); Moock Elec. Supply Co., 41 B.T.A. 1209, 1211-12 (1940), *acquiesced in* 1941-1 CUM. BULL. 9.

15. INT. REV. CODE OF 1954, § 166.

16. *Id.* § 165(g)(3).

17. Under INT. REV. CODE OF 1954, § 381(c)(1), the parent, of course, would succeed to the subsidiary's net operating loss carryover in future periods; for a good general discussion, see Dixon, *Liquidation of an Insolvent Subsidiary*, 50 TAXES 514 (1972).

18. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.05 (1971).

ful consideration to what tax treatment and ultimate tax benefit it can anticipate from any further transfusion of funds into the troubled affiliate. Given, for example, a corporate taxpayer which has already made a significant investment in a subsidiary, then, what kind of a tax outlook does it face in giving further financial support to the troubled subsidiary, or in seeking to salvage something from its investment or prior advances to such subsidiary. Obviously, the initial business consideration in this situation must be whether any further financial support is warranted as a matter of business judgment. However, an important corollary certainly ought to be the likely tax result if the subsidiary fails despite the additional transfusion of funds. Too often even in "death bed" situations, this tax corollary is overlooked, and only when the demise of the subsidiary has become a reality does the parent corporation come to realize it will get little or no tax benefit from its further advances.

While the various factors which apply in the debt versus equity area continue to apply in these financially troubled subsidiary situations, when advances are made to such a subsidiary, a strong, if not conclusive, presumption arises that such advances are capital investment. A leading case in this regard was *American Cigar Co. v. Commissioner*,[19] in which it was held that advances made under a belief that they were worthless and uncollectible and could not be repaid, were capital contributions. Similarly, where the taxpayer immediately charged off the advances as worthless and uncollectible, it was held the same were capital contributions.[20]

Several more recent cases have looked to the solvency of the debtor corporation at the time the advances were made and have held that if the debtor corporation was insolvent, the advances were capital contributions.[21] The case of *Arlington Park Jockey Club, Inc. v. Sauber*[22] is typical of a case of advances made to an insolvent subsidiary. There

19. 66 F.2d 425, 427 (2d Cir.), *cert. denied*, 290 U.S. 699 (1933).

20. Reading Co. v. Commissioner, 132 F.2d 306, 310 (3d Cir. 1942). *But see* Los Angeles Shipbuilding & Drydock Corp. v. United States, 166 F. Supp. 914, 920 (S.D. Cal. 1958), *vacated*, 289 F.2d 222 (9th Cir. 1961), where it was held that advances to a wholly owned subsidiary over a period of several years would not be deemed capital merely because the subsidiary was undercapitalized.

21. "Solvency" in tax cases is held to mean solvency in terms of bankruptcy rather than in equity. Thus, the question is whether the fair value of the assets exceeds the amount of the taxpayer's debts not merely whether the taxpayer can pay his debts as they mature. *Cf.* Swiss Colony, Inc., 52 T.C. 25, 35 (1969); Northern Coal & Dock Co., 12 T.C. 42, 48 (1949); Rev. Rul. 68-602, 1968-2 CUM. BULL. 135.

22. 262 F.2d 902 (7th Cir. 1959).

two corporate taxpayers, each engaged in operating race tracks, in 1947 formed a jointly owned subsidiary to purchase the Los Angeles Dons professional football team. Each corporation made an initial capital investment as well as initial loans on an interest-bearing note. In 1948, after the Dons had operated at a loss for 14 months, each shareholder advanced an additional $100,000, and, finally, after further unsuccessful operations, they each advanced further funds to pay off remaining current liabilities of the insolvent subsidiary at a time when they finally were able to find a buyer for the team. The court, in affirming the district court holding that all of the advances were capital contributions,[23] emphasized that even taxpayers' counsel conceded that advances made when the corporation was insolvent and faced bankruptcy could not be deemed loans since there could be no expectation of repayment.[24]

In certain special situations it would seem possible that, despite the stressed finances or insolvency of the debtor corporation, the corporate shareholder might be able to avoid capitalizing its continued advances if it can establish that the expenditures were made by the parent to promote and protect its own business.[25] Thus, if the debtor corporation were a distributor or outlet for the corporate shareholder's product, or an important source of supply of product required in the shareholder's business, the continued financial support would not necessarily be viewed as representing an intended investment. Similarly, financial support represented by a line of credit or by open accounts receivable would not generally be treated as a capital investment if they become uncollectible.[26] The fact that the parent corporation has accrued and recognized income on the sales to a subsidiary represented by the accounts receivable should justify a write-off as a bad debt when the account proves uncollectible.[27]

Frequently, corporate taxpayers who have made advances to a wholly owned or a partially owned subsidiary which has become insolvent are faced with the additional problems of making good on earlier guarantees or contractual commitments. In these cases the fact of the

23. *Id.* at 906.
24. *Id.* at 906; *see* Texas & Pac. Ry., 12 P-H Tax Ct. Mem. 507, 510 (1943); Scotland Mills, Inc., 34 P-H Tax Ct. Mem. 293, 304 (1965).
25. The deduction then would be as trade or business expenses under section 162. *See* Christie Coal & Coke Co., 38 P-H Tax Ct. Mem. 529 (1969).
26. Christie Coal & Coke, 38 P-H Tax Ct. Mem. 529, 552 (1969); Scotland Mills, Inc., 34 P-H Tax Ct. Mem. 293, 305 (1943).
27. Christie Coal & Coke, 38 P-H Tax Ct. Mem. 529, 559 (1969).

intervening insolvency is generally disregarded, and such payments may be treated by the corporate shareholder as a bad debt if the subsidiary was solvent when the guarantee or commitment was made.[28]

Another situation may arise where the corporate taxpayer is called upon to forgive or cancel a part of the indebtedness owing to it by its wholly or partially owned subsidiary. An early and favorable court decision dealing with this situation was *Giblin v. Commissioner.*[29] In reversing a decision of the Tax Court, the Fifth Circuit held that if the debtor corporation was insolvent both before and after the release of the indebtedness, such cancellation resulted in a deductible bad debt for the shareholder corporation.[30] The court rejected a contrary holding of the Sixth Circuit[31] and that court's apparent reliance on treasury regulations and decisions which dealt with the effect on the debtor corporation of a gratuitous forgiveness of debt by a shareholder.[32] The underlying assumption, of course, in the *Giblin* situation is that the indebtedness involved would be recognized as debt at the time it was created under the ordinary rules applicable in debt vs. equity determinations.[33] The theory applied by the court in *Giblin* is arguably sound: if the corporation is still insolvent after the forgiveness, there will be no increment in the stockholders' equity as a result of the release of the indebtedness. Accordingly, it would be inequitable to treat the amount of debt forgiven as a capital contribution.[34] On the other hand, if the debtor corporation becomes solvent by such forgiveness, then

28. Shiman v. Commissioner, 60 F.2d 65, 66-67 (2d Cir. 1932); Goerge B. Markle, Jr., 17 T.C. 1593, 1598-99 (1952); Daniel Gimbel, 36 B.T.A. 539 (1937).

29. 227 F.2d 692, 699 (5th Cir. 1955); *cf.* Drown v. United States, 203 F. Supp. 514 (S.D. Cal. 1962).

30. Giblin v. Commissioner, 227 F.2d 692, 699 (5th Cir. 1955).

31. Bratton v. Commissioner, 217 F.2d 486, 489 (6th Cir. 1954).

32. Giblin v. Commissioner, 227 F.2d 692, 698 (5th Cir. 1955). *But see* Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241, 243 (2d Cir. 1956); Charles E. (Pat) Boone, CCH Tax Ct. Mem. Dec. 32,633(M) (1974).

33. See discussion pp. 775-78 *supra*.

34. In Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241 (2d Cir. 1955), the court in following the Sixth Circuit *Bratton* decision, suggests that if the debtor does not have income but only a contribution to capital from a shareholder's debt forgiveness, "[c]onsistency requires that both parties treat it alike." *Id.* at 243. While this is a questionable premise, it should be noted that under the general principles applicable to the question of the realization of income from forgiveness of debt, income is held to be realized only to the extent assets are "freed up," that is, only to the extent the debtor has been made solvent by the forgiveness. United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); Harden Co. v. Commissioner, 118 F.2d 285, 286 (5th Cir.), *cert. denied*, 314 U.S. 622 (1941); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); Main Properties, Inc., 4 T.C. 364, 379-80 (1944); Lakeland Grocery Co., 36 B.T.A. 289, 292 (1937); Rev. Rul. 58-600, 1958-2 CUM. BULL. 29.

such reasoning would lead to the conclusion that a contribution to capital has occurred. If that is the result, it would seem clear that a corporate shareholder by forgiving indebtedness of a subsidiary could avoid having the indebtedness treated as a capital investment with no immediate tax benefit. This would occur by the simple expedient of forgiving, at least as an initial step, only so much of the indebtedness as would not make the subsidiary solvent. If the doctrine of *Giblin* is correct, then where solvency has resulted for the subsidiary, the corporate shareholder hopefully could still treat as a bad debt the portion of the debt forgiven—up to the point at which the debtor became solvent—and would then be required to capitalize only the excess. This would avoid the formalistic and structural result of *Giblin.* Clearly, however, if the corporate shareholder had accepted additional stock for the cancelled indebtedness, it would seem that the intent was to make a capital investment, and no bad debt deduction should be allowed.[35] Moreover, if the forgiveness is for the purpose of affording some direct or indirect benefit to the corporate shareholder, *as a shareholder,* it would appear that a bad debt deduction may not be allowed.[36]

The Specter of Schlumberger Technology

The opinion has been generally held that any distinction between business loans and nonbusiness loans applies only to transactions involving individuals, and, therefore, only to individual shareholder loans to their corporations and not intercorporate loans. This is, of course, a natural inference from the interaction of sections 166(a) and 166 (d).[37] However, in a 1971 decision, the Fifth Circuit in *Schlumberger Technology Corp. v. United States*[38] indicated that the same distinction

35. Ledgerwood Mfg. Co., 229 F.2d 241, 243 (2d Cir. 1955); W.A. Krueger Co., 36 P-H Tax Ct. Mem. 1033, 1036 (1967).

36. Finkel v. Commissioner, 295 F.2d 840 (1st Cir. 1961) (debt forgiven to facilitate a sale of stock). It is interesting to speculate, however, whether if the debt had been forgiven unconditionally and independent of the stock sale, a different result would not have followed. Certainly, if the shareholder debt forgiven is disproportionate to the stock ownership, such a result would be consistent with cases allowing loss on an unconditional and gratuitous surrender of stock in a corporation. Estate of Foster, 9 T.C. 930, 936 (1947), *acquiesced in* 1948-1 CUM. BULL. 2; Julius C. Miller, 45 B.T.A. 292, 298-99 (1941), *acquiesced in* 1941-2 CUM. BULL. 9; *see* discussion pp. 789-90 *infra.*

37. An interesting situation arises where loans made by an individual to his corporation, which would be nonbusiness loans, are subsequently transferred to another corporation controlled by the same individual. If these loans thereafter become worthless, they would be deductible as a business bad debt under section 166. *See* Earle v. W.J. Jones & Son, 200 F.2d 846 (9th Cir. 1952).

38. 443 F.2d 1115 (5th Cir. 1971), *aff'g in part, rev'g in part* 305 F. Supp. 1020 (S.D. Tex. 1969).

can apply to corporations in loans to their subsidiaries.

Schlumberger, the parent, was engaged in measuring physical phenomena in the earth and atmosphere and related business, when it acquired the stock of two unrelated corporations, one of which was engaged in the manufacture and sale of analog computers, and the other of which was engaged in the manufacture and programming of electronic systems. In addition to its purchase of the stock, the parent also advanced funds to each subsidiary on interest-bearing notes. Neither subsidiary was successful, and the parent, therefore, disposed of the stock at a loss and sold or retired the notes for less than their face values. The parent claimed the losses incurred on the notes as worthless debts, but the Internal Revenue Service challenged its right to an ordinary loss, not under section 166, but rather under section 1232.[39] Under this latter section amounts received on retirement of bonds, debentures, notes, certificates or other evidences of indebtedness issued by a corporation are treated as having been received on a sale or exchange, so that, except for original issue discount, capital gain or loss is recognized if the obligation was a capital asset in the hands of the holder. The service contended that the subsidiary's notes were capital assets in the hands of the parent and so it could have only a capital loss upon their retirement.

The district court held that the acquisition of one of the subsidiaries was as an investment and not an integral part of the conduct of the parent's own business.[40] Accordingly, it concluded that the debt obligation of that subsidiary was a capital asset subject to section 1232, and that the loss of the parent, therefore, was a capital loss.[41] While the Fifth Circuit reversed the finding that the advances to that subsidiary were investment-related and found a business reason for them, it did not reject the principle enunciated by the lower court that if the note had the character of an investment only, a capital loss under section 1232, rather than an ordinary loss under section 166, would be allowable.[42]

39. INT. REV. CODE OF 1954, § 1232(a)(1).

40. Schlumberger Technology Corp. v. United States, 305 F. Supp. 1020, 1024 (S.D. Tex. 1969).

41. *Id.* at 1024.

42. Schlumberger Technology Corp. v. United States, 443 F.2d 1115, 1121 (5th Cir. 1971). It would seem in any case where section 165(g)(3) would apply so that the loss on the stock investment would be an ordinary loss on a worthless security, it would be a strange result if the loss on a retirement of a loan could be a capital loss under section 1232, when, if instead of a retirement the note were also worthless, it also would have been an ordinary loss under section 165(g)(2)(C) and section 165(g)(3).

The real significance of *Schlumberger* then is that corporations investing in subsidiaries and making advances to them may be required to establish the motives behind their investment in bad debt cases. Further, while the issuance of notes or other evidence of indebtedness may be important for the purpose of "debt vs. equity" determinations, the parent corporation may face the dilemma that in accepting such documentation for the debt rather than merely relying on book entries, it may be inviting increased exposure under section 1232 if the debt subsequently is discounted or satisfied at less than face value.[43] Moreover, if the threat of *Schlumberger* can exist in a wholly owned subsidiary situation, it would seem that this doctrine must be of greater concern in dealing with the advancing of funds to partially owned subsidiaries, especially where the taxpayer corporation may own only a minority interest in the subsidiary.[44]

Realizing the Loss on the Investment

When a corporate shareholder decides to extricate its investment in a subsidiary, another set of problems arises. Of course, if the subsidiary's assets and business are merely liquidated or sold and all of the proceeds are used to pay off creditors other than the parent, the parent corporation then has realized a deductible loss on a worthless security. If the parent corporation owned 80 percent of the voting power of all classes of stock,80 percent of each class of nonvoting stock of the subsidiary (other than preferred stock), and 90 percent of the gross receipts of the subsidiary during its existence has been other than passive or investment-type income as specified in Section 165(g)(3) of the Code, an ordinary loss, rather than a capital loss, would result.[45] This advan-

43. The term "retirement" as used in section 1232 presumably means any reacquisition of the debt instrument by the issuing corporation and, therefore, is to be given no narrower meaning than its accepted meaning in common speech. Thus, a surrender to the issuing corporation for only a trifling consideration where the holder would have been better off to refuse to surrender the obligation and take a bad debt charge-off, is a retirement within the meaning of the statute. McClain v. Commissioner, 311 U.S. 527, 529 (1941).

44. Perhaps some comfort can be taken from the fact that under the *Corn Products* doctrine, the courts have narrowed the definition of capital asset to exclude items which are an integral part of the taxpayer's business and that this has been applied to include securities. Corn Prod. Ref. Co. v. Commissioner, 350 U.S. 46 (1955); Booth Newspapers Inc. v. United States, 303 F.2d 916, 921 (Ct. Cl. 1962); *see* Javaras, *Corporate Capital Gains and Losses—The Corn Products Doctrine,* 52 TAXES 770 (1974); Surrey, *Definitional Problems in Capital Gain Taxation,* 69 HARV. L. REV. 985, 993 (1956).

45. For a good general review of the alternative application of section 332 and section 165(g)(3), see Dixon, *Liquidation of an Insolvent Subsidiary,* 50 TAXES 514 (1972).

tageous result could motivate a parent to seek to increase its percentage of ownership so as to qualify under the statute. Where a corporate shareholder is considering making additional advances to a partially owned subsidiary which under the circumstances might be found to be a capital contribution, it should seek to increase its percentage of stock ownership at that time also so as to qualify for section 165(g)(3) treatment if the subsidiary should later fail. It has been held that if a corporate shareholder buys out another shareholder in a defunct, insolvent subsidiary for the sole purpose of qualifying under the statute, the ordinary loss provision will not apply.[46] If the subsidiary is still operating, however, the mere fact it may be in grave financial difficulty should not preclude recognition of the increased ownership under the statute, at least if this occurs contemporaneously with some other refinancing or credit arrangement involving the subsidiary.[47] In the case of corporate liquidations where a parent sold stock in a subsidiary shortly before it was liquidated so as to reduce its holdings below 80 percent and thereby make the liquidation taxable, section 332 will not apply to prevent that result.[48] Moreover, it has also been held that even if all of the assets of an insolvent, wholly owned subsidiary are transferred to the parent in complete liquidation of the subsidiary, and the parent thereafter continues to operate the business of the former subsidiary, a bad debt deduction and a worthless security deduction may be taken as long as the debt exceeds the fair market value of the assets transferred.[49]

Frequently, of course, the insolvent subsidiary will have net operating loss carry-overs which will play a significant part in the parent corporation's decision as to how the elimination of the investment in the subsidiary should be handled. If the parent merely sells its stock in the subsidiary, the net operating loss will pass with the corporation to its new

46. Hunter Mfg. Corp., 21 T.C. 424 (1953), *remanded by stipulation*, (3d Cir. 1955); Treas. Reg. § 1.165-5(d)(2)(ii) (1972).

47. *Cf.* Gussow, Kahn & Co., 13 T.C. 580 (1949).

48. Granite Trust Co. v. United States, 238 F.2d 670, 675 (1st Cir. 1956); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945). If section 332 does not apply, the subsidiary may realize a loss as well on its transfer of assets to the parent in partial discharge of its indebtedness to the parent. Northern Coal & Dock Co., 12 T.C. 42 (1949).

49. Rev. Rul. 70-489, 1970-2 CUM. BULL. 53. This result would apply equally in a merger of the insolvent subsidiary into a parent. Rev. Rul. 59-296, 1959-2 CUM. BULL. 87. If P cancels the debt of insolvent S and then immediately liquidates S, the cancellation of the debt will be disregarded in determining whether section 332 applies. Rev. Rul. 68-602, 1968-2 CUM. BULL. 135.

owners.[50] On the other hand, if the subsidary sells its assets and then liquidates under section 332, the parent will realize no loss on its stock investment, but will succeed to the subsidary's net operating loss under section 381.[51] An interesting potential double tax benefit of the loss in an 80 percent-owned subsidiary[52] seems possible in some parent-subsidiary situations where the parent has also made loans to the subsidiary. The following example illustrates the point.

> Parent A incorporates Subsidiary B and invests $100,000 as an initial capital investment. It subsequently lent another $200,000 to Subsidiary B in a factual situation in which the loan would be recognized as debt for income tax purposes. B thereafter encountered difficulties and incurred a net operating loss in the following year of $310,000. In order to assist B in obtaining credit from its trade creditors, Parent A then cancelled the $200,000 debt, but inasmuch as B was still insolvent after the forgiveness, A deducted the loan as a bad debt under the rationale of the *Giblin* decision.[53] After a period of continued operations, it finally concluded that B, even though having realized some intervening profits of $35,000, should be liquidated into the Parent. The assets of B, subject to its liabilities, were transferred to A in complete liquidation of B; said assets having a net value, after allowance for the liabilities assumed, of $25,000.

In this example section 332 prevents the parent from deducting its $75,000 loss on the investment in the subsidiary's stock, but it may assume whatever was the basis of the acquired assets. The parent also succeeds to the subsidiary's net operating loss carry-overs of some $275,000[54] which it can then use to offset its future operating income regardless of whether such income is generated from a totally different business or whether the business of the liquidated subsidiary is or is

50. Subject, of course, to the limitations of INT. REV. CODE OF 1954, § 382(a).

51. In this case the net operating loss can be carried forward only by the parent as contrasted with a slightly net operating loss of the parent itself generated by section 165(g)(3) where a carryback would be available. *See generally* Dixon, *Liquidation of an Insolvent Subsidiary,* 50 TAXES 514, 515 (1972). It also can be important in these liquidation of subsidiary matters to consider fully the tax benefit which may be possible with respect to intangibles such as goodwill being carried on the books of the subsidiary. If trade names, a product line, a distribution system, or a going concern are being abandoned as an incident to the liquidation, an ordinary loss deduction may be available. *See* Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220 (1972), *acquiesced in* 1973-26 CUM. BULL. 5. For a general discussion of loss of goodwill, see Penner, *Tax Consequences of Loss of Goodwill,* 34 TEX. B.J. 971 (1971).

52. That is, where section 165(g)(3) and section 332 apply.

53. Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955). Also, under the principles referred to in note 34, the subsidiary would have no income on such forgiveness and so its net operating loss is not affected.

54. INT. REV. CODE OF 1954, § 381(c)(1).

not continued. The effect, however, is that $200,000 of such net operating loss carry-over really represents the subsidiary's losses which were funded by the parent's loans, and the parent has also already enjoyed an ordinary loss bad debt deduction for that amount. Thus, a double deduction appears to be a possibility in that case, at least if the doctrine of *Giblin* applies.[55] In fact, there might even be situations where a further multiplication of tax benefit could be effected. For example, what would result if the parent had invested its $300,000—the capital investment of $100,000 and the loan of $200,000—in a wholly owned, previously operating profitable Subsidiary No. 1, and Subsidiary No. 1, in turn, made the stock investment and loans to Subsidiary No. 2 (Subsidiary B in the example). Then, if after Subsidiary No. 1 had enjoyed the tax benefit of the bad debt deduction on its loan to Subsidiary No. 2 (under *Giblin*) and had realized the benefit of the net operating losses against its operating profits, it was able to distribute all assets relating to its profitable business to the parent as a dividend tax free under Section 243(a)(3) of the Internal Revenue Code. Finally, if the parent sold the stock of Subsidiary No. 1 (consisting of the remaining assets and business of the liquidated Subsidiary No. 2) to an unrelated buyer for $50,000, the possible result could be that the parent would have indirectly benefited from the $200,000 bad debt write-off by Subsidiary No. 1, the $275,000 net operating loss carry-over of Subsidiary No. 2 to Subsidiary No. 1, and, in addition, it would have the benefit of a $250,000 long-term capital loss—all spawned by its single $300,000 investment. The proliferation of tax benefit from such losses could be extended by combining the above concepts and the ordinary loss concept under section 165(g)(3) as well as various alternatives in the timing of various intercorporate transactions. The statutory framework of the Internal Revenue Code does not seem to contain any express direct impediments to such maneuvering of these losses among related corporations. Whether in an appropriate case the courts could find a basis to block or limit such compounding of losses is still undetermined.[56]

The manner and the time at which a parent might seek to extricate

55. Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955).

56. In the case of consolidated returns under sections 1501-1504, this type of duplication of tax benefit is precluded by provisions for the adjustment of investment (that is, basis) in a subsidiary each year to reflect such tax benefits as have been so enjoyed by the corporation other than the loss subsidiary. Treas. Reg. § 1.1502-32 (1972). *See also* National Lead Co., 23 T.C. 988 (1955), *rev'd on other grounds*, 230 F.2d 161 (2d Cir. 1956), *aff'd*, 352 U.S. 313 (1957).

its investment in a subsidiary or charge off its loans to a subsidiary could also be significantly affected in certain situations if the holding in *Mutual Assurance Society of Virginia Corp. v. Commissioner*[57] should prevail over the contrary views taken by the First, Eighth and Ninth Circuits. In this recent case the Fourth Circuit rejected the holding of the Tax Court, which relied on *Charter Real Estate Co.*[58] to the effect that where a net operating loss is carried back and used in computing taxable income as a step in determining a taxpayer's tax for an earlier year under the alternative method of tax on capital gains, the excess of the net operating loss deduction over the *ordinary income* for the earlier year can be carried over to a succeeding year. By contrast, the Fourth Circuit held that even though the net operating loss cannot be used to offset the capital gain in the alternative tax computation[59]—and thus, no part of the alternative tax paid on capital gains for the earlier year would be refundable—such capital gains are included in the term "taxable income" for such earlier year and, therefore, serve to reduce on a dollar-for-dollar basis the amount of net operating loss which may be carried forward to a succeeding year, regardless of the fact that no tax benefit resulted to the taxpayer from that portion of the net operating loss carryback absorbed by such capital gains.[60] It would seem clear that if a parent corporation is facing substantial write-offs of loans to, or investment in, an insolvent subsidiary which would have the effect of generating a net operating loss for the parent, it probably would not want to take the action to "fold" the subsidiary and write off the loss if it had substantial net capital gains in any of the three preceding years which would offset the net operating loss carrybacks under the *Mutual Assurance* holding. On the other hand, even if the subsidiary is solvent and a section 332 liquidation is involved, there would be no problem since the subsidiary's net operating loss, if any, could only be carried over to following years by the parent. Interestingly, the *Mutual Assurance* holding might even mean that by structuring the loss as a capital loss—such as by selling enough stock so as to fall outside of section 332 and realize a capital loss on

57. 505 F.2d 128, 34 AM. FED. TAX. R.2d 74-6022 (4th Cir. 1974), *rev'g* CCH Tax Ct. Mem. Dec. 32,084(M) (1973).

58. The court simultaneously rejected the First Circuit Court of Appeals in Chartier Real Estate Co., 52 T.C. 346 (1969), *aff'd per curiam*, 428 F.2d 474 (1st Cir. 1970); *see* Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974); Olympic Foundry Co. v. United States, 493 F.2d 1274 (9th Cir. 1974).

59. INT. REV. CODE OF 1954, § 1201(a).

60. 505 F.2d 128, 34 AM. FED. TAX. R.2d 74-6022 (4th Cir. 1974); *cf.* Loan Manor Farms, Inc., 61 T.C. 436 (1974).

liquidation of the subsidiary—a greater tax benefit to the parent could result because such capital loss could then be carried back and applied against the capital gain of the earlier year.[61] While the reported cases have involved the carryback of net operating losses only to earlier years, the principle involved is equally applicable to carryovers to following years. Therefore, a parent which similarly had realized a substantial net operating loss which will be of benefit only as a carryover, or had succeeded to a subsidiary's net operating loss under section 332, would seek to refrain from realizing capital gains in the following years until the tax benefit of the net operating losses against ordinary income has been fully realized. The ultimate resolution of the conflict among the circuits on this question remains to be seen. The Fourth Circuit's decision presents at best a sterile, formalistic interpretation with a regrettable and inequitable result. A more visionary and equitable result, comparable to the tax benefit rule of the *Dobson* case,[62] could still be invoked today without judicial apology. By analogy to *Dobson* it would seem reasonable that the net operating loss carryback or carryover ought not to be affected by "taxable income," however defined, where no tax benefit from the net operating loss was realized.

An Alternative to the Sale of a Losing Subsidiary

One final alternative for the recouping of a tax benefit from an intercorporate loss deserves mention. The parent corporation in a situation other than a wholly owned subsidiary may surrender stock to the issuing corporation in lieu of a sale. For example, if Corporation A, which owned 75 shares out of 100 shares in Corporation X at a cost basis of $300,000, feels it could now sell for only $25,000 (thereby incurring a capital loss of $275,000), it would, in lieu of a sale, unconditionally and without consideration surrender 60 of its shares to Corporation X to facilitate a refinancing program for that company. Under the leading case of *Julius C. Miller*,[63] this surrender of stock would result in an ordinary loss deduction of $240,000 for Corporation A (60/75 of $300,000); and it would still own 15 remaining shares

61. INT. REV. CODE OF 1954, § 1212(a). For a good general discussion of tax planning alternatives related to *Chartier*, see Beghe, *Tax Planning for the Financially Troubled Corporation*, 52 TAXES 795, 811-817 (1974).

62. In Dobson v. Commissioner, 320 U.S. 489, 503 (1943), the United States Supreme Court sustained a Tax Court decision which had held that a recovery by a taxpayer of a loss incurred in an earlier year was not includable in income in the year of recovery where the loss in the earlier year had afforded no tax benefit to the taxpayer.

63. 45 B.T.A. 292 (1941), *acquiesced in* 1941-2 CUM. BULL. 9.

at a cost basis of $60,000. In other words, while a loss on stocks or securities will be deductible in almost all cases, the question remains as to *how* it will be deductible—as a capital loss or as a fully deductible ordinary loss. While most losses incurred on stock or securities would arise from a sale or exchange and be a capital loss,[64] a loss on a surrender of stock back to a corporation does not involve a sale or exchange, so the loss on a surrender is similar to an abandonment loss and is an ordinary loss rather than a capital loss. In many cases it follows that a stockholder can surrender a part of his or its shares back to the issuing corporation on a nonproportionate basis and get a fully deductible ordinary loss which has far greater tax benefit than a capital loss would afford. The touchstone for such an ordinary loss treatment is that the shareholder's action must be an unconditional action and without consideration to the taxpayer, which results in a shifting of the proportionate ownership interests among the shareholders. The amount of the loss has been held to be the basis of the stock surrendered, minus the increase in the book value of the remaining shares.[65] This result might even suggest that a corporate shareholder in a partially owned subsidiary holding debt, which, if cancelled, might be said to be a capital contribution, could be in a better position to realize an ordinary loss on such cancellation by first cancelling the debt in exchange for additional stock and then subsequently surrendering such stock to the issuing corporation.[66]

CONCLUSION

The questions of losses on intercorporate investments and loans is particularly timely considering the large number of similar questions and resultant early court decisions that arose during the Depression of the 1930's. Unfortunately, there is a fundamental uncertainty in almost all cases involving loans from a corporation to a wholly or partially owned subsidiary, dependent on whether such loans will be found to be debt or capital investment. There may also be uncertainty as to

64. Under INT. REV. CODE OF 1954, § 165(g), losses on worthless securities, other than in 80 percent affiliates, are deemed to be from a sale or exchange on the last day of the taxable year, and therefore are a capital loss.

65. Charles H. Duell, 29 P-H Tax Ct. Mem. 1532 (1960); Estate of Foster, 9 T.C. 930, *acquiesced in* 1948-1 CUM. BULL. 2.

66. *See generally* Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241 (2d Cir. 1955); Charles E. (Pat) Boone, CCH Tax Ct. Mem. Dec. 32,633(M) (1974); W.A. Kreuger Co., 36 P-H Tax Ct. Mem. 1033 (1967). *But cf.* Rev. Rul. 68-602, 1968-2 CUM. BULL. 135.

whether the subsidiary is solvent or insolvent and what the consequence will be of actions taken to improve the finances of the subsidiary or to liquidate or dispose of it. The matter is not helped by the present conflicting and often inconsistent court decisions. In any event, it should be clear that there are a number of alternative solutions which should be explored when losses develop in intercorporate loan and intercorporate investment situations. Frequently, creative handling of these matters can substantially improve the tax benefit which will flow from the unwinding of such intercorporate transactions.