

Insight

April 2008

Worthless Stock Deduction May Result in Tax Benefits

*“Obtaining a valuation from
an independent valuation
provider is essential...”*

VRC has addressed several situations where a business enterprise value for a particular legal entity is needed to provide support for the worthlessness of a legal entity as a worthless stock investment for its parent. The significance of a worthless stock deduction under Internal Revenue Code (IRC) Section 165(g)(3) is that it represents an ordinary as opposed to capital loss for a U.S. corporate taxpayer. The benefit of ordinary loss characterization is that an ordinary loss can offset both ordinary and capital gains for a company while a capital loss can only offset capital gains.

The general rule under IRC Section 165(g)(3) provides that if a security becomes worthless during a taxable year, the resulting loss will be treated as a sale of exchange of a capital asset, resulting in a capital loss equal to the taxpayer's basis in that asset. IRC Section 165(g)(3) goes on to provide that the loss resulting from a worthless stock deduction may be characterized as an ordinary loss provided the subsidiary is a qualified corporation affiliated with the taxpayer. Meeting the affiliation test requires that the taxpayer own 80% of the vote and value of the subsidiary. In addition, in order to be a “qualified corporation,” more than 90% of the subsidiary's gross receipts historically must have been from other than passive-type income such as royalties, rents, interest, dividends, etc. Assuming that the subsidiary meets the requirements as a qualified affiliated corporation, in order to claim a worthless stock deduction under IRC Section 165(g)(3), the taxpayer has the burden of proving that the security became worthless in the year of deduction and that the security had tax basis. Meeting these requirements is heavily dependent on a taxpayer's specific circumstances.

In order to support that the stock is worthless, a taxpayer must generally prove that 1) the security has no liquidating value and 2) there is a complete lack of future potential value, which is sometimes supported by the occurrence of an identifiable event occurring during the year of worthlessness. An identifiable event would include, but is not limited to, a cessation of business or a sale of substantially all of the assets. As noted above, a key component of support for this deduction is proving that the security has no liquidating value. Obtaining a valuation from an independent valuation provider is essential to the first requirement. The following case studies illustrate the role of valuation in support of IRC Section 165(g)(3) - worthless stock deductions.

CASE STUDIES

1) A multinational company engaged us to provide a valuation of real and personal property of its affiliates located in Denmark and the UK. The purpose of the appraisal was for tax reporting purposes as support for a worthless stock deduction under IRC Section 165(g)(3). Our valuation was a fair market value opinion of equity values on a controlling interest basis.

Our investigation included a review and analysis of the affiliates' operating performance and consultation with their respective management concerning historical and prospective operations. Both affiliates had a history of operating losses without indication of any beneficial change in the foreseeable future. Due to historical and forecasted operating losses we concluded that the Denmark and UK affiliates could not continue to operate as going concerns.

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“Our professional staff has the knowledge and expertise to handle the most complex tax engagements.”

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We determined that radical restructuring would be required in order for the Company to regain a competitive position within its industry. The restructuring would include the closing of the Denmark and UK affiliates and transferring production of these affiliates to locations outside of Denmark and the UK. The closing of the Denmark and UK locations would be an effort to regain a competitive position in the industry. Consequently, a cost approach using orderly liquidation values was used to estimate the equity values for the Denmark and UK locations.

2) For a multinational company in the construction equipment industry we were engaged to value the equity of its Australian subsidiary. The purpose of the valuation was for tax reporting purposes as support for a worthless stock deduction under IRC Section 165(g)(3). Our investigation included a review and analysis of the subsidiary’s operating performance and consultation with their respective management concerning historical and prospective operations.

Our investigation showed that while restructuring and cost improvement programs were partially successful, operating losses continued. Due to historical and forecasted operating losses we concluded that the subsidiary could not continue to operate as a going concern. For this reason, a cost approach using orderly liquidation values was used to estimate the equity values for the subsidiary.

RELY ON THE EXPERTS

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