NONDOCKETED SIGNIFICANT ADVICE REVIEW

CHIEF COUNSEL
OFFICE MEMORANDUM
FIELD ASSISTANCE

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Office: CC:IT&A:01

Date: May 31, 2001

Taxpayer (Name/EIN): [redacted]
CATS/TECHMIS No.: TL-N-1826-99

Audit	Appeals	Litigation	CEP	ISP
Y X N___	Y__ N__	Y__ N X	Y__ N__	Y__ N X

Facts:

[redacted] claims that it is entitled to deduct worthless stock held in [redacted] in tax year [redacted]. In its initial advice to Exam, Area Counsel concluded that [redacted] had not established that it was entitled to a worthless stock deduction in [redacted] since it did not present sufficient evidence that [redacted] stock lacked potential value at the close of that year. Area Counsel further asserted that [redacted] was still operating in [redacted] in [redacted] through the year [redacted] and that [redacted] funded [redacted] through [redacted]. Area Counsel advised Exam to request from [redacted] further evidence that [redacted]'s stock had no potential value in [redacted].

Thereafter, [redacted] provided the following additional information to Exam: all of [redacted]'s activities undertaken after [redacted] pertained to fulfilling its obligations under various leasehold contracts entered into before [redacted] and no plans to [redacted] were carried out after that date. Based on this information, Area Counsel has revised its prior advice to Exam to conclude that [redacted]'s stock had no potential value after [redacted] and, therefore, [redacted] is entitled to a worthless stock deduction for tax year [redacted].

In a telephone conversation with docket attorney Norma Rotunno on May 25, 2001, you explained that after [redacted] owned very few assets and the few assets it owned were far exceeded by its liabilities. Its liabilities stemmed mainly from its obligations under existing leasehold contracts. After [redacted]'s sole activities consisted of satisfying these liabilities by paying the other contracting parties to be released from its obligations under the contracts, and shutting down its business operations. The remainder of [redacted]'s liabilities after [redacted] were related to the shutdown of its business operations.

Issue:

Whether [redacted] is entitled to a worthless stock deduction for stock held in [redacted] under section 165(g) in tax year [redacted].

Analysis:

Section 165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss shall be treated as a sale or exchange on the last day of the taxable year of a capital asset. Section 165(g)(2) defines a security to include a share of stock in a corporation. Treas. Reg. § 1.165-1(a) provides that a loss may be deducted only in the taxable year in which it is sustained, as long as the loss is not canceled out through insurance or some other type of compensatory payment.

Treas. Reg. § 1.165-5(d) provides that a worthless stock deduction cannot be taken unless the taxpayer can show that the stock is completely worthless. The taxpayer must prove with objective evidence whether the stock in question was wholly worthless at the close of the tax year. Boehm v. Commissioner 326 U.S. at 292.

A deduction for worthless stock is allowed only when the taxpayer can show that the company's stock has neither liquidating nor potential value. Morton v. Commissioner, 38 B.T.A. 1270, 1278 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940), nonacq., 1939-1 C.B. 57. Liquidating value of a stock is generally determined by examining the company's asset value, derived from a comparison of total assets and total liabilities. Shipley v. Commissioner, 17 T.C. 740, 743 (1951); Morton, 38 B.T.A. at 1278, 1279.

Although a stock may lack liquidating value in a particular year, a taxpayer must also show that it lacks potential value in order to prove worthlessness. Delk v. Commissioner, 113 F.3d 984, 986 (9th Cir. 1997). A stock has potential value if the facts and circumstances indicate that there is reasonable hope and expectation that the company's foreseeable future operations will create liquidating value. Austin v. Commissioner, 71 T.C. 956, 970 (1979); Morton, 38 B.T.A. at 1278-1279. However, a taxpayer's hope and expectation for the company's future operations must be based on reasonable and realistic factors. See Steadman v. Commissioner, 50 T.C. 369, 378 (1968) (existence of one optimistic report on future of company not sufficient to negate worthlessness where substantial recapitalization of company was required). If there is only a remote chance that the stock can have value in the future, then a worthlessness deduction may be taken. Marsh v. Commissioner, 38 B.T.A. 878, 902, 903 (1938), acq., 1938-2 C.B. 20.

A taxpayer must carefully examine the activities of a corporation to determine whether or not they show any reasonable hope or expectation of future solvency. See Tippin v.

Commissioner, T.C. Memo. 1988-284. Cessation of business is not a factor conclusive to negating potential value but, conversely, continuation of the business is equally inconclusive, absent any strong indication that the continuation of business would result in any profit to the shareholders. Smith v. Helvering, 141 F.2d 529 (D.C. Cir. 1944); Frazier v. Commissioner, T.C. Memo. 1975-220. In examining whether a company's continued operation negates a worthlessness determination, a distinction must be made between activities related to making the company profitable and continuing its business, such as expanding its facilities and embarking on new projects, versus those activities related to completing commitments, terminating a business and finding ways in which to pay creditors. Boehm, 326 U.S. at 294. In Wally Findlay Galleries Int'l. & Subs. v. Commissioner, T.C. Memo. 1996-293, the Tax Court denied a worthless stock deduction despite the subsidiary's insolvency where the parent canceled intercompany debt and contributed capital to increase the subsidiary's value and marketability. Similarly, in Hawkins v. Commissioner, T.C. Memo. 1987-91, taxpayer's regular advancement of money to company negated worthless stock claim, despite company's liquidation of assets and defaults on debts. In contrast, the Tax Court has allowed a worthless stock deductions even though a company continued to operate where its operations were confined to winding up its affairs and completing existing commitments. Forbes v. Commissioner, 62 F.2d 571, 574 (4th Cir. 1933); Austin Co. v. Commissioner, 71 T.C. 955, 970 (1979); Frazier v. Commissioner, T.C. Memo. 1975-220, 34 T.C.M. at 963.

The ultimate determination of worthlessness is one of fact, and is made by examining all of the circumstances of each case. Boehm v. Commissioner, 326 U.S. 287, 293 (1945), reh'g. den., 326 U.S. 811 (1946) (timing of deductions requires not a legal test, but a practical, fact-sensitive test).

A loss is evidenced by closed and completed transactions and fixed by identifiable events. Treas. Reg. § 1.165-1(b). Such events clearly end all reasonable hope and expectation that the company will have potential value. Morton v. Commissioner, 38 B.T.A. at 1278, 1279. Identifiable events include: sale of the company's assets, cessation of business, revocation or surrender of the corporate charter, or bankruptcy and the appointment of a receiver to take over the company's assets and business. Morton v. Commissioner, 38 B.T.A. at 1278. None of these factors, alone, is dispositive. The occurrence of a single identifiable event is usually insufficient to establish worthlessness. All of the facts and circumstances must be examined before a conclusion is made as to potential value. Boehm, 326 U.S. at 292-293.

Even if an "identifiable event" does not occur, a taxpayer may show that a company's stock has lost all potential value when its "liabilities are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders." Morton, 38 B.T.A. at 1278, 1279. Such an exceptional case exists

where a company is so financially depressed that it is extremely unlikely to recover. Id. Thus, a deduction for worthlessness may be allowed despite the occurrence of an identifiable event if the above criteria are met.

In the present case, we agree that based on the evidence provided [redacted] appears to have lacked both liquidating value and potential value by the close of tax year [redacted]. As noted above, [redacted]'s liabilities far exceeded its assets at the close of the [redacted] tax year. Even though [redacted] continued its business after the [redacted] tax year, all of [redacted]s activities after [redacted] were conducted for the sole purpose of satisfying pre-existing obligations under its prior leasehold contracts and shutting down its operations. [redacted]s activities after [redacted] were not related to pursuing its normal business of oil and gas exploration, entering into new leasing agreements for further exploration, seeking new investors, or raising capital for the continuation of its business. Any funding taxpayer provided to [redacted] was used to buy [redacted]'s way out of existing leasehold contracts and to satisfy liabilities relating to the shutdown of its operations. Despite the fact that one of the above-mentioned identifiable events which would aid in negating the potential value of [redacted]s did not occur in tax year [redacted], taxpayer has presented sufficient evidence to show that there was no reasonable hope or expectation that [redacted]'s foreseeable future operations following tax year [redacted] would result in any profit to its shareholders. See Morton, 38 B.T.A. at 1278, 1279.

Further Action Needed: Y___ N X

Reviewed by: [signature]

Office: CC:IT&A:B01 Date: 5/31/01

E.J.