Deloitte.

M&A Tax Talk
Distressed market series

Economic disruption and tax losses: Restructuring businesses at depressed valuations

In a matter of months, the world has endured significant changes, with many businesses temporarily shuttering and economic activity curtailed in response to the COVID-19 pandemic. Because of this economic disruption, valuations for businesses have declined, sometimes substantially. Likewise, tax planning has been redirected. That is, business restructurings today may be less focused on transactions that reduce taxable gain (for example, through a tax-free spin-off) and more focused on the impact of unrealized tax losses.

Common situations involving restructurings

Tax consequences can be important considerations in corporate restructurings, especially for taxpayers with unrealized tax losses. The underlying business rationale of a corporate restructuring may be bolstered by focusing on the use of unrealized tax losses. The approaches outlined below are intended to illustrate a few situations involving losses in subsidiary stock, but losses may also be present in divisional assets. The three situations described are not universally applicable, but are limited to specific fact patterns.

Granite Trust scenario: Planning for a taxable liquidation

A corporate taxpayer contemplating a business restructuring may discover that it has a built-in gain in assets it plans to dispose of and an unrealized loss in other assets it seeks to retain. In a *Granite Trust* transaction, a corporate taxpayer could claim a capital loss on the liquidation of a subsidiary with an unrealized loss and off-set gain recognized on disposition of another subsidiary that has appreciated in value.[1]

Consider the following: Parent (P1) owns all the stock of two domestic subsidiaries (S1 and S2). The stock of S1 is highly appreciated, but the value of stock of S2 has declined significantly because of the economic disruption caused by the COVID-19 pandemic. P1 plans to sell S1 for cash in a taxable transaction and use the funds to continue the S2 business. The sale of S1 would trigger a significant income tax liability that P1 would like to offset with the unrealized loss in the stock of S2 while retaining the S2 business.

P1 is generally precluded from recognizing a loss in subsidiary stock on the liquidation of an 80 percent or greater owned subsidiary, such as S2.[2] However, in a *Granite Trust* transaction, P1 may be able to recognize a capital loss on the liquidation of S2 when, as part of the business restructuring, P1 reduces its ownership in S2 so that a tax-free liquidation is not available. Typically, P1 will reduce its ownership in S2 by selling some of the S2 stock to an affiliate that is not included in P1's consolidated tax group, such as a foreign subsidiary or a partnership that is owned by members of the P1 consolidated tax group. The capital loss recognized on the liquidation of S2 may then be used to offset the capital gain recognized on the sale of S1.

Granite Trust transactions raise several issues the company and its tax advisers should consider, including (i) whether the taxable liquidation of S2 may be recharacterized as a tax-free reorganization, (ii) whether the loss on the preliquidation sale of some of the S2 stock may be deferred, and (iii) the amount of potential gain S2 may have in its underlying assets that would be triggered by the liquidation of S2.

Worthless stock scenario

As part of a strategic review, a corporate taxpayer may determine that a subsidiary is insolvent (that is, liabilities exceed the fair market value of the subsidiary's assets). Insolvency alone is generally not sufficient to establish a deduction for tax purposes; however, certain actions taken during insolvency may permit a taxpayer to take a worthless stock deduction.

If an affiliated[3] domestic or foreign corporate subsidiary is insolvent,[4] Section 165(g) presents a potential opportunity for a domestic parent to recognize a loss through a worthless stock deduction.[5] The loss is usually a capital loss; however, if certain conditions are satisfied, the loss may be treated as an ordinary loss that may (i) offset profits in the current year, (ii) be carried back under the new limited five-year carryback rules enacted under the CARES Act, or (iii) be carried forward to offset future earnings of the business.

Consider the following: Parent 2 (P2) purchased the stock of a subsidiary (S3) for $100x. A significant portion of the purchase was financed through debt at S3. The recent economic disruption caused S3 to temporarily close, resulting in a significant decrease in value of S3's business, rendering it currently insolvent. A business restructuring based on "worthless stock deduction" planning may permit P2 to recover its $100x investment in S3, which may be an ordinary loss.

In the example above, for P2 to claim an ordinary worthless stock deduction, P2 must show that (i) it owned at least 80 percent of the voting power and value of S3, (ii) S3 satisfies a gross receipts test,[6] (iii) the stock of S3 became worthless in the year the deduction is claimed, and (iv) worthlessness is permanent through an identifiable event.

Determining whether an insolvent company is worthless has been the subject of controversy between the IRS and taxpayers. An IRS Revenue Ruling concluded that a liquidation of an insolvent subsidiary, including a deemed liquidation achieved by converting such subsidiary from a corporation to an LLC, is an identifiable event that establishes worthlessness *provided* the parent company does not receive *any* consideration for the stock of the subsidiary (or with respect to a particular class of the subsidiary's stock).[7]

Spin-off loss scenario

A corporate taxpayer may find that a business it plans to spin off contains assets with unrealized losses. With proper planning, a taxpayer may undertake a corporate restructuring that achieves the dual goals of (i) a taxable transaction at the corporate level, where unrealized losses are recognized, and (ii) a tax-free spin-off to the taxpayer's shareholders.

Consider the following: During 2019, Parent 3 (P3) announced its intention to distribute all the stock of its wholly owned subsidiary (S4) to shareholders in a tax-free spin-off. At the time of the announcement there was significant gain in S4's stock. However, due to the recent economic downturn, the stock of S4 has decreased in value to the point that P3 now has an unrealized loss in the stock of S4. P3 still plans to distribute the stock of S4 to its shareholders in a tax-free spin-off, but would also like to obtain a benefit for the unrealized tax losses.

Planning that allows for this result has been approved by the IRS in several private letter rulings.[8] One such mechanism is a "busted Section 351 transaction." To illustrate the busted Section 351 transaction, P3 could contribute the stock of S4 to a newly formed corporation (Newco) in exchange for common stock and "plain vanilla" preferred stock, and then sell the preferred stock to a third party pursuant to a binding commitment. P3 would recognize the loss inherent in the stock of S4 because the transfer to Newco would not meet the technical requirements for tax-free contributions under Section 351 (due to the failure of the control requirement).[9] To accomplish the tax-free spin-off, P3 contributes the stock of Newco to a newly formed holding company (SpinCo) in exchange for all the common stock of SpinCo. P3 then distributes the stock of SpinCo to its shareholders.

This relatively simple fact pattern raises a number of issues that the company and its advisers must consider carefully.

Conclusion

The situations above highlight the importance of proper tax planning as part of an overall business restructuring when unrealized tax losses are present. With continuing market volatility and depressed valuations, companies should reassess their current tax profile as part of any corporate restructuring. Once a company identifies potential unrealized tax losses in subsidiaries (or divisional assets), it should consult with its tax advisers to determine whether the particular restructuring situation affords an opportunity to realize such tax losses and, if so, consider a restructuring that causes a recognition and monetization.

Want to learn more?
Reach out to our contacts below:

Andrew Maki
Mergers & Acquisitions
Tax Partner
amaki@deloitte.com
Deloitte Tax LLP

Raffi Baroutjian
Washington National Tax
Tax Principal
rbaroutjian@deloitte.com
Deloitte Tax LLP

Endnote

1. *The situation is named after an early case, Granite Trust Co., v. U.S., 238 F.2d 670 (1st Cir. 1956), which used a similar structure.*
2. *See Section 332 (tax-free liquidation of certain 80 percent or greater subsidiary).*
3. *See Section 1504(a)(2) (requiring the parent corporation to own at least 80 percent of the total voting power and value of the subsidiary).*
4. *If the subsidiary has both common and preferred stock outstanding, a worthless stock deduction may be available on the common stock to the extent no consideration is available to the common stock after paying off the creditors and the preferred shareholders. See Spaulding Bakeries, Inc. v. Commissioner, 252 F.2d 693 (2d Cir. 1958).*
5. *Corporations should be aware that the ability to claim a worthless stock deduction in this fact pattern is also available if a corporation disposes of the stock of its insolvent subsidiary to an unrelated third-party buyer. The transaction must be structured so that the corporation receives no consideration for its subsidiary stock, allowing the corporation to claim a worthless stock deduction for the subsidiary stock. In the context of a disposition, the IRS has permitted taxpayers to structure the transaction as qualifying for a deemed asset sale and liquidation under Section 338(h)(10), resulting in the worthless stock deduction that can offset the gain on the deemed asset sale.*
6. *See Section 165(g)(3)(B) (Requiring more than 90 percent of the aggregate of the subsidiary's gross receipts for all taxable years to have been from sources other than royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock and securities).*
7. *See Rev. Rul. 2003-125 I.R.B. 2003-53 (2003).See PLR 200422003 (Feb. 13, 2004) (Taxpayer allowed to recognize a multimillion-dollar loss that was intentionally triggered in spin-off following a "busted" Section 351 exchange and a Section 311 transfer). See also PLR 200851014 (Aug. 26, 2008), PLR 201818010 (May 22, 2017), and, PLR 200611003 (Dec. 1, 2005). In general, the taxpayer must represent that the Section 355 distribution would have been completed regardless of the loss recognized.*
8. *An alternative scenario may involve a loss in divisional assets or subsidiary assets. The divisional assets or the subsidiary can be sold to SpinCo in a taxable transaction (together with a Section 338(h)(10) election in the case of a sale of subsidiary stock) with the loss being recognized when SpinCo leaves the P3 consolidated group.*