CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 019

June 25, 1958

WORTHLESS STOCK: DETERMINATION OF WORTHLESSNESS

Syllabus:

Taxpayer allowed a loss deduction based on worthlessness of his stock, notwithstanding technical objections to the contrary.

In 1945 taxpayer X and three other men, all electrical contractors, formed a corporation to engage in electrical maintenance work. Taxpayer paid $5,000 for one-fifth of the capital stock. In March, 1946 an audit of the corporate books showed large operating losses and a shrinkage of net worth to $37. Nearly $8,000 was owed to X for salary and advances. Taxpayer and three of the others, on the strength of the audit, decided that the business was a failure and not worth any further effort or investment. They signed over their stock to X, who had retired from his own electrical contracting business and felt that he could make use of the corporate structure in re-entering that business. After X changed the nature of the corporate business to electrical construction, the losses were recouped and the business continued to operate at a profit. On his 1946 return taxpayer took a capital loss on the ground that the stock had become worthless. Advice is requested as to whether a loss deduction based on the worthlessness of the stock should be allowed taxpayer.

This appears to be a case where the taxpayer has suffered a real loss but, because of the technicalities of the situation, he stands in a bad position for substantiating a loss deduction.

There can be no deduction for loss of value of stock until the stock becomes completely worthless, both in present and potential value. And, as with all loss deductions, there must be an identifiable event which fixes the loss in the taxable year. The fact that the stock was worthless in the sense that it was unsalable is not sufficient. The basic condition underlying worthlessness is insolvency of the corporation. But the mere fact of present insolvency is insufficient if the stock can be reasonably considered to have potential value. Continued operation of the business is evidence of potential value that will usually rebut a contention of worthlessness based on operating losses or liabilities in excess of assets.

In the instant case the corporation was practically insolvent, the remaining net worth being negligible. It may be taken for granted that the stock was unsalable to outsiders. There is considerable difficulty, however, in dispelling the possibility that the stock had potential value. The corporation did continue to operate and soon began showing a profit. However, this recovery was made possible by a substantial change in the nature of the business.

Taking the practical, realistic and flexible approach prescribed by the Supreme Court in Lucas v American Code Co., 280 US 445 and Boehm v Comm., 326 US 287, a loss deduction based on worthlessness can and should be accepted in this case. The fact that the corporation continued in operation and recovered from insolvency need not be decisive against the taxpayer here when it is considered that for all practical purposes the electrical maintenance corporation expired when all outstanding stock was turned over to X. True, there was no formal liquidation nor surrender of the corporate charter, but the corporation which went on to success in the electrical construction business was a continuation of the old, unsuccessful corporation in form only and not in substance. Since the other four stockholders were already in the electrical construction business on their own accounts, it was neither fitting nor practical for them to continue their association with the corporation if it changed the nature of its business from maintenance to construction.
In view of the audit of March 31, no outsider would have bought their stock from them, and X would not have paid them anything for it because he had already invested heavily of both time and money without return from the business. To be realistic, there was nothing taxpayer and the others could do except write off their stock as a total loss. Had they had an eye to tidy arrangement of their affairs for tax purposes, they might have requested a nominal consideration from X to establish the stock transfer as a sale, or they might have arranged a dissolution of the corporation and an assignment of all assets to X. But failure to adopt such a formal procedure should not cause taxpayer to lose a deduction for a loss he really suffered.

The loss deduction should be allowed taxpayer.