State of California
Franchise Tax Board
Legal Division MS A260
PO Box 1720
Rancho Cordova, CA 95741-1720

tel: 916.845.5244 fax: 916.843.6080
ftb.ca.gov

10.25.12 Chief Counsel Ruling 2012-06

****
****
****
****

SUBJECT : Request for Chief Counsel Ruling for ********** *******. (FEIN: **-*******)

Dear M*. *******:

This is in response to your Chief Counsel Ruling request of September 19, 2012 wherein you seek guidance about the possible application of Treasury Regulation (Treas. Reg.) section 1.337(d)-2 for California purposes with respect to a worthless stock loss attributable to members of a combined reporting group.

FACTS

********** is a group of affiliated entities that operates *********. All of the entities are either corporations or limited liability companies (LLC) that have elected to be treated as associations taxable as corporations or as disregarded entities. As such, all of the entities are either directly included in a federal consolidated return group or are disregarded entities that are treated as divisions of members of the federal consolidated return group. Similarly, all of the entities are either directly included in a combined reporting group for California tax purposes or are disregarded entities that are treated as divisions of members of the combined reporting group for California tax purposes.

During ********, certain entities filed for relief under Chapter 11 of Title 11 of the United States Code. According to the approved bankruptcy plan, some of the creditors received LLC interests in the entities. This necessitated those entities that were corporations to convert to LLCs, which occurred during **********. The conversion acted as a corporate liquidation since in effect the corporation's assets and liabilities are first distributed to the shareholder, who in turn contributes them to the LLC. Ordinarily, the liquidation of a corporation included in a federal consolidated group comes under the purview of Internal Revenue Code (IRC) section 332[1], which provides that no gain or loss is recognized by corporate shareholder upon the liquidation. However, because they were insolvent, this rule did not apply with respect to three of the entities that were converted to LLCs. Rather, pursuant to

[1] Pursuant to California Revenue & Taxation Code (CRTC) section 24451, California incorporates IRC section 332.

the holding in Revenue Ruling 2003-125, 2003-2 Internal Revenue Cumulative Bulletin 1243[2], the corporate shareholders were able to deduct their basis in the stock of the converted entities as a worthless stock deduction in accordance with IRC section 165(g)[3].

As mentioned above, the corporations that converted into LLCs had been included in the Company's federal consolidated return group. Treasury Regulation (Treas. Reg.) section 1.337(d)-2(a)(1)[4] states:

> *General Rule.* No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary. However, for transactions involving loss shares of subsidiary stock occurring on or after September 17, 2008, see [Treas. Reg. section] 1.1502-36..... (Emphasis in original).

A question has arisen as to whether for California tax purposes Treas. Reg. section 1.337(d)-2(a)(1) will operate to disallow the worthless stock deduction pertaining to the insolvent converted entities.

ISSUE

For California tax purposes, will Treas. Reg. section 1.337(d)-2(a)(1) operate to disallow the worthless stock deduction pertaining to the insolvent converted entities?

HOLDING

For California purposes, Treas. Reg. section 1.337(d)-2(a)(1) will not operate to disallow any worthless stock deduction pertaining to the insolvent converted entities.

DISCUSSION

The rules contained in Treas. Reg. section 1.337(d)-2 were originally intended to prevent a situation wherein a level of federal corporate taxation was circumvented as a result of the operation of the federal consolidated return regulations. Generally what would occur is that a newly-acquired corporation would sell its assets for a gain. Pursuant to the federal consolidated return rules, specifically Treas. Reg. section 1.1502-32[5], the gain would increase the acquirer's basis in the newly-acquired corporation's stock. Thereafter, the acquirer would sell the newly-acquired

---

[2] Because the federal revenue ruling pertains to IRC provisions that California incorporates, the revenue ruling is applicable for California purposes. (See FTB Notice 2009-08.)

[3] Pursuant to CRTC section 24347, California incorporates IRC section 165(g).

[4] Treas. Reg. section 1.337(d)-2 ostensibly pertains to IRC section 337. Pursuant to CRTC section 24451, IRC section 337 is incorporated for California purposes. Accordingly, pursuant to CRTC section 23051.5(d), Treas. Reg. section 1.337(d)-2 ostensibly applies for California purposes.

[5] Treas. Reg. section 1.1502-32 is inapplicable for California purposes.

corporation's stock at an artificially low price, resulting in a loss that would eliminate the gain recognized by the newly-acquired corporation on the sale of its assets. Consequently, the consolidated group would not have a net gain. (See Bittker & Eustice, "*Federal Income Taxation of Corporations and Shareholders*", (6th ed., 1994) ¶ 13.43[5][c].)

Although the problem identified above was a result of the interplay of the federal consolidated rules, the regulations that alleviated the problem were not contained in the federal consolidated return regulations because they were bundled with a set of rules that also alleviated a problem identified with the misuse of IRC section 337. (See Bittker & Eustice, "*Federal Income Taxation of Corporations and Shareholders*", (6th ed., 1994) ¶ 13.43[5][b].) The Treasury Department finally promulgated consolidated return regulations that addressed the situation during September 2008 when it issued Treas. Reg. section 1.1502-36[6]. However, for transactions occurring prior to the date Treas. Reg. section 1.1502-36 was promulgated, Treas. Reg. section 1.337(d)-2 is applicable. (See Treasury Decision 9424, 2008-2 Internal Revenue Cumulative Bulletin 1012.)

For the most part, California does not provide for the filing of consolidated returns[7]. Treas. Reg. section 1.337(d)-2 is only applicable for taxpayers that file consolidated returns. Accordingly, since California does not generally provide for the filing of consolidated returns, Treas. Reg. section 1.337(d)-2 is not applicable for California purposes in this case. For these forgoing reasons, Treas. Reg. section 1.337(d)-2 will not operate to disallow a worthless stock deduction pertaining to the insolvent corporations that converted into LLCs.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Craig Swieso
Tax Counsel IV

---

[6] Treas. Reg. section 1.1502-36 is inapplicable for California purposes.

[7] Taxpayers whose principal business is that of a common carrier by railroad may file a consolidated return for California purposes. (See CRTC section 23361, et seq.)