***Reynolds Metals Company and Consolidated Subsidiaries v. Commissioner of Internal Revenue*, 105 T.C. 304 (1995)**

A parent corporation does not realize a deductible capital loss when its subsidiary redeems debentures, even if the parent's stock issued upon conversion of those debentures had a fair market value exceeding the redemption price; the excess value is considered a capital contribution to the subsidiary.

Summary

Reynolds Metals Company (Metals) sought to deduct a capital loss when its subsidiary, Reynolds Metals European Capital Corporation (RMECC), redeemed debentures that were convertible into Metals' stock. Metals argued that when debenture holders converted, Metals acquired the debentures with a basis equal to the fair market value of its stock issued. The Tax Court denied the deduction, holding that the excess of the stock's fair market value over the debenture's principal was a capital contribution to RMECC, not a deductible loss. The court reasoned that the conversion involved both acquiring the debentures and fulfilling Metals' obligation under the conversion feature, and the latter was a capital contribution.

Facts

In 1969, RMECC, a wholly-owned subsidiary of Metals, issued debentures convertible into Metals' common stock. Metals guaranteed the debentures. In 1987, RMECC called the debentures for redemption. Most debenture holders converted their debentures into Metals' stock before the redemption date because the stock's market value exceeded the redemption price. Metals then received cash from RMECC equal to the principal and accrued interest of the converted debentures. Metals claimed a capital loss deduction, arguing the fair market value of its stock issued exceeded the cash received from RMECC.

Procedural History

Reynolds Metals Company and Consolidated Subsidiaries petitioned the Tax Court, contesting the Commissioner of Internal Revenue's deficiency determination that disallowed their capital loss deduction for 1987.

Issue(s)

1. Whether debentures converted into parent company stock and then redeemed by the subsidiary survive the conversion as obligations of the subsidiary.
2. Whether the parent company is entitled to a capital loss deduction when its subsidiary redeems debentures that were converted into the parent's stock, where the fair market value of the stock issued upon conversion exceeded the redemption price.

Holding

1. Yes, the debentures survived the conversion as obligations of RMECC because the terms of the indenture indicated that converted debentures remained outstanding until formally cancelled by the trustee.
2. No, Metals is not entitled to a capital loss deduction because the excess of the fair market value of Metals' stock over the principal amount of the debentures represents a capital contribution to RMECC, not a deductible loss under Section 165(f) of the Internal Revenue Code.

Court's Reasoning

The court reasoned that the indenture's terms clearly indicated the debentures survived conversion until cancellation. Section 2.08 of the indenture stated that acquisition of debentures by Metals, including through conversion, does not operate as a redemption until delivered to the trustee for cancellation. Further, Section 4.12 referred to "Converted Debentures" as still existing. Regarding the capital loss, the court distinguished *International Telephone & Telegraph v. Commissioner*, noting that while precedent established basis in debentures equals the stock's fair market value, it didn't preclude examining whether that value should be partially attributed to the conversion feature itself, which benefits the subsidiary. The court determined that issuing Metals' stock involved two elements: acquiring debentures and discharging the conversion obligation. The excess value of Metals' stock over the debenture's principal was attributed to the conversion feature—a benefit to RMECC—and thus considered a capital contribution. The court stated, "Under this approach, Metals' basis in the debentures would be limited to their principal amount, with the result that Metals would have neither gain nor loss on their redemption. The excess of the fair market value of Metals' shares over that amount would be considered a capital contribution by Metals to RMECC and an addition to Metals' basis in its RMECC shares." The court rejected Metals' argument that the stock outlay was for its own business purpose (securing aluminum supply), finding insufficient evidence for direct, quantifiable benefit to Metals distinct from its shareholder relationship with RMECC.

Practical Implications

This case clarifies that a parent company's issuance of stock upon conversion of subsidiary debentures, even if seemingly creating a loss when the subsidiary later redeems those debentures, is often treated as a capital contribution. Legal professionals should analyze such transactions by separating the debt retirement from the equity conversion aspect. When advising corporations on issuing convertible debt through subsidiaries, it's crucial to understand that the parent's stock issuance in conversion might not generate a deductible loss upon redemption by the subsidiary. This ruling emphasizes the shareholder-investor relationship's influence on intercompany transactions and reinforces the principle that capital contributions are not deductible losses. Later cases would likely cite this to deny loss deductions in similar parent-subsidiary convertible debt scenarios, especially where the parent guarantees the conversion feature, highlighting the importance of structuring intercompany financing carefully to achieve desired tax outcomes.

