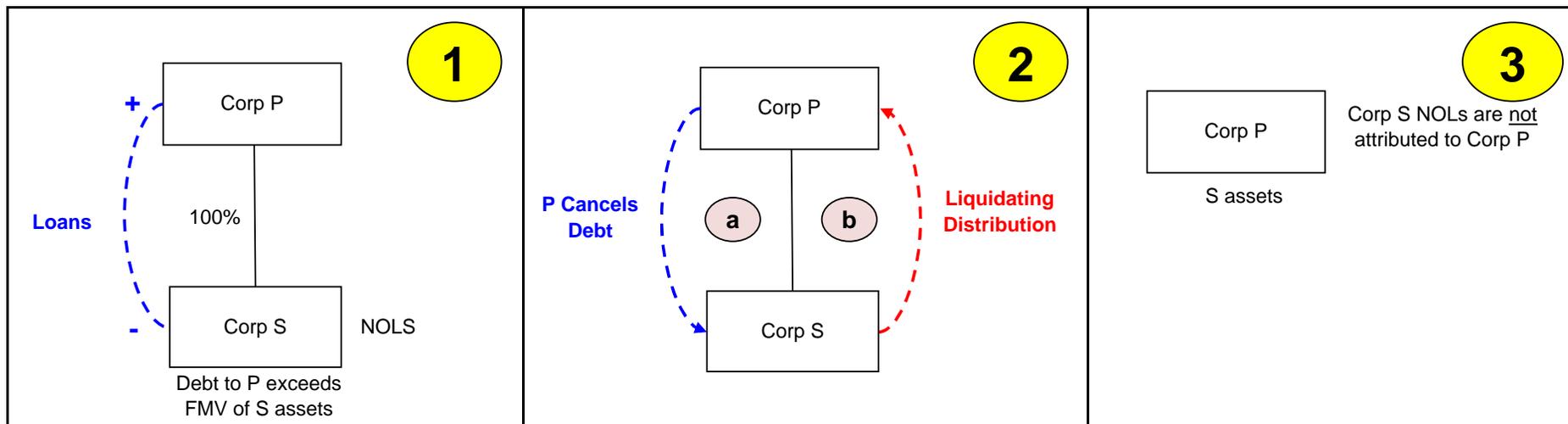


**Pre-Liquidation Debt Cancellation  
of Insolvent Subsidiary**

Initial Structure

Liquidation

Ending Point



S corporation was a wholly owned subsidiary of P corporation. S had sustained operating losses in prior years that resulted in a net operating loss carryover. S was indebted to P in an amount greater than the fair market value of its assets. P desired to avail itself of S's net operating loss carryover under the provisions of section 381. P cancelled the indebtedness owed to it by S and immediately thereafter S transferred all of its assets subject to its liabilities to P pursuant to a plan of complete liquidation.

Reg. 1.332-2(b) provides that section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation. Since the step involving the cancellation of the indebtedness from S to P was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of S's net operating loss carryover, such step will be considered transitory and, therefore, disregarded. By disregarding the cancellation P is considered to have received nothing in payment for its stock interest in S. Accordingly, the transaction is not a "liquidation" within the meaning of section 332 and the net operating loss of S may not be carried over and availed of by P under section 381. See also Rev. Rul. 59-296 and Rev. Rul. 68-359.