OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Loss Disallowance Rules

This Field Service Advice responds to your memorandum dated May 17, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

Parent .
Sub
Sub A
Sub B
Date 1
Date 2
Date 3
Date 4
Date 5
Date 6
X Division
Y Division

ISSUE:

Are pre-November 19, 1990 extraordinary gain dispositions eliminated from both the extraordinary gain disposition (“EGD”) and the positive investment adjustment (“PIA”) accounts in computing the loss disallowance amount under Treas. Reg. § 1.1502-20 (“-20")?

CONCLUSION:

Gains from EGD-type transactions realized prior to November 19, 1990 are positive investment adjustments included in the PIA account.

FACTS:

Under our understanding of the facts, Parent is the common parent of an affiliated group of corporations that files a consolidated return. On Date 1, Sub A, a subsidiary of Parent, purchased all of the outstanding stock of Sub. Sub joined Parent’s consolidated income tax return for the fiscal year ending Date 2. According to the incoming material, it appears that Sub had gains from pre-November 19, 1990 EGD-type transactions, resulting from the sale of the assets of its X Division on Date 3, as well as from the sale of the assets of its Y Division on Date 4. It is the proper treatment of these gains under the LDR that is at issue in this Field Service Advice request.

On Date 5 Sub A contributed 100% of Sub’s stock to Sub B, a wholly owned subsidiary of Sub A. On Date 6 Sub B sold 100% of Sub’s stock to a unrelated corporation. The parties agree to the following: 1) the amount realized on the sale of Sub’s stock was $212,494,459; 2) the taxpayer’s adjusted basis in Sub’s stock at the time of the sale was $239,786,872; and, 3) the loss realized on the sale of Sub’s stock was $27,292,413. There is a dispute as to how much of this loss should be disallowed under the LDR of -20.

The narrow question you ask us to address concerns whether, in determining the amount of loss disallowed under the LDR, the amount of the PIA account under -20(c)(1)(ii) includes the amount of gain allocable to pre-November 19, 1990 EGD-type transactions. Such items are specifically not taken into account as EGD under paragraph -20(c)(1)(i). The taxpayer argues that such amounts should be ignored for all purposes in determining the loss disallowed under -20. That is, the taxpayer argues that such amounts should be excluded from both the EGD account under -20(c)(1)(i) and from the PIA account under -20(c)(1)(ii). The agent agrees pre-November 19, 1990 EGD-type gains are excluded from the EGD account but argues that to the extent these amounts result in positive adjustments under -32, they must be included in the PIA account.

LAW AND ANALYSIS:

A. Historical Overview

The Tax Reform Act of 1986, Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1 ("1986 Act") repealed the General Utilities doctrine. The General Utilities doctrine, which takes its name from General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), was codified in sections 311, 336, and 337 of the Internal Revenue Code of 1954.[1] The doctrine provided an exception to the two-level system of corporate taxation by according nonrecognition treatment to gain or loss resulting from a corporation's disposition of appreciated or depreciated property to its shareholders, either in liquidation (former section 336), or as a dividend (former section 311), or when it sold the property and distributed the proceeds in liquidation (section 337). The 1986 Act repealed the General Utilities doctrine by amending sections 311, 336, and 337 to require, with limited exceptions, the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating distribution or a sale in connection with a liquidation.

The statutory amendments under the 1986 Act implemented General Utilities repeal in the separate return context. Congress enacted section 337(d), which specifically authorized the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by the 1986 Act, including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations). The LDR carry out the purposes of these amendments in the consolidated return context.

In the consolidated return context prior to these amendments, when a target company sold or distributed appreciated property to members of an acquiring group, that group could obtain a loss on the subsequent sale of the target company due to positive basis adjustments to the subsidiary's stock (under -32) which were made when the target company sold or distributed the appreciated property. This result was contrary to the repeal of the General Utilities doctrine. Instead, the shareholders should have reported a gain on the sale of the target company, and the target company should have paid a tax on its built-in gains. The -20 regulations were promulgated to provide a result in the consolidated return context that was consistent with the repeal of the General Utilities doctrine.

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[1] All section references will refer to the Internal Revenue Code of 1986, unless otherwise specified. For example, Code sections under the Internal Revenue Code of 1954 will be referred to as a "former" section.

B. Application of LDR

The LDR generally provides that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. "Disposition" means any event in which gain or loss is recognized, in whole or in part. Treas. Reg. § 1.1502-20(a)(2). Treas. Reg. § 1.1502-20(c) specifies that the amount of loss disallowed under paragraph -20(a)(1) with respect to the disposition of a share of stock will not exceed the sum of the following three items: (1) extraordinary gain dispositions; (2) positive investment adjustments; and (3) duplicated loss.

Treas. Reg. § 1.1502-20(c)(2)(i) defines the term extraordinary gain disposition for purposes of § 1.1502-20. Treas. Reg. §§ 1.1502-20(c)(2)(i)(A)-(D) provide the operating rules for purposes of calculating the EGD amount. Loss on the sale of a share of stock is disallowed to the extent of the share's allocable portion of income or gain, net of directly related expenses (e.g. commissions, legal fees, state income taxes), attributed to actual or deemed gain dispositions of (1) section 1221 capital assets; (2) section 1231(b) property (e.g., depreciable property or land used in a trade or business); (3) bulk sales or other dispositions of nondepreciable business assets, such as inventory, copyrights, or receivables used in the same trade or business; (4) dispositions of business assets described in section 1060(c); (5) any positive section 481 adjustments resulting from a change of accounting method, including a change attributable to pre-November 19, 1990 periods (e.g., recovery of LIFO reserve); (6) income from discharge of indebtedness (not excluded from basis under section 1503(e); and (7) any other event (or item) identified in revenue rulings and revenue procedures.

When § 1.1502-20(c) was proposed setting forth the accounts described above, taxpayers commented that separately accounting for EGD prior to the time the proposed regulations were published would be an extreme hardship, because there had been no requirement to keep records necessary to separately state income and gain from EGD. In response to taxpayers' comments, the final regulations provide that an extraordinary gain disposition is taken into account under 1.1502-20(c)(1)(i) only if it occurs on or after November 19, 1990. Treas. Reg. § 1.1502-20(c)(2)(i). Accordingly, income and gain from EGD need be separately stated only on a going forward basis. Thus, it is clear that this concession was only to remove the requirement that pre-November 19,1990 EGD-type transactions be separately stated, not to eliminate them from the § 1.1502-20(c) calculations entirely.

In calculating the disallowed loss, the regulations also consider positive investment adjustments under -32. The PIA amount includes the sum of the amounts under Treas. Reg. § 1.1502-32(b)(2)(i) through (iii) for the consolidated return year (before distributions) that result in positive basis adjustments under Treas. Reg. § 1.1502-32(b)(1)(i) and (c)(1), (**but only to the extent the amount exceeds the amount included in the extraordinary gain provision of -20(c)(1)(i)**). To a limited extent, deficits of one year can be offset against earnings and profits of another year for tax years ending on or before September 13, 1991. However, they cannot be netted for years thereafter.

C. Treatment of Pre-November 19, 1990 EGD-Type Gains

Taxpayer argues that the language of the regulation effectively exempts pre-November 19, 1990 income and gain from EGD-type transactions from the LDR. It's reasoning is: (1) § 1.1502-20(c)(1)(ii) provides that PAI do not include the "amount described in paragraph (c)(1)(i)"; (2) § 1.1502-20(c)(1)(i) only states that "extraordinary gain dispositions" include the amount of income and gain attributable to EGD; (3) § 1.1502-20(c)(2)(i) actually defines EGD as the transactions set forth above, and (4) although an item of income or gain from an EGD is not taken "taken into account under § 1.1502-20(c)(i)" if it occurs before November 19, 1990, it is nevertheless "described in § 1.1502-20(c)(i)." The taxpayer concludes, therefore, that gain and income from pre-November 19, 1990 EGD are excluded from the calculation of the PIA amount.

Although at first glance taxpayer's argument may appear to have some merit, it is incorrect. While it is true that the PIA amount includes *all* § 1.1502-32 adjustments *except* amounts described in § 1.1502-20(c)(i), the *amount* of gain and income described in § 1.1502-20(c)(i) for EGD occurring prior to November 19, 1990 is *zero--and so "zero" amount is described in § 1.1502-20(c)(1)(i).* Section E.3.a. of the preamble to § 1.1502-20 and § 1.377 (d)-2, T.D. 8364, 1991-2 C.B. 43, supports this position. That section's statement that "[t]he final regulations also clarify that extraordinary gain dispositions *include* only events that occur on or after November 19, 1990" (emphasis added) means that any disposition gain that arises before this date is simply not an amount "described in" (i.e., included in the definition of) § 1.1502-20(c)(i). Therefore, it is the position of this office that income and gain from EGD-type transactions occurring prior to November 19, 1990 fall outside the scope of § 1.1502-20(c)(i). Accordingly, to the extent such amounts affect the positive basis adjustment under the relevant provision of Treas. Reg. § 1.1502-32, they are taken into account *in full* in the PIA account for purposes of § 1.1502-20.

The taxpayer also argues that if the specific exclusion of extraordinary gain dispositions from the EGD only has the effect of moving such amounts to the PIA account, then the exclusion is rendered meaningless. This argument is wholly without merit. The tax consequences imposed upon the EGD account are harsher than those applicable to the PIA account, in that taxpayers are not permitted to net extraordinary or other losses against extraordinary gains. Additionally, the (taxpayer favorable) transitional netting rules of Treas. Reg. § 1.1502-20(c)(2)(v) are not applicable to the EGD amount. Thus, the exclusion of pre-November 19, 1990 gains from the EGD calculation has a significant effect on the tax treatment of these transactions.

The harsher treatment afforded EGD reflects the universally accepted view that EGD items are those most obviously capable of enabling the circumvention of GU repeal through the consolidated return regulations. Yet, under taxpayer's analysis, amounts of income and gain attributable to EGD would wholly escape the provisions of § 1.1502-20. Removing pre-November 19, 1990 EGD from LDR would enable taxpayers to achieve the very abuse at which both § 337(d) and § 1.1502-20 are aimed. Such a result clearly thwarts the Congressional mandate of § 337(d). It is axiomatic that if a provision has more than one plausible interpretation, the interpretation that produces the result more sound and in keeping with legislative intent will prevail.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted] If you have any further questions, please call (202) 622-7930.

Deborah A. Butler
Assistant Chief Counsel

By: ______________________________
STEVEN J. HANKIN
Special Counsel
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cc: Regional Counsel CC:
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