OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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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: 1.1502-20 Loss Disallowance

This Field Service Advice responds to your memorandum dated June 1, 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.

LEGEND:

P =
S1 =
S2 =
S3 =
X =
Y =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
B and C =
D =
d =

e =
f =
$b =
$c =
$d =
$e =

FACTS

P is the parent of a consolidated group of corporations. On Date 1, P owned 100% of the stock of S1, which P had purchased on Date 2. On Date 3, S1 incorporated S2. In incorporating S2, S1 contributed cash and its B and C businesses to S2 in exchange for S2 stock. S1 retained its D business. Subsequently, S1 distributed its S2 stock to P.[1]

On Date 4, P formed S3 by contributing its S1 stock to S3 in exchange for S3 stock. On Date 5, S1 distributed d to S3, which, in turn, distributed d to P.[2] S1 recognized a gain of $b on the distribution pursuant to section 311(b), which was deferred under Treas. Reg. § 1.1503-13(c).

The d was previously used by S1 in its D business. On Date 6, P and Y, a wholly-owned subsidiary of X, entered into a license agreement with respect to d. Under the agreement, Y, X, and all other subsidiaries of X were granted an irrevocable, assignable, worldwide perpetual, royalty bearing license to use d. The license was exclusive for the first two years and nonexclusive thereafter.

On Date 1, S3 sold its S1 stock to X for $c. S3 claimed a loss on this sale. S1's deferred gain of $b was taken into account at the time of this sale. See Treas. Reg. § 1.1502-13(f)(iii). P filed an election under Treas. Reg. § 1.1502-20(g) to reattribute S1 losses to P.

ISSUE 1

Whether S1's distribution of d, the gain on which S1 took into account at the time of S3's sale of the S1 stock, constitutes an “extraordinary gain disposition,” as defined in § Treas. Reg. §1.1502-20(c)(1)(i) .

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[1]We are assuming the distribution did not qualify as a section 355 distribution and the transaction was not a D reorganization.

[2]The facts indicate that S1 distributed d to P. However, we are treating this as a distribution of d from S1 to S3, which then distributed d to P.

CONCLUSION 1

We believe you need to come in for a separate FSA on whether the d constitutes property described by section 1221(3) or property described in section 1231(b). However, if the d is property described by section 1221(3) or property described in section 1231(b), we believe S1's distribution of d, the gain on which S1 took into account at the time of S3's sale of the S1 stock, constitutes an “extraordinary gain disposition,” as defined in § Treas. Reg. §1.1502-20(c)(1)(i).

ISSUE 2

What is the amount of loss disallowed to the parent on its sale of the subsidiary’s stock under Treas. Reg. § 1.1502-20?

CONCLUSION 2

Further factual development of this case is necessary to ascertain the amount of loss disallowed to the parent on its sale of the subsidiary’s stock under Treas. Reg. § 1.1502-20.

DISCUSSION

Issue #1

Treas. Reg. § 1.1502-20(c)(2)(i) provides that an “extraordinary gain disposition” is–

(A) An actual or deemed disposition of –

(1) A capital asset as defined in section 1221 (determined without the application of any other provision of the Code or regulations).

(2) Property used in a trade or business as defined in section 1231(b) (determined without the application of any holding period requirement).

(3) An asset described in section 1221 (1), (3), (4), or (5), if substantially all the assets in such category from the same trade or business are disposed of in one transaction (or series of related transactions).

(4) Assets disposed of in an applicable asset acquisition under section 1060(c).

(B) A change in method of accounting resulting in a positive section 481 adjustment.

(C) A discharge of indebtedness.

(D) Any other event (or item) identified by the Commissioner in revenue rulings and revenue procedures.

An extraordinary gain disposition is taken into account under paragraph (c)(1)(i) of this section only if it occurs on or after November 19, 1990 and results in income or gain for purposes of computing earnings and profits (determined net of directly related expenses). For this purpose, federal income taxes may be directly related to extraordinary gain dispositions only to the extent of the excess (if any) of the group's income tax liability actually imposed under subtitle A of the Internal Revenue Code for the taxable year of the extraordinary gain dispositions over the group's income tax liability for the taxable year redetermined by not taking into account the extraordinary gain dispositions. For this purpose, the group's income tax liability actually imposed and its redetermined income tax liability are determined without taking into account the foreign tax credit under section 27(a) of the Code.

Property described in section 1221(3) includes:

> a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by–
>
> > (A) a taxpayer whose personal efforts created such property,
> >
> > (B) in the case of a letter memorandum, or similar property, taxpayer for whom such property was prepared, or
> >
> > (C) a taxpayer in whose hands the basis of such property is determined for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).

Section 1231(b) defines “property used in a trade or business” as, property used in a trade or business which is subject to the allowance for depreciation provided in section 167, held for more than 1 year which is not property includible in the inventory of the taxpayer if on hand at the end of the year or held primarily for sale to customers in the ordinary course of taxpayer’s business.

We believe you need to come in for a separate FSA on whether the d constitutes property described by section 1221(3) or property described in section 1231(b). However, if the d is property described by section 1221(3) or property described in section 1231(b), we believe S1's distribution of d, the gain on which S1 took into account at the time of S3's sale of the S1 stock, constitutes an "extraordinary gain disposition," as defined in Treas. Reg. § 1.1502-20(c)(1)(i). S1's deferred gain was triggered into income and reflected in S1's earnings and profits, as well as S3's basis in its S1 stock, at the time of the sale. See Treas. Reg. § 1.1502-13(f)(iii); Treas. Reg. § 1.1502-33(a).

Issue #2

We believe all or a portion of loss that S recognized on the distribution of its stock in X is disallowed under Treas. Reg. § 1.1502-20. We are interested in the further development of this issue, and you should seek a supplemental field service advice on the Treas. Reg. § 1.1502-20 issue once you have developed the facts of this case.

LAW AND ANALYSIS

The Loss Disallowance Rules

The Treas. Reg. § 1.1502-20 loss disallowance rules ("LDR") generally provide 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 (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.[3]

Extraordinary gains: Loss on the sale of a share of stock is disallowed to the extent of the share's allocable portion of any member's earnings and profits, net of directly related expenses (e.g. commissions, legal fees, state income taxes), attributed to actual or deemed gain dispositions occurring after November 18, 1990, of (1) 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

[3]The Treas. Reg. § 1.1502-20 regulations applicable to the tax year at issue are the Treas. Reg. § 1.1502-20 regulations prior to amendment by T.D. 8560. These regulations adopt the Treas. Reg. § 1.1502-32 investment adjustment rules applicable to the tax year at issue prior to amendment by T.D. 8560.

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. Treas. Reg. § 1.1502-20(c)(2)(i). These extraordinary gain dispositions apply only to the extent that immediately before the disposition of the share, they are directly or indirectly reflected in the basis of the share after applying the basis adjustment rules of section 1503(e), Treas. Reg. § 1.1502-32(g), and other applicable provisions. Treas. Reg. § 1.1502-20(c)(2)(iii).

Positive investment adjustments: In calculating the disallowed loss, the regulations consider positive investment adjustments. These are the annual earnings and profits (before distributions) (other than those covered by the extraordinary gain provisions), that result in positive basis adjustments under Treas. Reg. § 1.1502-32(b)(1)(i) and (c)(1). These earnings and profits adjustments apply only to the extent that immediately before the disposition of the share, they are directly or indirectly reflected in the basis of the share after applying the basis adjustment rules of I.R.C. § 1503(e), Treas. Reg. § 1.1502-32(g), and other applicable provisions. 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.

Duplicated loss: The amount of duplicated loss apportioned to each share is the portion of the loss carryforwards and net built-in losses attributed to the share. Treas. Reg. § 1.1502-20(c)(2)(vi). The amounts determined under this paragraph with respect to a subsidiary must include the subsidiary's allocable portion of corresponding amounts with respect to each of its lower-tiered subsidiaries. The duplicated loss amount is determined immediately after a disposition by first adding (1) the aggregate adjusted basis of the subsidiary's assets, but not the adjusted basis of its stock or securities in a group member; (2) any losses attributable to the subsidiary and carried to its first taxable year after the disposition; and (3) any deferred deductions (such as passive losses under I.R.C. § 469) of the subsidiary. The total amount is then reduced by the sum of (1) value of the subsidiary's stock; (2) liabilities of the subsidiary; and (3) any other relevant items.

CASE DEVELOPMENTS, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

There are examples in the regulations (Treas. Reg. § 1.1502-20(c)(4)) which illustrate the principles of paragraph (c)(1). We recommend you review these examples and get back to us if you have any questions regarding the application of the loss disallowance rules and whether you need more facts in setting up the issue.

Additionally, it is unclear to us whether the taxpayer has not only amounts disallowed under the extraordinary gain register, but also amounts disallowed under the positive investment adjustments register and duplicated loss register. First, we are unsure whether we have all the facts necessary to determined whether the taxpayer has a duplicated loss (within the meaning of Treas. Reg. § § 1.1502-20(c)(1)(iii) & (c)(2)(vi)). However, based on the limited facts provided to us, it appears the "value of the subsidiary's stock" (within the meaning of Treas. Reg. § 1.1502-20(c)(2)(vi)(B)(1)) should be $c, rather than $d. As a result, based on these limited facts, it appears the taxpayer has a duplicated loss.

[redacted]

[redacted]

Further, we note that if the distribution of d, together with the sale of S1, does not constitute an “extraordinary gain disposition” as defined in Treas. Reg. §1.1502-20(c)(1)(i), the taxpayer may then have some amount of -- or a larger amount of -- loss disallowed under the positive investment adjustment register.

We also clarify that the SRLY loss reattributed to P under Treas. Reg. § 1.1502-20(g) reduces S3's basis in the S2 stock, and thus, reduces the amount of loss S3 recognized on the disposition of the S1 stock. See Treas. Reg. § 1.1502-20(g)(4), Example 1. Whereas, in contrast, the $b amount of extraordinary gain does not reduce the amount of loss that S3 recognized on the disposition. Instead, it is an amount of recognized loss disallowed under Treas. Reg. § § 1.1502-20(a) & (c).

Additionally, as already indicated, the facts concerning the f stock are unclear. Furthermore, we are unsure of the facts surrounding taxpayer’s apparent assertion that f was an “inactive” corporation, and taxpayer made no investment adjustments with respect to the f stock. However, you indicate you believe this aspect of the case will not have a material impact on the loss disallowance issue. However, we are unsure whether this will have a material impact on the loss disallowance issue.

Further, we recommend you come in for a separate FSA on whether d constituted property described in either section 1221(3) or section 1231(b). As you indicate in your incoming, the facts are unclear concerning whether d was internally developed or externally purchased, or some combination of the two. However, if the software was internally developed, it might not fall under 1221(3)(A) since, if created by employees of the company, it may not have been created by the taxpayer's personal efforts. Rev. Rul. 55-706, even though superseded by Rev. Rul. 62-141 for other reasons, indicates that property owned by a corporate taxpayer is not considered as created by the personal efforts of the taxpayer where the employees created the property and all the compensation, costs and expenses are paid by the corporation. Based on this theory, even if facts are developed that indicate that S1 developed the software it still might not fall within 1221(3)(A).

Additionally, the software might not fit into 1221(3). It might not fall under 1221(3)(B) since software is not similar to a letter or memorandum. It may not fall under 1221(3)(C) because, although it has a carryover basis, the taxpayer from whom the basis carried over might not be a taxpayer that fits in (A) or (B).

Lastly, we provide no comment on the section 382 limitation set forth in your memorandum.

If you have any further questions, please call 622-7930.

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