OFFICE OF
CHIEF COUNSEL

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

Number: **200108009**
Release Date: 2/23/2001
CC:DOM:FS:CORP
TL-N-2445-99
UILC: 1502.20-00

November 16, 2000

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL-

CC:
Attn:

FROM: JASPER L. CUMMINGS, JR.
ASSOCIATE CHIEF COUNSEL CC:CORP

SUBJECT: Loss Disallowance Rules Under Treas. Reg. section 1.1502-20

This Field Service Advice supplements and clarifies the Field Service Advice issued to you on June 30, 2000 (the "prior FSA"), which responded to your memorandum dated March 28, 2000. The prior FSA is hereby incorporated by reference. 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.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Ultimate Parent Group	=
Ultimate Parent	=
Ultimate Sub	=
Target Parent Group	=
Target Parent	=
Target Sub 1	=
Target Sub 2	=
Individual B	=
Date L	=
#B	=
$C	=
$G	=
$L	=
$W	=
$EEE	=
Year C	=
Year G	=

ISSUES

1. Whether losses recognized, if any, on the sale of the Target Parent stock would be disallowed pursuant to the anti-avoidance provisions under Treas. Reg. section 1.1502-20(e).

2. When Ultimate Sub received a distribution of property, namely the Target Sub 2 stock, from Target Parent prior to Target Parent leaving the Ultimate Parent consolidated group, and Ultimate Sub reduced its investment adjustment basis in the stock of Target Parent by the fair market value of the property distributed under Treas. Reg. section 1.1502-32, must Target Parent recognize gain where the property distributed has a fair market value greater

than basis, and if so, how should the loss disallowance rules under Treas. Reg. section 1.1502-20 apply?

CONCLUSIONS

1. Anti-avoidance rules apply in transactions where taxpayers enter into transactions with a view to avoid the loss disallowance rules. In the current case, assuming the trademarks decreased in value to the extent claimed by Ultimate Parent, the Ultimate Parent Group would have been entitled to a loss when it sold the Target Parent stock even if ownership of the trademarks had not been moved to a corporation (Target Sub 2) ultimately owned by Ultimate Sub. The transfer of the trademarks to Target Sub 2 and the distribution of that stock by Target Sub 1 to Target Parent and by Target Parent to Ultimate Sub generated a gain to Target Sub 1 (for which the Ultimate Parent Group had a tax liability) but the distribution did not increase the allowable loss to the Ultimate Parent Group upon the disposition of the Target Parent stock. (It did increase the loss realized on the Target Parent disposition but it increased the loss disallowance rule loss limitation in the same amount causing a wash in the allowable loss). Since the allowable loss was not increased by the movement of the trademarks away from the Target Parent stock chain prior to that stock's disposition, the movement should not be treated as if the Ultimate Parent Group effectuated the transaction with a view to avoid the loss disallowance rules. Furthermore, since the Ultimate Parent Group will recognize gain with respect to distribution of appreciated property resulting in an increase in basis under Treas. Reg. section 1.1502-32 which will correspondingly increase the loss disallowance limitation under Treas. Reg. section 1.1502-20 upon the disposition of the Target Parent stock, the Treas. Reg. section 1.1502-20 rules will be correctly applied. Consequently, the Ultimate Parent Group should not be treated as if it distributed the Target Sub 2 stock to Ultimate Sub with a view to avoiding the loss disallowance rules.

2. When Target Sub 1 distributed the Target Sub 2 stock to Target Parent, followed by Target Parent's distribution of that stock to Ultimate Sub, a member of the Ultimate Parent Group, that stock had built-in gain to Target Sub 1 which was recognized under IRC section 311(b) and was triggered when Target Parent was sold to Individual B. As a result: 1) any gain recognized would have increased the basis of Target Parent in its Target Sub 1 stock and correspondingly the basis of Ultimate Sub in its Target Parent stock under the Treas. Reg. section 1.1502-32 investment basis adjustment rules; and 2) the amount of loss disallowance applicable upon the sale of the Target Parent stock to Individual B would have been increased in the amount of that recognition of the built-in gain in the Target Sub 2 stock as it is an extraordinary gain disposition under Treas. Reg. section 1.1502-20(c)(1)(i). This result is in addition to the requirement that Ultimate Sub make adjustments for reducing its basis in the stock of Target Parent with respect to the distribution of the Target Sub 2 stock worth $W under Treas. Reg. section 1.502-32(b)(2)(iv).

FACTS

The facts from the prior FSA are incorporated by reference. The relevant facts are that in Year C, Ultimate Sub, a member of the Ultimate Parent Group, purchased Target Parent for $C. Target Sub 1, a subsidiary of Target Parent, had trademarks with a fair market value of $G and $EEE basis. By Year G those trademarks purportedly decreased by $L[1] ($G less $W). On or about Date L, the trademarks were contributed by Target Sub 1 to Target Sub 2 in an IRC section 351 exchange whereby Target Sub 1 received Target Sub 2 stock with a fair market value of $W and $EEE basis. Within #B days of the contribution of the trademarks to Target Sub 2, Target Sub 1 distributed the Target Sub 2 stock to Target Parent and Target Parent distributed the Target Sub 2 stock to Ultimate Sub. The Target Parent stock was then sold to Individual B.

Discussion

The general rule of the loss disallowance rules provide that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. See Treas. Reg. section 1.1502-20(a)(2). Treas. Reg. section 1.1502-20(c) limits the general rule by specifying that the amount of loss disallowed shall not exceed the sum of extraordinary gain dispositions, positive investment adjustments and duplicated losses. Losses in excess of extraordinary gain dispositions, positive investment adjustments and duplicated losses in the loss disallowance rule regime are certain economic losses which should not be disallowed.

Anti-Avoidance Rules

The anti-avoidance rules under Treas. Reg. section 1.1502-20(e) provide that the rules under Treas. Reg. section 1.1502-20 must be applied in a manner that is consistent with and reasonably carries out their purposes. Where a taxpayer acts with a view to avoid the loss disallowance rules, adjustments must be made to carry out their purposes. The regulations describe several examples, among others, such as the shifting of value example and the basic stuffing case example.

The anti-avoidance rules and the examples describing some of the parameters of the anti-avoidance rules were not narrowly written to apply only to specific and limited circumstances nor were they written to be the definitive source of describing and capturing the myriad of ways a taxpayer could circumvent the loss disallowance rules. Instead, the anti-avoidance rules lay a general foundation that considers,

[1] For the purposes of simplifying this discussion, we are using $L as the amount of the decline in the value of the trademarks. The actual value of the trademarks will ultimately have to be used however.

among other factors, the intent of the taxpayer given the regulatory scheme for which the transaction applies. It is our purpose in this Supplemental FSA to address the most probable intent of Ultimate Parent given the regulatory scheme for which the transaction applies.

Economic Losses With Respect to a Decline in Value of Built-in Gain Property

Where a taxpayer acts with a view to avoid the loss disallowance rules, adjustments must be made to carry out their purposes. The anti-avoidance rules do not apply merely because a taxpayer makes a mistake with respect to calculating the loss disallowed under the loss disallowance rules nor do they apply, in general, where a taxpayer is entitled to certain economic losses.

A review of the circumstances with respect to the transaction indicates that the Ultimate Parent Group should not be treated as if it had acted with a view to avoid the loss disallowance rules. In the prior FSA, and in the clarification requested in issue #2 below, we have assumed that Ultimate Parent did not properly calculate certain extraordinary gain dispositions relating to the deemed sale of a capital asset (Target Sub 1's distribution of Target Sub 2 stock that had built-in gain).

In this Supplemental FSA, the Service must determine whether the Ultimate Parent Group is entitled to a loss on the sale of the stock of a subsidiary where the fair market value of certain assets of the subsidiary declined. To the extent the trademarks declined in value and the stock of the subsidiary is sold, those losses relating to the decline in the fmv of an asset are economic losses. Economic loss that is not duplicated is generally allowable under the loss disallowance rule regime.

Assuming that the trademarks had decreased in value to the extent purported by the taxpayer, such a decline would be reflected in the value of the stock of Target Parent- consequently, loss on the sale of the Target Parent should not subject Ultimate Parent to the anti-avoidance rules merely because the trademarks were transferred to Target Sub 2 followed by a distribution of Target Sub 2 to Target Parent. If the trademarks had remained with the Target Parent Group, instead of being distributed to Ultimate Sub (the trademarks were contributed to Target Sub 2 prior to the Target Sub 2 stock being distributed to Ultimate Sub), Ultimate Parent still would be entitled to a loss on the disposition of the Target Parent stock with respect to the decline in the fair market value of those trademarks. The Ultimate Parent Group, therefore, by transferring the trademarks to Target Sub 2 and distributing that stock should not be treated as if it had acted with a view to avoid the loss disallowance rules. Example 1 of Treas. Reg. section 1.1502-20(c)(4) provides for a scenario similar to the facts before us.

Example 1 of Treas. Reg. section 1.1502-20(c)(4) provides the following illustration:

> “Example 1. Allowed loss attributable to lost built-in gain. (i) Individual A forms T. P buys all the stock of T from A for $100, and T becomes a member of the P group. T has a capital asset with a basis of $0 and a value of $100. The value of the asset declines, and T sells the asset for $40. Under the investment adjustment system, P's basis in the T stock increases to $140. P then sells all the stock of T for $40 and recognizes a loss of $100.
>
> (ii) The amount of the $100 loss disallowed under paragraph (a)(1) of this section may not exceed the amount determined under paragraph (c)(1) of this section. The $40 of T's earnings and profits is from an extraordinary gain disposition, as defined in paragraph (c)(2)(i) of this section, and is reflected, within the meaning of paragraph (c)(2)(iii) of this section, in the basis of the T stock immediately before the disposition. The earnings and profits are therefore described in paragraph (c)(1)(i) of this section. Because this amount is the only amount described in paragraph (c)(1) of this section, the amount of P's $100 loss that is disallowed under paragraph (a)(1) of this section is limited to $40. (No amount is described in paragraph (c)(1) (ii) of this section because the amount of T's positive investment adjustments does not exceed the amount included under paragraph (c)(1)(i) of this section.)”

In the facts before us, the trademarks are similar to the asset in Example 1 that has a $100 fmv and $0 basis that declines in value. In the example in the Treasury Regulations, the $60 decline in value is not disallowed. The $40 gain in the example, however, is disallowed because it is an extraordinary gain disposition.

In the facts before us, when Ultimate Sub purchased Target Parent, the trademarks had a fmv of $G and a basis of $EEE. The trademarks purportedly declined to a fmv of $W. If the trademarks had been sold to a third party after they declined by $L in value, the Ultimate Parent Group would recognize $W gain. The $W gain would have been reflected in the investment adjustments and a commensurate amount would have been added to the amount of loss disallowance which would have been disallowed upon subsequent disposition of Target Parent (operating as a virtual wash in terms of the amount of loss allowance). The portion of the loss on the disposition of the Target Parent stock equal to the $L decline in value of the assets would not have been disallowed upon the sale of Target Parent. On the facts before us, the fmv of the trademarks declined below their value at the time Ultimate Sub purchased the Target Parent stock and any amount of loss associated with that decline in value should not be disallowed.

Therefore, since Target Parent had an asset that declined in value after Target Parent’s stock was purchased by Ultimate Sub, the loss on the sale of the Target Parent stock should not be disallowed under the loss disallowance rules to the

extent of the decline in value of that asset. Since Ultimate Sub is entitled to the loss on the sale of Target Parent stock with respect to a decline in value of the stock associated with the decrease in value of the trademarks, the sale of the Target Parent stock should not be treated as if the taxpayer acted with a view to avoid the Treas. Reg. section 1.1502-20 regulations.

2. Treas. Reg. section 1.1502-32 and Extraordinary Gain Dispositions

Ultimate Parent has stated, subsequent to the prior FSA, that it properly accounted for the distribution of the Target Sub 2 stock by reducing its basis in the Target Parent shares by approximately $W which reflects the fmv of the trademarks.[2] Despite Ultimate Sub reducing its basis in the shares of Target Parent for the $W value of Target Sub 2 stock, which is required pursuant to Treas. Reg. section 1.1502-32(b)(2)(iv), any losses resulting from the sale of the Target Parent stock are disallowed to the extent of extraordinary gain dispositions. The extraordinary gain dispositions, in the facts before us, result from a distribution of property (the Target Sub 2 stock which reflects the gain potential in the trademarks), where such property has a fair market value higher than its basis. We are providing further background and analysis upon this issue.

Background

The loss disallowance rules carry out the purposes of the repeal of the General Utilities doctrine in the consolidated return context. 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 is named after the General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) case, which was subsequently codified in sections 311, 336, and 337 of the Internal Revenue Code of 1954. The doctrine provided exceptions to the two-level system of corporate taxation by according nonrecognition treatment on 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. The loss disallowance rules carry out the purposes of these amendments in the consolidated return context.

---

[2]Although this fact was unclear at the time of the prior FSA, the Service made the assumption that the appropriate Treas. Reg. section 1.1502-32 adjustments were made.

As previously mentioned, the loss disallowance rules provide, as a general loss disallowance rule, that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. Treas. Reg. section 1.1502-20(c) limits the general rule by specifying that the amount of loss disallowed shall not exceed the sum of extraordinary gain dispositions, positive investment adjustments and duplicated losses.

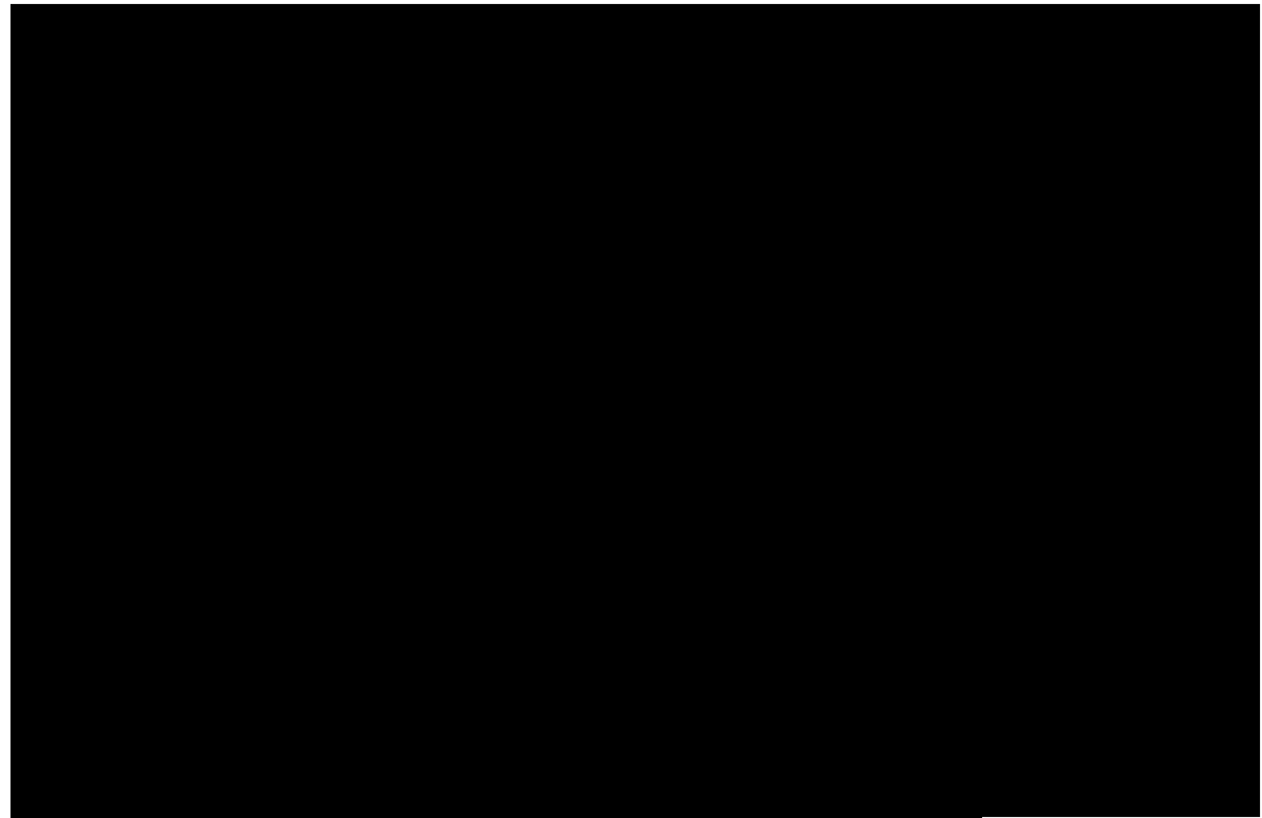
Treas. Reg. section 1.1502-20(c)(2)(i) defines the term extraordinary gain disposition for purposes of section 1.1502-20. Treas. Reg. sections 1.1502-20(c)(2)(i)(A)-(D) provide the operating rules for purposes of calculating the extraordinary gain disposition amount. Under the operating rules, loss on 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 section 1221 capital assets, etc.

Application

It is our understanding of the facts before us that Target Parent, a subsidiary of Ultimate Sub, had a wholly owned subsidiary Target Sub 1 that owned a capital asset under IRC section 1221, namely the Target Sub 2 stock, with built-in gain potential. Under the facts, the distribution of the Target Sub 2 stock to Target Parent which Target Parent then distributed to Ultimate Sub under section 311(b) resulted in a recognition of gain to Target Sub 1 that was triggered when Target Parent was sold outside the Ultimate Parent Group. The documentation we have been provided does not reflect how this gain was treated by the Ultimate Parent Group. More specifically, when Ultimate Sub had Target Parent distribute the Target Sub 2 stock it had received as a distribution from its subsidiary Target Sub 1 to Ultimate Sub, the distribution occurred after Target Sub 1 had contributed valuable trademarks with a $W fair market value and $EEE basis to Target Sub 2. The Target Sub 2 stock Target Sub 1 received from Target Sub 2 as a result of the section 351 exchange of the trademarks had a fair market value of $W and $EEE basis. See IRC section 358. Target Sub 1 distributed the Target Sub 2 stock to Target Parent when the Target Sub 2 stock had a $W fmv and $EEE basis in the hands of Target Sub 1. Upon distribution of the Target Sub 2 stock, any gain recognized to Target Sub 1 under IRC section 311(b) would be for the amount of the difference between the fmv of $W and $EEE basis. In a consolidated return context this gain would be deferred until a triggering event. This gain would have been triggered when Target Parent left the Ultimate Parent Group as a result of Ultimate Sub selling the Target Parent stock to Individual B. See Treas. Reg. section 1.1502-14(c) and (d) of the regulations as then in effect. The IRC section 311(b) gain with respect to the Target Sub 2 stock should have been treated by Target Sub 1 as if it sold the Target Sub 2 stock. See IRC section 311(b)(1)(B). The basis Target Parent had in its Target Sub 1 stock, and correspondingly the basis that Ultimate Sub had in its Target Parent stock, would have then increased

by $W as a result of the gain. See Treas. Reg. section 1.1502-32. The IRC section 311(b) gain on the Target Sub 2 stock distribution is, under the facts, a gain from a sale of a capital asset which results in an extraordinary gain disposition under Treas. Reg. section 1.1502-20. Upon the sale of the Target Parent stock, $W would be disallowed because of this extraordinary gain disposition.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



Please call if you have any further questions.

JASPER L. CUMMINGS, JR.
ASSOCIATE CHIEF COUNSEL
(CORPORATE)
By: ALFRED C. BISHOP, JR.
Branch Chief (CC:CORP:Br.6)