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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

Attn:

FROM: Associate Chief Counsel, Corporate CC:CORP

SUBJECT: Capital Loss on Preferred Stock Sale

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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LEGEND

PCorp	=
SubA	=
SubAl	=
SubA2	=
SubB	=
SubBI	=
Year1	=
Year2	=
Year3	=
Year4	=
Year5	=
Year6	=
Year7	=
Date1	=
Date2	=
Date3	=
Date 4	=
StateA	=
City 1	=

#a	=
#b	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
%a	=

%b =

%c =

%d =

%e =

%f =

%g =

ISSUE

Whether SubA, a subsidiary-member of a consolidated group, may deduct a loss purportedly realized on the sale of stock of one of its subsidiaries.

CONCLUSION

The taxpayer has incorrectly computed its basis and in fact has realized no loss. Further, even if the taxpayer's basis computation were correct, any loss realized is subject to section 1.1502-20 of the Income Tax Regulations and other disallowance provisions.

FACTS

PCorp is a City 1 based company and the common parent of a controlled group of corporations that files its Federal income tax return (Form 1120L) on a consolidated basis.

SubA is a wholly-owned subsidiary of PCorp. SubA was formed Date3, and began its trade or business on Date4. SubA's services can be categorized into three business lines: cash and physical, risk management, and finance.

SubA has two wholly-owned subsidiaries, SubA1, and SubA2.

SubB is another wholly-owned subsidiary of PCorp. SubB has a wholly-owned subsidiary, SubB1".

SubA, SubA1, SubA2, SubB, and SubB1 all were included in the PCorp group consolidated return for the taxable year Year1.

During Year1, SubA held fixed-price risk management liabilities under swaps, options, swaptions, and forward contracts in excess of $a, as well as credit reserves in excess of $b.

On Date1, members of the taxpayer's consolidated group engaged in the following transactions.

1. PCorp, SubA, SubA2, and SubB1 executed an Assignment of Accounts Receivable wherein PCorp transferred to SubA an account receivable from SubA2 in the amount of $c, and an account receivable from SubB1 in the amount of $d, for a total amount of $e.

2. SubA increased its account payable to PCorp in the amount of $e.

3. SubA2 and SubB1 each agreed to convert the transferred receivables into promissory notes to SubA. SubA2 executed a promissory note in favor of SubA in the amount of $c, and SubB1 executed a promissory note in favor of SubA in the amount of $d (collectively the "Promissory Notes").

4. SubA and SubA1 entered into a Subscription Agreement wherein SubA1 agreed to enter into a Master Swap Agreement in order to "transfer," as between SubA and SubA1 only, (1) the economic liability of certain liabilities of SubA under swap, option, swaption and forward contracts (the "Swap Liabilities"), which totaled $f, and (2) the economic risk of certain credit reserves of SubA that were characterized as liabilities (the "Credit Reserves"), which totaled $g. The Swap Liabilities and the Credit Reserves are collectively referred to herein as the "Liabilities." The Liabilities totaled $h. SubA and SubA1 also entered into a Liability Management Agreement and a Services Agreement.

5. SubA1 filed a restated Certificate of Incorporation with the StateA Secretary of State and redefined the purpose, or nature of the business, of the corporation to be: (1) the management of certain liabilities pursuant to a Liability Management Agreement between SubA1 and SubA; (2) to undertake obligations under a Master Swap Agreement and a Service Agreement with SubA; and (3) any other lawful business or activity, provided such other business purposes are approved in writing by SubA in its sole discretion. Under the restated articles, the board of directors for SubA1 authorized the issuance of #a shares of voting preferred stock, each without a par value.

6. SubA transferred to SubA1 the Promissory Notes totaling $e in return for (i) the "assumption" of the Liabilities totaling $h, (ii) #b shares of SubA1 voting preferred stock, and (iii) $i. The face amount of the Promissory Notes exceeded the total amount of the Liabilities by $j.

Certain of the contracts creating the Swap Liabilities (the "Swap Contracts") required consent to assignment. Consequently, pursuant to a Subscription Agreement, SubA and SubA1 entered into a Master Swap Agreement and transactions on the same terms as the Swap Liabilities in order to transfer, as between SubA and SubA1 only, the economic liability of the Swap Liabilities without breaching any of the Swap Contracts. In order to transfer the economic risk of the Credit Reserves, the Master Swap Agreement and transactions granted SubA an option to receive payments from SubA1 if there was a payment default by third parties under the contracts under which the Credit Reserves arose.

In connection with the transfer of the Swap Liabilities, SubA and SubA1 entered into an additional transaction on terms that would hedge SubA1 against any increases in the Swap Liabilities as a result of changes in market conditions (the "SubA1 Hedge Transactions"). The liability of SubA1 with respect to the Credit Reserves was capped at the amount of the Credit Reserves.

Pursuant to the Liability Management Agreement, SubA1 agreed to be responsible for managing the Swap Liabilities and the Credit Reserves in an effort to reduce them. SubA1 had the right, subject to approval by SubA, to enter into any subcontract with any third party to perform its obligations under the Liability Management Agreement. Before engaging in any swap restructuring, SubA1 was required to submit the proposed terms to SubA in writing, and SubA would then evaluate whether the restructuring would be a net benefit to SubA. Any derivative contracts entered into pursuant to a swap restructuring were to be carried out by SubA, as well as any other activities that, in SubA's view, were more appropriate for it to carry out. Similarly, before engaging in any credit restructuring, SubA1 was required to submit the proposed terms to SubA in writing, and SubA would then evaluate whether the restructuring would be a net benefit to SubA, and SubA would carry out any activities that, in its view, were more appropriate for SubA to carry out. Of the contracts comprising the Swap Liabilities, %a were due to mature in Year2, %b in Year3, %c in Year4, %d in Year5, and %e in each of the years Year6 and Year7.

Pursuant to the Liability Management Agreement, SubA agreed to pay SubA1 an annual base fee of $k as compensation for its services. Pursuant to the Services Agreement, SubA agreed to provide or cause to be provided to SubA1 certain corporate and staff services, including, inter alia, the following: tax matters, registration and transfer of SubA1 securities, SEC filings, investor relations, insurance, audit, treasury and banking, financial, credit analysis, accounting, transaction structuring and pricing, administrative services, payroll services, data processing services, facility services, trading services, and legal. In consideration therefor, SubA1 agreed to reimburse SubA or the applicable SubA affiliate for (i) $l a month ($m annually) for administrative and general expenditures, (ii) the actual cost of any item purchased for SubA1 by SubA, and (iii) outsourced charges.

To assist SubA1 in performing its obligations under the Master Swap Agreement and Liability Management Agreement, on Date1, PCorp and SubA1 entered into a Revolving Credit Agreement whereby PCorp agreed to make one or more advances to SubA1 in an aggregate amount not to exceed at any time $n. Pursuant to the Revolving Credit Agreement, SubA1 could use advances only for the purpose of enabling it (i) to perform its obligations under the Master Swap Agreement, the Liability Management Agreement, and the Services Agreement, (ii) to pay salaries of the employees of SubA1 and (iii) to pay dividends to the holders of the SubA1 preferred stock.

On Date2, SubA sold its #b shares of SubA1 voting preferred stock to three employees of SubA1 for a total sales price of $j. The three employees had been transferred to SubA1 from SubA, but continued to perform duties for SubA.

On the Schedule D, Capital Gains and Losses, for SubA attached to the PCorp group return for Year1, SubA reported a basis in the #b shares in the amount of $o, and a loss on the sale of the #b shares in the amount of $p.[1]

The PCorp group attached to its return for the Year1 taxable year the statement required by § 1.1502-20(c)(3) with respect to the loss claimed on the disposition of the preferred stock in SubA1.

The taxpayer claims that it engaged in the transactions to add value to the company by restructuring the contracts comprising the Swap Liabilities. According to the taxpayer, any value from the contracts would be long-term, and it transferred them to a separate entity to demonstrate management's long-term commitment to the project. The taxpayer claims that it offered employees the opportunity to purchase equity in the new entity as an incentive to focus their efforts on the transferred contracts. Those employees estimated that they devoted less than %f of their time to restructuring the contracts after the transaction, and that the majority of their time was spent on performing their regular duties at SubA.

The taxpayer explained that the accounts receivable from SubA2 and SubB1 were converted into Promissory Notes payable to SubA1 in order to provide SubA1 with sufficient assets to cover the liabilities being transferred.

[1] The basis calculation provided to us is as follows: $e - $r (in premiums on unrealized liabilities) + $s (in intercompany receivable/payables). We are not commenting on the correctness of the basis calculation.

LAW AND ANALYSIS

The instant transaction is the same as or substantially similar to those described in I.R.S. Notice 2001-17, 2001-09 I.R.B. 1. This memorandum addresses first the proper computation of SubA's basis in the stock of SubA1 and then the application of § 1.1502-20 and other provisions to any loss realized.

I. Overview of Code Provisions

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and, immediately after the exchange, such person or persons are in control of the corporation. For purposes of section 351, control is defined as ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c).

Section 351(b) provides that if section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under section 351(a), other property or money, then gain (if any) to such recipient shall be recognized, but not in excess of the amount of money received plus the fair market value of such other property received, and no loss to such recipient shall be recognized.

Section 357(a) in relevant part provides that except as provided in sections 357(b) and (c), if the taxpayer (i.e., the transferor) receives property which would be permitted to be received under section 351 without the recognition of gain if it were the sole consideration (i.e., the stock of the transferee corporation) and, as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property and shall not prevent the exchange from being within the provisions of section 351.

Section 357(b) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in section 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption or acquisition shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange. Section 357(b)(2) provides that the burden is on the taxpayer to prove by the clear preponderance of the evidence that such assumption or acquisition is not to be treated as money received by the taxpayer.

Section 357(c)(1), in relevant part, provides that, in the case of an exchange to which section 351 applies, if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Section 357(c)(2)(A) provides that section 357(c)(1) shall not apply to any exchange to which section 357(b)(1) applies.

Section 357(c)(3)(A) provides that if a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either would give rise to a deduction, or would be described in section 736(a), then, for purposes of section 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

Section 357(c)(3)(B) provides that section 357(c)(3)(A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or increase in, the basis of any property.

Section 358(a)(1) provides in relevant part that, in the case of an exchange to which section 351 applies, the basis of property permitted to be received under such section without the recognition of gain or loss (i.e., the stock of the transferee corporation) shall be the same as that of the property exchanged, decreased by the fair market value of any other property received by the taxpayer, the amount of money received by the taxpayer, and the amount of loss to the taxpayer that was recognized on the exchange, and increased by the amount that was treated as a dividend and the amount of gain to the taxpayer which was recognized on such exchange (other than the dividend amount).

Section 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of section 358, be treated as money received by the taxpayer on the exchange.

Section 358(d)(2) provides that section 358(d)(1) shall not apply to the amount of any liability excluded under section 357(c)(3).

Section 362(a), in relevant part, provides that in a section 351 transaction, the (transferee) corporation’s basis in the property acquired in the transaction will be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

II. Analysis.

As of the writing of this field service advice, the taxpayer has not articulated the grounds for how it arrived at the claimed loss in issue. Presumably the taxpayer is relying on sections 351, 357 and 358, as well as the inapplicability of § 1.1502-20, to arrive at the claimed loss.

The transaction is purported to qualify as an exchange under section 351, and the basis of the transferee stock received is purported to be equal to the basis of the transferred asset, unreduced by the liability assumed by the transferee corporation. See sections 358(d)(2), 357(c)(3). Although liabilities assumed by a transferee corporation in a section 351 exchange ordinarily are treated as money received by the transferor for purposes of section 358, and reduce basis in the transferee stock accordingly, presumably the taxpayer either is arguing that the Liabilities at issue here are not "liabilities" within the meaning of section 357 or is relying on section 357(c)(3)(A) and the exception under section 358(d)(2) as grounds for not reducing the basis of the stock received in the purported exchange.

A. Preliminary Points.

As a threshold matter, the position of this office is that the Swap Liabilities and Credit Reserves in this case are liabilities for purposes of sections 357 and 358.

Congress enacted section 357(c)(3) in response to several court cases that had developed different approaches to prevent the application of section 357(c)(1) to an assumption of a liability that had not produced a financial or tax benefit for the transferor. See Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976), rev'g in part and aff'g in part 61 T.C. 28 (1973); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), rev'g T.C. Memo. 1971-262 (reasoning that the term "liability" under section 357(c) was meant to be limited to what might be called "tax liabilities", i.e., liens in excess of tax costs); Focht v. Commissioner, 68 T.C. 223 (1977) (reasoning that the term "liability" under section 357 should be limited to those obligations which, if transferred, cause gain recognition under Crane v. Commissioner, 331 U.S. 1 (1947), and an obligation should not be treated as a liability to the extent that its payment would have been deductible if made by the transferor).

In contrast to the approaches developed by the courts, however, Congress did not define (or redefine) the term "liabilities" for purposes of section 357(c) or section 357 in general. Rather, under section 357(c)(3), Congress excluded certain "liabilities" from the section 357(c)(1) determination; specifically "liabilities" the payment of which would give rise to a deduction, unless the “liability” had generated, or would generate, a tax benefit for the transferor. Further, the Senate Finance Committee Report accompanying the Revenue Act of 1978, which enacted section 357(c)(3), states that the provision “is not intended to affect the definition of the term liabilities for any other provision of the Code, including sections 357(a) and 357(b).” S. Rep. No. 1263, 95th Cong., 2d Sess. 185 (1978), 1978-3, Vol 1 C.B. 481, 483.

Accordingly, an argument that the very liabilities described by section 357(c)(3)(A) are not “liabilities,” or are not to be taken into account, for purposes of sections 357 and 358 is unpersuasive. Any other interpretation would render sections 357(c)(3) and 358(d)(2) superfluous.

Finally, for purposes of this discussion we are treating the Liabilities as “assumed” for purposes of section 357. Neither sections 357(d) nor 358(h) apply in this case because the exchange occurred prior to their effective dates, October 18, 1998 and October 19, 1999, respectively. See § 309 of the Community Renewal Tax Relief Act of 2000, P.L. 106-554. The new section 358(h) and its legislative history do provide some guidance, however.[2]

B. Arguments.

Following is a discussion of potential arguments based upon the facts as currently developed. Further factual development may suggest additional arguments, including some arguments set forth in Notice 2001-17.

1. Section 357(b)(1)(B)

In the instant case, the nature of the liability and the circumstances under which the arrangement for the assumption or acquisition was made strongly suggest that the principal purpose of the taxpayer with respect to the assumption or acquisition was

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[2] In general, under the newly enacted section 358(h), if the basis of stock (determined without regard to section 358(h)) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduce the transferor’s basis of the stock by reason of the assumption. § 358(h)(1). However, except as provided by the Secretary of the Treasury, section 358(h)(1) does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets with which the liability is associated are transferred to the corporation as part of the exchange. § 358(h)(2).

not a bona fide business purpose. Consequently, section 357(b)(1)(B) applies to treat the assumption or acquisition as money received by the transferor on the exchange. Section 358(a)(1)(A)(ii) then applies to reduce the basis in the transferee stock by the amount of the deemed money received.

Section 357(b) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in section 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption or acquisition shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange. Section 357(b)(2) provides that the burden is on the taxpayer to prove by the clear preponderance of the evidence that such assumption or acquisition is not to be treated as money received by the taxpayer.

Application of section 357(b)(1) supersedes application of both sections 357(a) and 357(c). Sections 357(a), 357(c)(2)(A). Section 357(a) provides for application of the general rule of section 357, "[e]xcept as provided in subsection (b) and (c)". Section 357(c)(2)(A) expressly provides that section 357(c)(1) shall not apply to any exchange to which section 357(b)(1) applies. This necessarily extends to section 357(c)(3), which simply excludes certain liabilities "for purposes of" applying section 357(c)(1). Thus, in an exchange to which section 357(b)(1) applies, section 357(c)(1) does not apply and therefore section 357(c)(3) is rendered moot. Accordingly, neither the general rule of section 357(a), nor section 357(c)(1) and (3), apply to an exchange to which section 357(b)(1) applies. Section 357(a), 357(c)(2)(A).

Turning to the instant case, no trade or business, nor any assets to which the assumed liabilities related, were transferred. The only assets transferred were the Promissory Notes, which totaled slightly more than the Liabilities assumed. In return therefor, the transferee assumed said Liabilities and issued preferred stock having a fair market value equal to the net amount transferred (i.e., equal to the total amount of the Promissory Notes transferred in excess of the Liabilities assumed). The transferor then promptly sold the preferred stock for a huge loss.

The taxpayer has articulated several as of yet unsubstantiated business reasons for the exchange, the plausibility of which we do not speculate on here. In any event, while the transferor may have had some business benefit from the assumption (such as centralized administration of the Liabilities), the overall circumstances of the assumption strongly suggest that the principal purpose for it was not a bona fide business reason. Therefore, absent a clear preponderance of evidence establishing otherwise, application of section 357(b)(1) should be given strong consideration in this case.

The application of section 357(b)(1) will result in the assumption of the Liabilities being treated as the receipt of money by the transferor on the exchange, and its basis in the transferee preferred stock will be reduced to that extent under section 358(a)(1)(A)(ii).[3]

2. Sections 357(c)(3), 358(d) and 358(a)(1)(A)(ii)

Even assuming section 357(b) does not apply, the taxpayer's reliance on the exception under section 358(d)(2) for not reducing the basis of the transferee preferred stock received in the exchange, based upon section 357(c)(3)(A), is misplaced.[4]

Specifically, section 357(c)(3)(A) does not apply to the Liabilities assumed in this case because we presume that the transferor remains entitled to take the deduction arising from payment of the Liabilities subsequent to the exchange.[5] Therefore, section 358(d)(2) does not apply, and the transferor's basis in the transferee stock must be decreased by the amount of the Liabilities assumed. Sections 358(d)(1) and 358(a)(1)(A)(ii).

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[3] Even if an assumed liability otherwise would qualify as an excludible liability under section 357(c)(3), if section 357(b) applies to the exchange then section 358(d)(2) would not apply. Functionally, the provision currently set forth in section 358(d)(1) (formerly section 358(d) of the 1954 Code, which was formerly section 113(a)(6) of the 1939 Code) has never had application when the provision currently set forth in section 357(b) (formerly section 112(k) of the 1939 Code) applies. By its terms, assumed liabilities to which section 357(b) applies are considered as money received by the transferor. Thus, when section 357(b) applies to a section 351 exchange, section 358(a)(1)(A)(ii) applies without resort to section 358(d)(1) (in effect, section 358(d)(1) is rendered moot). Stated otherwise, section 358(d)(1) only has application when section 357(b) does not apply to the exchange. As an exception to section 358(d)(1), therefore, section 358(d)(2) does not apply when section 357(b) applies to an exchange, because section 358(d)(1) has no application.

[4] We are assuming the taxpayer is interpreting § 1.1502-80(d) as excluding the application of section 357(c)(1), but not section 357(c)(3), to any transaction to which § 1.1502-13, § 1.1502-13T, § 1.1502-14, or § 1.1502-14T applies. We do not address the correctness of this interpretation here.

[5] For purposes of this argument, we presume that the deduction for satisfaction of the Liabilities remains with the transferor rather than the transferee. Cf. Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), with Rev. Rul. 95-74, 1995-2 C.B. 36. However, this question requires further factual and legal development.

Section 357(c)(3)(A) provides in relevant part that if a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which "would give rise to a deduction," then, for purposes of section 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject. Section 357(c)(3)(A)(i). Conversely, section 357(c)(3)(A) does not apply to exclude a liability to the extent the liability has already been deducted by the transferor.[6] Section 357(c)(3)(A)(i). Nor does section 357(c)(3)(A) apply to exclude any liability to the extent that the incurrence of the liability resulted in the creation of, or increase in, the basis of any property. Section 357(c)(3)(B).

By logical extension, section 357(c)(3)(A)(i) does not apply to exclude a liability to the extent the transferor remains entitled to claim the deduction subsequent to the exchange. This is consistent with the function of section 357(c)(3). Congress enacted section 357(c)(3) to prevent inappropriate gain recognition resulting from the application of section 357(c)(1) to certain liabilities. In general, the assumption of a deductible liability in a section 351 exchange should be a nonrealizable event, because it is improper to treat the assumed liability as income to the transferor when he is denied the tax benefit for its satisfaction. Focht v. Commissioner, 68 T.C. 223, 237 (1977). To prevent such inappropriate gain recognition under section 357(c)(1), Congress enacted section 357(c)(3). See section 103(a)(12) of the Technical Corrections Act of 1979 (P.L. 96-222, 1980-1 C.B. 499, 509); S. Rep. No. 96-498, 1980-1 C.B. 517, 546. Conversely, it follows that section 357(c)(3)(A)(i) does not apply to exclude a liability when the transferor remains entitled to claim the deduction for its payment subsequent to the exchange (i.e., the transferor is not denied the tax benefit for its satisfaction).

In the instant case, the transferee did not acquire a trade or business, nor take over any assets related to the Liabilities. Consequently, the transferee will not be entitled to a deduction upon satisfaction of the Liabilities. See Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946);[7] Cf. Rev. Rul. 95-74, 1995-2

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[6] This is implicit in section 357(c)(3)(A)(i), and is expressly stated in the Senate Finance Committee Report accompanying the Technical Corrections Act of 1979, which amended section 357(c)(3). See S. Rep. No. 96-498, 1980-1 C.B. 517, 546.

[7] The case of Holdcroft Transp. Co. v. Commissioner, supra, involved a transfer of a business and its assets, pursuant to the predecessor to section 351, in exchange for common stock and the assumption of the liabilities of the transferor, two of which were lawsuits that arose prior to the transfer. Although the transferor partnership would have been entitled to deductions for the payments had it actually made them, the court found that the expense of settling the claims of the predecessor

C.B. 36, Rev. Rul. 80-198, 1980 C.B. 113. Rather, we presume that the transferor remains entitled to any future deduction arising from satisfaction of the Liabilities. That being the case, section 357(c)(3)(A)(i) does not apply to the Liabilities, and the transferor's basis in the transferee stock must be reduced by the amount of the Liabilities assumed.[8] §§ 358(d)(1) and 358(a)(1)(A)(ii). To apply section 357(c)(3)(A)(i) to these Liabilities would grossly pervert Congressional intent for section 357(c)(3) because it would effectively operate to manufacture a double deduction. See sections 1.161-1, 1.1016-6(a).

3. The Loss is Not a Bona Fide Loss Allowable Under Section 165

The loss claimed by the taxpayer on the sale of the preferred stock is not a bona fide economic loss representing a real change of position in a true economic sense, and therefore is not allowable under section 165.

Section 165 provides that "a taxpayer may deduct any loss sustained during the taxable year for which the taxpayer is not indemnified by insurance or otherwise." The loss must be a bona fide loss representing a real change of position in a true economic sense; substance rather than form governs in determining a deductible loss. Section 1.165(b). A deduction for a loss must be based on an actual economic loss. See, e.g., Scully v. U.S., 840 F.2d 478 (7th Cir. 1988).

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entity was not an operating expense or loss of the business of the transferee, but was part of the cost of acquiring the predecessor's property. The fact that the claims were contingent and unliquidated at the time of the acquisition was not of controlling consequence. Consequently, the court held that they were nondeductible capital expenditures.

[8] This result also is consistent with several revenue rulings regarding the treatment of the assumption of deductible liabilities in a valid section 351 exchange. See Rev. Rul. 95-74, 1995-2 C.B. 36, Rev. Rul. 80-199, 1980 C.B. 122, and Rev. Rul. 80-198, 1980 C.B. 113. Each of these rulings involved an exchange, for bona fide business purposes, of substantially all of the assets associated with a business, and an assumption of deductible liabilities that related to an asset transferred. Each ruling concluded that the assumed liabilities properly were not included in determining the amount of liabilities assumed for purposes of section 357(c)(1). Further, Rev. Rul. 95-74 and Rev. Rul. 80-198 also each concluded that the transferee corporation, which (unlike here) acquired substantially all of the assets associated with a business, including the assets associated with the assumed liabilities, would be entitled to a deduction upon satisfaction of the assumed liabilities (this latter issue was not addressed by Rev. Rul. 80-199).

Focusing exclusively on the property involved in the purported exchange, immediately prior thereto the transferor possessed $e in Promissory Notes from SubA2 and SubB1, and $h in liabilities (yielding a net positive economic position of $j). Immediately after the exchange (in which the Promissory Notes and the Liabilities were transferred), the transferor possessed $j in transferee preferred stock plus $i cash (yielding a net positive economic position of $q). Next, immediately after the sale of the transferee preferred stock, the transferor possessed $q cash (yielding a net positive economic position of $q). As discussed, presumably the transferor will not lose any deduction that will arise from the payment or satisfaction of the Liabilities. Thus, the transferor has suffered no economic detriment. Indeed, consistent with the foregoing, the taxpayer did not record a loss on the sale of the preferred stock for non-tax book purposes.

The "loss" on the sale of the preferred stock effectively is nothing more than an acceleration of, and duplication of, the deduction associated with payment of the Liabilities. Accordingly, given that the claimed loss is not a bona fide loss representing a real negative change of position in a true economic sense, it is not allowable under section 165.

4. Business Purpose and Section 351

The business purpose doctrine applies to section 351 exchanges. See Rev. Rul. 55-36, 1955-1 C.B. 340; see also Caruth v. United States, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). The facts indicate that the taxpayer may have asserted a business purpose, however, it is not clear that the facts indicate whether in fact the taxpayer's claimed business purpose was genuine. Consequently, should none of the taxpayer's claimed business purposes for the exchange be substantiated, it can be argued that the exchange does not qualify for section 351 nonrecognition treatment for lack of business purpose.

5. Economic Substance

You asked us to consider a lack of economic substance argument. In determining the tax consequences of a transaction, including whether a transaction qualifies for favorable nonrecognition treatment, the courts will look at the substance of the transaction or relationship, not merely its form. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). The key question in analyzing a tax-motivated transaction is "whether what was done, apart from the tax motive, was the thing the statute intended." Gregory v. Helvering, 293 U.S. 465, 469 (1935). In Gregory, the Court disregarded the potential tax consequences of a corporate reorganization despite the fact that the taxpayer had complied with all statutory requirements because the transaction had no valid economic purpose and on its face lay outside the intent of the statute.

A transaction must have economic substance to be respected for tax purposes. See ACM Partnership v. Commissioner ("ACM"), 157 F.3d 231, 247 (3rd Cir. 1998), aff'g in relevant part T.C. Memo. 1997-115. The inquiry into whether transactions have sufficient substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them. Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989). The objective and subjective prongs of the inquiry are related factors, both of which are necessary to complete the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership v. Commissioner, 157 F.3d at 247. The first of these two factors focuses on whether the transaction at issue had any practical economic consequences, other than the creation of tax benefits, i.e., whether the transaction appreciably changed the taxpayer's "economic position." Id. at 248-249. The second factor focuses on whether the taxpayer had a valid business purpose or profit motive. Id. at 253-254.

Turning to the instant case, certainly the accelerated, if not duplicated, loss built into the transferee preferred stock was not "the thing" that was intended for section 351, nor for sections 357 and 358. As discussed with respect to section 165, supra, the facts of the instant case reflect that the transferor did not appreciably change its economic position. Nor, for that matter, do the facts suggest that the transferee changed its economic position. Given that the purpose for the assumption was not a bona fide business purpose, consideration should be given to the argument that the transaction lacked economic substance and should not be respected for tax purposes.

6. Section 1.1502-20

If, despite the arguments discussed above, the taxpayer is treated as having realized a loss, such loss is subject to the Loss Disallowance Rules ("LDR") of § 1.1502-20 and other provisions and principles of law, as discussed below.

(a) Relevant Facts

As set forth above, PCorp transferred to its subsidiary, SubA, two accounts receivable (totaling $d) from two other members (SubA2 and SubB1) of the PCorp consolidated group. SubA increased its account payable to PCorp by this amount. On the same day, SubA2 and SubB1 each converted the transferred receivables into Promissory Notes.[9] On the same date, SubA transferred the Promissory Notes

[9] It will be necessary to determine whether the Promissory Notes qualify as another subsidiary's "securities" within the meaning of § 1.1502-20(c)(2)(vi)(A)(1). For purposes of this memorandum we assume the Promissory Notes are other subsidiaries'

to its subsidiary, SubA1, in return for SubA1's assumption of $h of SubA's Liabilities, #b shares of SubA1 voting preferred stock, and $i. The face amounts of the Promissory Notes exceeded the total amount of the Liabilities by $j.

On Date2, SubA sold its #b shares of SubA1 voting preferred stock to three employees of SubA1 for a total sales price of $j. SubA claimed a $o basis in the #b shares,[10] and thus claimed a $p loss on the stock sale. The taxpayer has not articulated the grounds for how it arrived at the claimed loss in issue. However, as previously discussed, presumably the taxpayer is relying, in part, on sections 351, 357 and 358 to arrive at the claimed loss. Presumably PCorp's starting point for determining SubA's basis in the SubA1 stock is equal to the basis SubA had in the Promissory Notes, unreduced by the Liabilities assumed by SubA1. <u>See</u> sections 358(d)(2) and 357(c)(3).

(b) Overview

The structure of the transaction outlined above was carefully designed to try to avoid the Loss Duplication portion of the § 1.1502-20. Under the Loss Duplication provision, which will be discussed more fully below, Duplicated Loss is determined <u>immediately after</u> a disposition (or deconsolidation) of subsidiary stock, and, as applied to this case, equals the amount by which the sum of SubA1's:

a. aggregate adjusted asset basis (<u>other than its basis in another subsidiary's stock and securities</u>),
b. loss carryforwards, and
c. deferred deductions

exceed the sum of its

a. stock value,
b. liabilities, and
c. any other relevant items.

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securities. If you discover that this assumption is unwarranted, we recommend you seek supplemental Field Service advice. Note that if the Promissory Notes are not securities, the amounts would not be excluded from SubA1's asset basis calculation for purposes of the Duplicated Loss formula (even absent the application of § 1.1502-20(e), § 1.1502-13(g) or § 1.1502-13(h)(1) (see discussion in text below)).

[10] See footnote 1.

We suspect that the sole reason SubA1's assets principally consisted of other subsidiaries' securities (i.e., the Promissory Notes) at the time of its stock sale was because, under the Duplicated Loss formula, such items would be excluded from SubA1's aggregate adjusted asset basis. It appears from the facts thus far developed that SubA1 had minimal, if any, loss carryforwards or deferred deductions, and that SubA1's assets principally consisted of the Promissory Notes[11] (which are arguably "another subsidiary's' securities" within the meaning of § 1.1502-20(c)(2)(vi)(A)(1)). Thus, if the basis of the Promissory Notes are excluded from, and not otherwise reflected in, the top portion of the Duplicated Loss formula, SubA1 would have, as it claimed, a Duplicated Loss amount of zero.

This portion of the memorandum explains why the consolidated return regulations actually result in disallowing the entire loss claimed by SubA on its sale of SubA1's preferred stock. As discussed more fully below, we believe the Promissory Notes are Intercompany Obligations (i.e., obligations between members of a consolidated group) that are subject to the Intercompany Obligation provisions of § 1.1502-13(g). That provision provides, inter alia, that if a member realizes an amount of income or loss directly or indirectly, from the assignment or extinguishment of an Intercompany Obligation, the Intercompany Obligation is treated as satisfied under § 1.1502-13(g)(3)(ii); if the Intercompany Obligation remains outstanding, it is treated as reissued immediately after the transaction. Section1.1502-13(g)(3)(iii).

As we discuss more fully below, we believe SubA's sale of the SubA1 preferred stock resulted in an indirect realization of the Intercompany Obligations held by SubA1. Accordingly, at that time there was a deemed satisfaction of the Intercompany Obligations. Thus, at the time SubA1's Duplicated Loss amount was calculated (i.e., immediately after the SubA1 stock sale), SubA1 is deemed to hold the proceeds from the deemed satisfaction of the Intercompany Obligations, rather than the Promissory Notes (i.e., the other subsidiaries' securities) themselves. Thus, for purpose of the Duplicated Loss formula, SubA1's aggregate adjusted asset basis includes the deemed proceeds from the Promissory Notes ($e). Since the fair market value of SubA1 stock is $j,[12] and (as discussed more fully below),

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[11] Under the facts presented, it is unclear what assets, other than the Promissory Notes, were held by SubA1 at the time of its stock sale. For purposes of this memorandum, we assume that SubA1 held no other assets. However, in order to calculate SubA1's LDR amount, the agent will need to establish SubA1's actual aggregate adjusted asset basis immediately after the sale of its stock.

[12] This is the amount the SubA1 employees paid for the preferred stock. For purposes of this memorandum only, in calculating the Duplicated Loss, we assume that the value of SubA1's stock is $j. The agent will need to establish the actual FMV of the

Service position is that the Liabilities in this case should not be taken into account for purposes of the Duplicated Loss formula because they had not yet been taken into account for tax purposes, SubA1's Loss Duplication amount would be $e, rather than zero (which is reflective of the amount of loss duplication that is preserved for the PCorp group [or any of its members] upon SubA1's payment of the Liabilities).

Finally, as will be discussed more fully below, we note that in addition to the foregoing technical arguments, SubA's claimed loss on the SubA1 preferred stock sale should also be disallowed through application of the anti-avoidance rules of § 1.1502-13(h)(1) and § 1.1502-20(e)(1).

(c) Law

All consolidated group members are subject to the provisions of § 1.1502-20. Section 1.1502-20(a) in relevant part provides that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of another member. Section 1.1502-20(c)(1) modifies the broad disallowance rule of § 1.1502-20(a) by providing that the amount of loss disallowed with respect to a share of stock is limited to the sum of the subsidiary's extraordinary gain dispositions ("EGD"),[13] positive investment adjustments ("PIA"),[14] and duplicated loss amount

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SubA1 stock. Once this amount (and all other noted amounts) are established, we recommend you seek supplemental advice regarding the LDR calculation.

[13] The amount of income or gain, net of directly related expenses, that is allocated to the share from "extraordinary gain dispositions," as defined in § 1.1502-20(c)(2)(i)).

[14] The positive adjustments made pursuant to §§ 1.1502-32(b)(2)(i) through (iii) for each consolidated return year during which the subsidiary was a member of the group, determined without taking distributions into account that are allocated to the share, but only to the extent such amount exceeds the amount described in § 1.1502-20(c)(1)(i) for the year.

with respect to the disposed of shares. From the incoming facts, it appears that only the Loss Duplication component of the LDR is applicable to the present case.[15]

Under § 1.1502-20(c)(2)(vi), duplicated loss is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of --

(A) The sum of --

(1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and

(2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and

(3) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary, over

(B) The sum of –

(1) The value of the subsidiary's stock, and

(2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

Section 1.1502-20(e) provides that the rules of the LDR must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments must be made to carry out their purposes.

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[15] For purposes of this memorandum, we assume the amount of EGD and PIA to be allocated to the SubA1 preferred stock is zero. Under the incoming facts, SubA held SubA1 preferred shares a very brief period of time. Since only EGD and PIA directly or indirectly reflected in the basis of the share immediately before the disposition or deconsolidation (i.e., those occurring during the brief period the shares were outstanding) are taken into account under the LDR (see § 1.1502-20(c)(2)(iii)), it is likely there were few, if any, EGD or PIA with respect to the preferred shares. However, further factual development will be needed to determine the exact amounts of EGD and PIA to be allocated to the shares.

In addition to the § 1.1502-20 regulations, all transactions between consolidated group members are subject to the Intercompany Transactions provisions of section 1.1502-13 of the Income Tax Regulations. In particular, transactions involving Intercompany Obligations are subject to the provisions of § 1.1502-13(g). An Intercompany Obligation is an obligation between members, but only for the period during which both parties are members. For this purpose, the term "obligation" is defined broadly and includes any obligation of a member constituting indebtedness under general principles of Federal income tax law.

If a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an Intercompany Obligation, the Intercompany Obligation is treated for all Federal income tax purposes as satisfied under § 1.1502-13(g)(3)(ii) (see § 1.1502-13(g)(3)(i)). If the Intercompany Obligation remains outstanding, it is treated as reissued immediately after the transaction. Section 1.1502-13(g)(3)(iii).

Section 1.1502-13(j)(1) provides that any reference to an asset (e.g., in this case, an Intercompany Obligation) includes, as the context may require, a reference to any other asset (e.g., the SubA1 preferred stock) the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

Section 1.1502-13(h)(1) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13, including, for example, by avoiding treatment as an Intercompany Transaction, adjustments must be made to carry out the purposes of this section.

(d) Discussion

Under the facts of this case, PCorp attempts to accelerate and duplicate a single operating loss (i.e., the Liabilities) by recognizing a loss on the sale of the SubA1 stock, while preserving the same loss for the PCorp group's later use. Loss recognized on the disposition of subsidiary stock is typically duplicated if it is attributable to a loss or expense that has not been recognized and absorbed by a group (such as the future payment of the Liabilities at issue here), and that very same loss is preserved for later recognition by the group or any of its members when such amount is properly taken into account for tax purposes. This is the exact abuse the Loss Duplication formula was designed to disallow. However, despite duplicating its single loss, PCorp hoped to circumvent the impact of the Loss Duplication factor by investing SubA1's assets in the securities (i.e., the Promissory Notes) of other PCorp subsidiaries. By so doing, PCorp hoped to take advantage of the literal language of the Duplicated Loss formula, which excludes from SubA1's aggregate adjusted asset basis the amount of basis it has in other subsidiaries' securities. If the Duplicated Loss amount is so calculated, there would be no Duplicated Loss disallowed on the sale of the SubA1 stock. This result is wholly inconsistent with the intent and purposes of the regulation and must be challenged.

As we discussed above, our position is that the SubA1 stock sale resulted in an indirect realization of loss from the assignment of Intercompany Obligations (i.e., the Promissory Notes). Thus, at the time SubA1's Duplicated Loss amount is calculated, SubA1 is deemed to hold the proceeds from the deemed satisfaction of the Intercompany Obligations, rather than the Intercompany Obligations themselves. Thus, for purposes of the Duplicated Loss formula, SubA1's aggregate adjusted asset basis includes the deemed proceeds from the other members' securities. Accordingly, all of the loss SubA claimed on the SubA1 stock sale is disallowed. This result is likewise supported by the anti-avoidance rules of § 1.1502-13(h)(1) and § 1.1502-20(e)(1). An overview of certain purposes and theories of the consolidated return regulations that support these arguments follows.

Although an affiliated group is, economically, one business unit, subsidiary stock is in fact a separate and distinct asset on which gain or loss can be recognized. Under tax principles generally applicable to corporations, a disposition of a corporation's assets and its stock would produce gain or loss on both the assets and the stock. Outside the consolidated setting, where the group members are generally viewed as separate taxpayers, this duplication of gain and loss is not inappropriate. Once a group elects to file a consolidated return, however, the group is more generally viewed and taxed as a single entity. Under this single entity theory, the duplication of both gain and loss by transactions in member stock is an inappropriate distortion of the income of a consolidated group.

Section 1502 directs the IRS and Treasury to prescribe such regulations as necessary in order that the tax liability of the group, and of each corporation in the group, both during and after the period of affiliation, is determined in a manner that clearly reflects its income tax liability and that prevents the avoidance of such liability. The purpose of the LDR is to prevent the inappropriate deduction of loss. Its formula is designed to take into account several types of losses considered inappropriate. One such inappropriate loss is that which enables consolidated taxpayers to circumvent the repeal of the General Utilities doctrine. The PIA and EGD factors address this type of loss. Another is a loss that is recognized on member stock but that is attributable to the group's unrecognized, or recognized but unutilized, losses that are preserved for a later, and thus "duplicative", recognition or use. The loss duplication component of the LDR addresses this latter loss.

Duplicated loss occurs typically, but not exclusively, when a subsidiary has an asset that declines in value, or when a subsidiary pays or accrues an expense, but the loss or expenditure has not reduced the basis of the subsidiary stock, because, e.g., the loss has not been utilized by the group or the deduction was deferred. Duplication can occur whether or not the subsidiary remains a member of the group and whether or not the loss or expense will be deductible by the subsidiary the stock of which is sold.

The determination of loss duplication with respect to a share of subsidiary stock is made by comparing the subsidiary's potential tax benefits with the value of its assets. The potential tax benefits include the aggregate adjusted basis of the subsidiary's assets, the losses carried to the subsidiary's first taxable year following the disposition, and the subsidiary's deferred deductions. The value of the assets is extrapolated from the consideration paid for the stock, plus the subsidiary's liabilities. The excess (of the potential tax benefits over the value of the assets) reflects the amount of loss that is preserved and may be duplicated by the group.

Applying the terms of § 1.1502-20 to the current case, Duplicated Loss is the amount by which the sum of SubA1's aggregate adjusted basis in its assets (other than any basis it has in the stock and securities in another subsidiary), loss carryforwards, and deferred deductions exceed the sum of its stock value, liabilities, and any other relevant items. Such amounts include SubA1's allocable share of corresponding amounts with respect to all lower tier subsidiaries. This computation is made immediately after the disposition of SubA1's preferred stock.

In making its LDR calculation, PCorp apparently takes the position that SubA's purported loss on the SubA1 preferred stock sale is fully allowed.[16] In calculating its LDR amount, PCorp presumably excludes from SubA1's inside asset basis amount the amount of basis properly allocable to the Promissory Notes because, under § 1.1502-20(c)(2)(vi)(A)(1), PCorp presumably concludes that such items are excluded from the Duplicated Loss formula. Thus, PCorp presumably calculates the loss disallowance amount as follows:

EGD	$0
PIA	$0
Duplicated Loss Amount, excess of:	
the sum of:	
inside asset basis	

[16] As we noted previously, for purposes of this memorandum, we assume SubA1 has zero EGD and PIA to be allocated to its preferred stock. We further assume that in applying the Loss Duplication formula, SubA1 had no loss carryforwards or deferred deductions (since it is not entitled to a deduction on the payment of the Liabilities). Furthermore, we assume that SubA1's stock value is $j.

(excluding member securities and stock)	$0 [17]		
NOLs	$0		
deferred deductions	$0		
subtotal:		$0	
over the sum of:			
FMV of stock	$j		
liabilities assumed	$ 0		
subtotal:		$j	
total duplicated loss amount (not less than $0)			$0

Total Loss Disallowance Amount: $0

This is an incorrect measure of SubA1's Duplicated Loss. For purposes of applying the duplicated loss formula, SubA1's aggregated adjusted asset basis must reflect the basis of any securities SubA1 owns in another subsidiary.

In the first place, any amount SubA realized on the SubA1 stock sale was an amount indirectly realized on the Intercompany Obligations (i.e., the Promissory Notes) held by SubA1. Thus, the stock sale is within the scope of § 1.1502-13(g). Two arguments support treating the stock sale in this manner. First, if we assume that SubA correctly computed its basis in the SubA1 preferred stock, then SubA's basis in the SubA1 stock is determined, in whole or in part, by reference to SubA's basis in the Promissory Notes.[18] Accordingly, under § 1.1502-13(j)(1), the SubA1 stock is a "successor asset" to these Intercompany Obligations. Thus, under § 1.1502-13(j)(1), where the context requires, any reference in § 1.1502-13(g) to an Intercompany Obligation (here, the Promissory Notes) includes a reference to the

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[17] Although Promissory Notes in the amount of $e million were transferred by SubA to SubA1, the taxpayer presumably treated these as "other subsidiaries' securities" that were excludable from SubA1's aggregate adjusted asset basis.

[18] That is, assume that the transaction in which SubA acquired the SubA1 stock qualified as a § 351 transaction, and that under the relevant portions of § 358, the basis of property SubA received in the transaction (SubA1's preferred stock) was the same as that of the property exchanged (i.e., the Promissory Notes). If we assume that the Liabilities did not reduce SubA's basis in the SubA1 stock, then SubA's basis in the SubA1 preferred stock would be determined directly and wholly by reference to its basis in the Promissory Notes. As such, the stock would clearly be a "successor asset" of the Intercompany Obligations within the meaning of § 1.1502-13(j)(1).

SubA1 preferred stock. Thus, any transaction in which an amount (other than zero) is realized on such preferred stock is an indirect realization of an amount with respect to the Intercompany Obligations, triggering the application of § 1.1502-13(g).

Second, as noted above, § 1.1502-13(g) is not limited to transactions involving a direct realization on an Intercompany Obligation, but applies as well to amounts "realized . . . indirectly" with respect to an Intercompany Obligation. Neither the Intercompany Transaction regulations nor the Preambles to the regulations address the intended scope of the term "realizes . . . indirectly". It appears, however, that there is but a narrow range of transactions for which such a clause would be necessary.[19] Only those transactions in which the amount realized is a function of the inherent attributes of the obligation, but that neither involves the obligation directly nor effects a deconsolidation, necessitate the "realizes . . . indirectly" clause.

Where, as here, stock represents little more than an interest in Intercompany Obligations, the sale or disposition of such stock is an indirect realization of the Intercompany Obligations within the meaning of § 1.1502-13(g)(3)(i). Accordingly, the amount SubA realized on the sale of the SubA1 preferred stock is an amount indirectly realized on the Intercompany Obligations held by SubA1.

As discussed above, if a member realizes a loss directly or indirectly from the assignment or extinguishment an Intercompany Obligation, the obligation is treated as satisfied under § 1.1502-13(g)(3)(ii); if it remains outstanding, it is treated as reissued immediately after the transaction. Section 1.1502-13(g)(3)(iii). Accordingly, for Federal income tax purposes, the sale of the SubA1 preferred stock is treated as follows. Under § 1.1502-13(g)(3)(ii), the issuers of the Intercompany Obligation (i.e., SubA2 and SubB1) are treated as having satisfied the Intercompany Obligations for their face amount immediately before SubA's sale of SubA1's preferred stock. At the time of the stock sale, SubA1 is treated as holding the proceeds of the issuers' deemed satisfaction of the obligations, not the

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[19] First, if a transaction actually involves an Intercompany Obligation, there is a direct realization and no need for the "indirect" clause. Second, if a transaction does not involve a member obligation directly, but rather an interest in the entity holding the obligation, most cases are otherwise covered by § 1.1502-13(g) and so would have no need for the "indirect" clause. For example, if a transaction involves a member obligation that is held by a person or entity that is not a member of the group, § 1.1502-13(g) has no application at all because the obligation is not an Intercompany Obligation. And, if the holder is a member but a disposition of its stock deconsolidates the holder, the regulation provides for a satisfaction of the obligation at fair market value, so again the "indirectly" clause is not needed.

obligations themselves. Immediately after the sale, before any other transaction occurs or is deemed to occur (including the deemed reissuance of the notes), the Loss Duplication factor is calculated. Thus, SubA1 is treated as holding the deemed satisfaction proceeds at the time the Duplicated Loss amount is calculated. Under this model, the amount of loss disallowed under the LDR would be calculated as follows:

EGD			$0
PIA			$0
Duplicated Loss Amount, excess of:			
the sum of:			
inside asset basis (including the proceeds from the deemed satisfaction of any Intercompany Obligations under § 1.1502-13)	$e		
NOLs	$0		
deferred deductions	$0		
subtotal:		$e	
over the sum of:			
FMV of stock	$j		
liabilities assumed	$0[20]		
subtotal:		$j	
total duplicated loss amount:			$h
Total Loss Disallowance Amount:			$h

Note that all of the Duplicated Loss amount is being allocated to the SubA1 preferred stock sold to the three SubA1 employees. Since this transaction was structured to give rise to the preferred stock loss, and since the liability assumption which played a central role with respect to this loss was undertaken at least formally in exchange for that stock, the duplicated loss amount is allocated entirely to such stock. See § 1.1502-20(c); § 1.1502-20(e)(3), Example 1.

[20] In determining the correct amount of liabilities to be included in the Loss Duplication formula, Service position is that "liabilities" are not taken into account for the duplicated loss calculation if they have not been taken into account for tax purposes. Since the instant Liabilities had not been taken into account for tax purposes at the time SubA sold the SubA1 preferred stock, Service position would support excluding those Liabilities for purposes of calculating the Duplicated Loss component of the LDR.

The foregoing technical interpretation of the § 1.1502-13(g) regulation results in all of SubA's claimed loss on the sale of its SubA1 preferred stock being disallowed under § 1.1502-20. In addition, the loss is disallowed through application of the anti-avoidance rules of § 1.1502-13(h)(1) and § 1.1502-20(e)(1).

Any interpretation and application of a regulation must be guided by the policy concerns and objectives of the regulation. But, in the case of the consolidated return provisions at issue here, such inquiry is not only mandated by principles of statutory and regulatory interpretation, it is mandated by the provisions themselves.

Beginning in 1991, the consolidated return regulations underwent a major revision that produced, among other things, the LDR and Intercompany Transaction regulations applicable to the present case. These regulations differ substantially from the prior ones in that they rely less on inflexible, mechanical rules and more on a flexible, principle driven approach. The reason for this change was to render the regulations more capable of readily and timely accommodating changes in the tax law, as well as other economic and policy considerations. Because the regulations rely heavily on broad principles, direction in the interpretation and application of these provisions was provided to ensure they would be applied always in a manner that furthers their policy.

The Intercompany Transaction regulations are intended to ensure the clear reflection of the taxable income (and tax liability) of a consolidated group as a whole by preventing Intercompany Transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). Section 1.1502-13(a)(1). Section 1.1502-13(g) seeks to preserve the location of economic gain or loss on member obligations and to prevent tax avoidance through the use of Intercompany Obligations. Section 1.1502-13(h)(1) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13, including, for example, by avoiding treatment as an Intercompany Transaction, adjustments must be made to carry out the purposes of the section.

The only apparent accomplishments of the current transactions were the creation of high basis, low value stock and the sale of that stock in a transaction expected to escape characterization as a transaction with respect to an Intercompany Obligation. By avoiding that characterization of the transaction, PCorp would avoid the satisfaction and reissuance provisions of § 1.1502-13(g). As such, PCorp would argue that at the time the Loss Duplication calculation was made, the basis of the securities SubA1 held in another subsidiary would be excluded from SubA1's aggregate adjusted asset basis under the literal terms of the Duplicated Loss formula. Since PCorp, if successful, would avoid any disallowance of the loss on the stock, the tax benefit from the future payments of the Liabilities would be effectively accelerated (and duplicated). However, if the sale of the SubA1 stock is treated as an indirect realization of the Intercompany Obligations held by SubA1, the attempt to accelerate (and duplicate) the loss would be thwarted.

Acceleration of deductions, not yet permitted to be taken into account under generally applicable tax accounting rules, by moving assets and liabilities between members of a consolidated group, is wholly inconsistent with the purpose of clearly reflecting the group's consolidated taxable income. Accordingly, since PCorp acted with a principal purpose of avoiding the purposes of the Intercompany Transaction regulations, proper adjustment must be made to avoid the recognition of loss on the sale of SubA1's preferred stock.

Similarly, the first sentence of the anti-avoidance rules of § 1.1502-20(e)(1) mandates that the rules of § 1.1502-20 be applied in a manner that is consistent with and reasonably carries out their purposes. The second sentence provides that if a taxpayer acts with a view to avoid the effect of the rules of § 1.1502-20, adjustments must be made as necessary to carry out their purposes. As previously discussed, the purpose of the Loss Duplication factor is to limit a consolidated group's ability to deal in member stock in order to realize, and yet preserve for later use, the underlying unrecognized or unutilized losses of the member.

SubA's loss on the SubA1 stock is solely attributable to the economic recognition of the diminution of value resulting from known, but unpaid, operating expenses (i.e., the payment of the Liabilities) that were not yet taken into account for tax purposes. Such a loss falls squarely within the intended scope of the Loss Duplication provision. However, because PCorp carefully structured the SubA1 stock sale to avoid the provisions of § 1.1502-20, the regulation would appear to result in a loss disallowance amount of zero**.** This is because the Duplicated Loss formula excludes from SubA1's aggregated adjusted asset basis amount the basis it has in the Promissory Notes (because they are other subsidiaries' securities). Thus the stock sale transaction effectively circumvents the LDR, thereby avoiding their purposes. This result would clearly be prohibited under the first sentence of § 1.1502-20(e).

Finally, the second sentence of the anti-avoidance rules of § 1.1502-20(e) requires that if PCorp structured this transaction and acted with a view to avoid the LDR, then adjustments must be made to carry out their purposes. In this case, it appears that PCorp had sophisticated tax planning advice from outside accounting and investment firms. These parties proposed the plan, and then advised and assisted PCorp in carrying it through to completion. We need to evaluate PCorp's claimed non-tax goal in carrying out this complex set of transactions. However, we believe the overwhelming purpose was to provide SubA with an immediate basis in the SubA1 stock that would, absent the LDR and general tax avoidance principles, permit a large, duplicated loss on the sale of the stock. As such, if you determine that PCorp structured this transaction and acted with a view to avoid LDR, then the resulting loss must be disallowed under the second sentence of § 1.1502-20(e)(1).

In conclusion, the mandate of § 1.1502-20(e) requires that, irrespective of any language in § 1.1502-20(c)(2)(vi)(A)(1) seemingly to the contrary, intragroup securities must be included in the Loss Duplication calculation.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call if you have any further questions.

Assistant Chief Counsel (Corporate)

By: Alfred C. Bishop
Branch Chief (CC:CORP:6)

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