INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-108530-00/CC:CORP:B3

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Corp P =

Corp S =

Corp B =

Corp BB =

Date 1 =

Date 2 =

Year X =

Year Y =

ISSUE:

Whether a subsidiary's permanently unrestored loss under § 1.267(f)-1T(c)(6) from a sale of assets to its parent reduces the subsidiary's earnings and profits (E&P), thereby requiring the parent to make a § 1.1502-32(b)(2)(i) basis reduction in its subsidiary's stock.

CONCLUSION:

Even if the subsidiary is required to reduce its E&P by the amount of the § 1.267(f)-1T(c)(6) unrestored loss from a sale of assets to its parent, under the facts presented, a § 1.1502-32(b)(2)(i) basis reduction is not required because the § 1.1502-

76(b)(5)(ii) election excludes the subsidiary from being a member of the parent's consolidated group at the time the loss becomes permanently unrestored.

FACTS:

Corp P was the common parent of an affiliated group of corporations filing consolidated returns (the "Corp P Group"). Corp S, a wholly owned subsidiary of Corp P, and Corp S's subsidiaries were members of the Corp P Group. For simplicity, Corp S and its subsidiaries are hereinafter referred to as "Corp S." In early Year X, Corp P and Corp B, an unrelated third party, began discussions about the possible purchase of Corp S by Corp B. Although Corp B was interested in acquiring Corp S's business, Corp S held assets that Corp B refused to acquire (the "Unwanted Assets").

After substantial negotiations, Corp P, Corp B, and Corp BB (a subsidiary of Corp B) reached an agreement on Date 1, Year X, for Corp P to sell its stock in Corp S to Corp BB, but without the Unwanted Assets. Under the circumstances surrounding the transaction, a distribution of the Unwanted Assets by Corp S to Corp P was not possible. Accordingly, during Year X, Corp S sold the Unwanted Assets to Corp P for their fair market value which resulted in a loss to Corp S. The loss was deferred under §§ 1.267(f)-2T(b) and 1.1502-13(c).

On Date 2, Year Y, Corp P sold Corp S to Corp B. As a result of the sale of Corp S on Date 2, Corp S and its subsidiaries were members of the Corp P Group for less than 30 days in Year Y. A § 1.1502-76(b)(5)(ii) election was made to exclude Corp S from the Corp P Group for Year Y.

LAW[1] AND ANALYSIS:

Law

Section 1.267(f)-1T(a)(3) provides that § 1.267(f)-1T applies to loss on the sale of property between two members of a controlled group that do not join in filing a consolidated return for the taxable year the loss is incurred, while § 1.267(f)-2T applies if the members do join in filing a consolidated return.

For purposes of §§ 1.267(f)-1T and -2T, the term "group" means "controlled group" as defined in § 267(f)(1). Section 1.267(f)-1T(b)(1). Section 267(f)(1) defines a "controlled group" as having the same meaning given to such term by § 1563(a), except for certain modifications, including substituting "more than 50 percent" for "at least 80 percent."

[1] The law cited above is as in effect for the years at issue.

Section 1563(a)(1), as modified and as relevant here, defines a "controlled group" as one or more chains of corporations connected through stock ownership with a common parent corporation if (A) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations; and (B) the common parent corporation owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

For purposes of §§ 1.267(f)-1T and -2T, the term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return of another group. Sections 1.267(f)-1T(b)(7) and 1.1502-1(e).

Section 1.267(f)-1T(c)(1) provides that except as otherwise provided in this section, the rules for deferred intercompany transactions in § 1.1502-13 apply under § 267(f)(2) to the deferral and restoration of loss on the sale of property directly or indirectly between the selling and purchasing members of a controlled group, as if: (i) the taxable year in which the sale occurred were a consolidated return year (as defined in § 1.1502-1(d)) and (ii) all references to a "group" or an "affiliated group" were to a "controlled group."

Section 1.267(f)-1T(c)(3) provides that if, under § 1.267-1T, a loss is deferred by a selling member on the sale of property to a purchasing member, then such loss shall not be reflected in E&P until that amount is restored.

Section 1.267(f)-1T(c)(6) provides: "If a selling member of property for which loss has been deferred ceases to be a member when the property is still owned by another member, then, for purposes of this section, § 1.1502-13(f)(1)(iii) shall not apply to restore that deferred loss and that loss shall never be restored to the selling member" (the "no restoration" rule).

Section 1.267(f)-1T(c)(7) provides, in relevant part, that if § 1.267(f)-1T(c)(6) precludes a loss from being restored, on the date the selling member ceases to be a member, the owning member's basis in the property shall be increased by the amount of the selling member's unrestored deferred loss at the time the selling member ceased to be a member of the controlled group.

Section 1.267(f)-2T(b) provides that if a loss is incurred on a sale by a selling member to a purchasing member of a controlled group in a taxable year during which they join in filing a consolidated return, § 1.1502-13 applies, except as otherwise provided.

Section 1.267(f)-2T(d)(1) provides, in relevant part, that if a selling member joins in filing a consolidated return with a purchasing member of a controlled group for a taxable year during which the selling member sells property to the purchasing member at a loss, and if either such member later has a separate return year, then the event that results in the separate return year does not alone result in restoration of the selling member's deferred loss under § 1.1502-13(f), except as otherwise provided [such exceptions being nonapplicable here].

Section 1.267(f)-2T(d)(2) provides, in relevant part, that any amount that was not restored under § 1.267(f)-2T(d)(1) shall be restored under § 1.267(f)-1T.

Section 1.1502-1(a) provides that "group" means an affiliated group as defined in § 1504.

Section 1.1502-13(a)(1) defines, in relevant part, an "intercompany transaction" as a transaction between two corporations that are members of the same consolidated group immediately after the transaction. Section 1.1502-13(a)(2)(i) defines a "deferred intercompany transaction" as including the sale or exchange of property.

Section 1.1502-13(c)(1)(i) provides: "To the extent gain or loss on a deferred intercompany transaction is recognized under the Code for a consolidated return year, such gain or loss shall be deferred by the selling member."

Section 1.1502-13(f)(1)(iii) provides that deferred gain or loss shall be taken into account by the selling member immediately preceding the time when either the selling member or the member which owns the property ceases to be a member of the affiliated group.

Section 1.1502-32(a) provides, in relevant part, that each member of a consolidated group owning stock in a subsidiary shall adjust the basis of such stock for the difference between the positive adjustments and negative adjustments described in § 1.1502-32(b)(1) and (b)(2). Section 1.1502-32(b)(2)(i) requires a negative adjustment to a subsidiary's stock for an allocable part of the deficit in E&P of the subsidiary for the taxable year.

Section 1.1502-33(a) provides: "Gain or loss on an intercompany transaction shall be reflected in the earnings and profits of a member for its taxable year in which such gain or loss is taken into account under § 1.1502-13."

Section 1.1502-76(b)(5)(ii) provides, in relevant part, that for purposes of the regulations under § 1502, if, during a consolidated return year of a group, a corporation has been a member of such group for a period of 30 days or less, then such corporation may at its option be considered as not having been a member of the group during such year (the "30 day election").

Rev. Rul. 71-440, 1971-2 C.B. 326, concerning elections under § 1.1502-76(b)(5)(ii), holds that for purposes of restoration of intercompany items such as deferred intercompany gains, excess loss accounts, etc., the subsidiary is treated as having ceased to be a member of the group as of the end of the preceding taxable year.

Analysis

The Examining Agent has raised a number of arguments to support the position that Corp S is required to reduce its E&P at the time it is determined that the loss is not restored to Corp S under § 1.267(f)-1T(c)(6). The Examining Agent then argues that because Corp S must reduce its E&P at the time the loss is disallowed, Corp P must reduce its basis in the stock of Corp S pursuant to § 1.1502-32(b)(2)(i) before Corp S is sold to Corp B.

Taxpayer takes the following position concerning this transaction: (1) When Corp S sells the Unwanted Assets at a loss in an intercompany sale to Corp P, Corp S's loss is deferred under §§ 1.267(f)-2T(b) and 1.1502-13(c). (2) When Corp P sells Corp S to Corp B, the normal restoration rule for deferred intercompany losses of § 1.1502-13(f)(1)(iii) is specifically overridden by the special "no restoration" rule of § 1.267(f)-1T(c)(6), which is applicable by reason of § 1.267(f)-2T(d). (3) Under the "no restoration" rule, Corp S's loss on the intercompany sale of the Unwanted Assets to Corp P is permanently denied and Corp P's basis in the Unwanted Assets is increased by the amount of Corp S's permanently denied loss (see § 1.267(f)-1T(c)(6) and (7)). (4) Under § 1.1502-33(a), Corp S's deferred loss on an intercompany transaction (including the sale of the Unwanted Assets to Corp P) would be reflected in Corp S's E&P in the year in which that loss is restored. In this case, Corp S's loss is never restored (because of the "no restoration" rule) and therefore never reflected in Corp S's E&P under § 1.1502-33(a). (5) Under § 1.1502-32(a) and (b)(2), Corp P would reduce its basis in its Corp S stock by an amount equal to any deficit in Corp S's E&P, as determined under § 1.1502-33. Since Corp S's permanently denied loss is never reflected in Corp S's E&P under § 1.1502-33, that permanently denied loss never results in a reduction in Corp P's basis in its Corp S stock under § 1.1502-32.

For purposes of this discussion, we assume, without deciding, that the Examining Agent is correct in concluding that Corp S is required to reduce its E&P by the amount of unrestored loss when the loss becomes permanently unrestored to Corp S.

Because of the 30 day election, Corp P and Corp S are not considered members of the same consolidated (or affiliated) group at any time during Year Y. Thus, Year Y is considered a separate return year for Corp S. Under § 1.1502-13(f)(1)(iii), the 30 day election would cause a restoration of Corp S’s loss immediately before the end of Year X, since Corp S will be treated as leaving the Corp P Group at that time. However, § 1.267(f)-2T(d)(1) provides that the separate return year of Corp S does not

restore the loss to Corp S under § 1.1502-13(f). Rather, the loss is to be restored in accordance with § 1.267(f)-1T. Section 1.267-2T(d)(2).

While the 30 day election removes Corp S from the Corp P Group at the end of Year X, the 30 day election has no effect on the treatment of Corp P and Corp S as members of the same controlled group. Thus, Corp P and Corp S are members of the same controlled group until Date 2, Year Y, the date on which Corp S was actually sold to Corp B. Accordingly, under § 1.267(f)-1T(c)(6), Corp S's loss is not permanently unrestored to Corp S until Date 2, Year Y, the date on which Corp S ceased to be a member of the same controlled group as Corp P. Therefore, if Corp S's E&P is reduced on account of the permanent nonrestoration of the loss to Corp S, as the Examining Agent argues, Corp S's E&P adjustment would occur in Year Y. However, in Year Y, Corp P and Corp S are not members of the same consolidated group. Consequently, Corp P would not be required to reduce its basis in Corp S under § 1.1502-32.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.