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Memorandum

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to: Associate Area Counsel
(Large & Mid-Size Business)
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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

<u>LEGEND</u>

Parent =

Parent Consolidated Group =

Sub 1 =

Sub 2 =

Sub 3 =

LLC =

Sub 4	=
Sub 5	=
Sub 6	=
State A	=
State B	=
State C	=
Date A	=
Date B	=
Date C	=
Date D	=
Date E	=
Date F	=
Date G	=
Date H	=
Date I	=
Date J	=
Date K	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
<u>a</u>	=
<u>b</u>	=

c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=

y =

z =

aa =

bb =

cc =

dd =

ISSUE

Whether, upon the liquidation of Sub 6, Sub 3 properly recognized a capital loss of $a from its sale of b% of its Sub 6 stock to LLC, which had been deferred under I.R.C. § 267(f)(2)?

CONCLUSION

Sub 3 improperly recognized, upon the liquidation of Sub 6, the capital loss of $a from its sale of b% of its Sub 6 stock to LLC. This loss should continue to be deferred under I.R.C. § 267(f)(2) and the regulations thereunder.

FACTS

Pre-Transaction Organizational Structure

Parent is the common parent of a group of financial services corporations that files a consolidated income tax return (the "Parent Consolidated Group" or the "taxpayer").

Parent directly owns all of the stock of Sub 1 and Sub 2. Sub 1 owns c%, and Parent owns d% of the common stock of Sub 3, a State A corporation. Sub 3 is a holding company that is not directly engaged in any business. Sub 1 also indirectly owned the stock of LLC, a State B limited liability company that was originally treated as a corporation for federal income tax purposes.

Prior to Date A, Sub 3 owned e% and Sub 1 owned f% of common stock of Sub 4. Sub 4 had two classes of non-voting preferred stock outstanding: Class A (Sub 3 owned g% and individuals owned h%); Class B (Sub 3 owned c% and Sub 1 owned d%). Sub 4's assets consisted of State C lease participations owned through an LLC that was disregarded for federal income tax purposes and a State C loan participation that Sub 4 owned directly.

Parent, Sub 1, Sub 2, Sub 3, LLC and Sub 4 were members of the Parent Consolidated Group at the outset of the transaction described below.

Prior to Date A, Sub 3 owned c% of the common stock of Sub 5. Sub 5 had been a real estate investment trust ("REIT") since Year 1. The remaining d% of Sub 5 was owned by Parent. Sub 5 had four classes of preferred stock outstanding: Class A (i% owned by Sub 3; j% owned by individuals); Class B non-voting (k% owned by Sub 2); Class C non-voting (k% owned by public shareholders); Class D voting (k% owned by Sub 3).

In Year 2, the taxpayer received instructions on a federal income tax savings transaction that was to be undertaken for the purported business purpose of state tax savings. As an initial step, the taxpayer was to transfer built-in loss (BIL) assets to one REIT and transfer built-in gain (BIG) assets to another.

By Date B, Sub 3 had a BIL in its Sub 5 stock and a BIG in its Sub 4 stock. At such time, Sub 5 was already a REIT, and Sub 4 was to be converted to a REIT as part of the plan.

Immediately prior to and in connection with Sub 4's conversion into a REIT, Sub 3 transferred l% of its BIL Sub 5 common stock to Sub 4 in an I.R.C. § 351 transaction. After the contribution, Sub 3's basis in its Sub 4 stock reflected its basis in the contributed Sub 5 stock under I.R.C. § 358.

Initially, Sub 4's basis in the contributed Sub 5 stock was the same as it was in the hands of Sub 3 prior to the I.R.C. § 351 transfer under I.R.C. § 362. As I.R.C. § 362(e) was not applicable at the time of this I.R.C. § 351 transaction, Sub 3's BIL in the Sub 5 stock could be duplicated.

On Date B, Sub 4 converted into a REIT. The Parent Consolidated Group elected deemed sale treatment under Treas. Reg. § 1.337(d)-7T(a)(1) with respect to Sub 4's conversion.[1]

A corporation electing deemed sale treatment recognizes gain or loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date. Generally, such an election would result in the assets' basis being equal to their value. However, a taxpayer cannot apply deemed sale treatment if its application would result in the recognition of a net loss. For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income) without regard to character.[2] The I.R.C. § 337 deemed sale regulations contain an anti-stuffing rule which requires a C corporation to disregard converted property in computing its recognition of gain or loss if:

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[1]Section 1.337(d)-7 states that if property owned by a C corporation… becomes the property of a …REIT (the converted property), in a conversion transaction … then section 1374 treatment will apply … unless the corporation elects deemed sale treatment … as provided in paragraph (c) of this section.

[2] In the case of a net loss, § 1374 treatment would be inapplicable, as well.

(i) the converted property was acquired by the C corporation in an I.R.C. § 351 transaction;

(ii) such converted property had an adjusted basis immediately after its acquisition in excess of its FMV; and

(iii) the acquisition of such converted property by the C corporation was part of a plan, a principal purpose of which was to reduce gain recognized by the C corporation in connection with the conversion.

The § 337 "anti-stuffing" rule applies the principles of § 336(d). Losses disallowed under § 336(d) represent a permanent loss, as there is no basis adjustment, offset to subsequent gain, or other deferral of loss disallowance. Section 336(d)(ii) provides that any [BIL] property acquired [within the 2 year period prior to the date of the conversion except as otherwise provided] be treated as acquired as part of a plan [to recognize a loss]. The conference report accompanying the enactment of 26 U.S.C. § 336(d) indicates that this 2 year presumption will not apply if there is a clear and substantial relationship between the contributed property and the conduct of the corporation' s current or future business or a meaningful relationship between the contribution of the assets of a trade or business or a line of business and the utilization of the corporate form to conduct the business. *See* H.R. Conf. Rep. No. 99-841, pt. II, at 200 (1986). The taxpayer reported that the conversion of Sub 4 generally resulted in recognition of the built-in gain and loss inherent in the assets of Sub 4 as follows:

1. $m loss on the l% of the Sub 5 common stock owned by Sub 4,

2. $n gain on State C lease participations isolated in an LLC owned by Sub 4, and

3. $o gain on State C loan participations owned by Sub 4.

The taxpayer claimed that Sub 4 converted to a REIT because the taxpayer needed an entity other than Sub 5 to qualify for REIT status. The taxpayer states that Sub 1 had been selling participation interests in mortgages and contributing multi-state loans to Sub 5 for state tax reasons and it was concerned that continuing to do so could jeopardize Sub 5's REIT status. The taxpayer rebuts the I.R.C. § 336(d) 2 year presumption in stating that the purpose of contributing Sub 5 REIT stock to Sub 4 was to help qualify Sub 4 as a REIT. We express no opinion on the Sub 3 transfer of l% of its BIL Sub 5 common stock to Sub 4 in the I.R.C. § 351 transaction, the conversion of Sub 4 into a REIT, and the effect of the deemed sale treatment under Treas. Reg. § 1.337(d)-7T(a)(1) with respect to such conversion.

Formation of Sub 6

On Date C, Sub 3 formed Sub 6, a State B corporation. Sub 6 was a member of the Parent Consolidated Group from its formation until Sub 3 sold b% of its Sub 6 stock to

LLC as described below. Pursuant to an I.R.C. § 351 transfer, Sub 3 contributed the following assets to Sub 6:

1. all of its remaining common and preferred Sub 5 stock (basis of $p);

2. all of its common and preferred Sub 4 stock (basis of $q); and

3. a receivable from Sub 1 with basis of $r (no payments of principal or interest were ever made on the note from Sub1).

As noted above, Sub 3 had a BIL in its remaining Sub 5 stock at the time of this contribution.[3] In prior steps, Sub 3 had eliminated most or all of the BIG in its Sub 4 stock. Thus, after the I.R.C. § 351 transaction, Sub 3 owned k% of the stock of Sub 6 and such stock had a BIL. Sub 6 had no business activity other than holding the three assets identified above. The taxpayer states that Sub 6 had been created due to a Year 2 change in State A law that made REIT dividends taxable in State A. Sub 3, a State A corporation, now held its REIT interests through Sub 6, a State B corporation, instead of holding them directly. The taxpayer claims the restructuring was undertaken for the purpose of savings of state tax.

Sub 4 and Sub 5's Payment of REIT Dividends to Sub 6

On Date E and Date F, Sub 4 and Sub 5 declared distributions on their common stock and on Sub 5's Class B preferred stock to shareholders of record on Date D. These distributions were paid on Date G. In general, in order to maintain REIT status, Sub 4 and Sub 5 are required to distribute at least e% of their taxable income each taxable year under I.R.C. § 857(a). The taxpayer indicated that it has been the historical practice of Sub 4 and Sub 5 to satisfy the I.R.C. § 857(a) distribution requirement by distributing k% of their taxable income, and in some years, to distribute an amount in excess of that year's taxable income, if excess cash was generated in the particular year. In addition, the taxpayer indicated that distributions paid in prior years of $t exceeded the combined $u I.R.C. § 857(a) distribution requirement for that period by $v. Sub 4 paid a dividend of approximately $w and Sub 5 paid a dividend of $x in Year 3 as part of their Year 4 distribution requirement. These were actual distributions that exceeded the Year 4 annual I.R.C. § 857(a) distribution requirement. To the extent of the excess, the distributions were used to reduce or satisfy the I.R.C. § 857(a) distribution requirement for the Year 3 taxable year.

Accordingly, Sub 6 took into account dividend income from Sub 4 and Sub 5 of $y for its taxable year ended Date H, per Treas. Reg. § 1.1502-76(b)(1). The taxpayer took into account Sub 6's $y of dividend income on its federal income tax return for its taxable year ending Date I. Sub 3 increased its basis in Sub 6 by the amount of Sub 6's $y taxable income, from its Date D, basis of $s to $z, per Treas. Reg. § 1.1502-32. Sub 6

[3] The taxpayer claims that Sub 3's basis in its Sub 6 stock was $s as of Date D.

was not required to adjust its basis in Sub 4 or Sub 5 upon their payment of $y. Accordingly, Sub 6's potential loss on the sale of its REIT stock increased by $y.

Conversion of LLC to REIT Status

On Date J, LLC elected to be treated as a REIT for federal and state income tax purposes. LLC elected that its REIT status be retroactively effective for its Year 4 taxable year per Treas. Reg. §§ 1.856-2(b) and 301.7701-3(c)(1)(v)(B).

Sub 3's Sale of b% of Sub 6 Stock to LLC

On Date K, Sub 3 sold b% of its Sub 6 common stock to LLC in exchange for LLC nonqualified preferred stock. As stated above, Sub 6's assets consisted of its interest in Sub 5, its direct and indirect interests in Sub 4, and a receivable. Sub 3's BIL in its Sub 6 stock reflect the BIL Sub 3 had once held in its Sub 4 stock.

Sub 3's adjusted basis in the b% of its Sub 6 stock that it sold to LLC was $aa. Accordingly, Sub 3 *realized* a capital loss of $a from its sale of b% of its Sub 6 stock to LLC. However, Sub 3's loss from its sale of b% of its Sub 6 stock to LLC was deferred under I.R.C. § 267(f)(2) because Sub 3 and LLC remained members of a controlled group under I.R.C. § 267(f)(1). Accordingly, Sub 3's intercompany loss of $a was deferred under I.R.C. § 267(f)(2).

Liquidation of Sub 6

On Date H, Sub 6 was liquidated into Sub 3 and LLC. LLC received rights to b% of the note receivable and b% of Sub 6's REIT stock. The taxpayer takes the position that as a result of the I.R.C. § 331 liquidation:

- Sub 3 recognized its deferred $a loss (from its sale of b% of its Sub 6 stock to LLC).
- Sub 3 reported a capital loss of $bb on the transfer of its cc% of Sub 6 to Sub 6 in the liquidation transaction. (Sub 3's reported adjusted basis in the cc% of the Sub 6 stock was $dd.)

Because LLC became a REIT and was no longer a member of the consolidated group, its Sub 6 stock was not aggregated with Sub 3's Sub 6 stock under Treas. Reg. § 1.1502-34 for purposes of applying I.R.C. § 332. Accordingly, the taxpayer contends that the liquidation qualifies as a taxable exchange under I.R.C. § 331.

The taxpayer's purported business purpose of its sale of b% of the Sub 6 stock to LLC and the liquidation of Sub 6 was to move cash (from the note receivable) and future REIT earnings from Sub 6 to LLC so LLC could use the funds to purchase more assets and pay off some of its debt to Sub 1. The taxpayer states that Sub 1 had sold participation interests in its home equity loans to LLC in exchange for a note. The participation interests were qualifying REIT assets.

As mentioned above, the taxpayer purported to create Sub 6, a State B corporation, as a means of saving state taxes. The taxpayer stated that it needed to create a State B corporation because Sub 3 (the original Sub 4 REIT shareholder) was a State A corporation and a Year 2 change in State A law made REIT dividends taxable in State A. The taxpayer states that its purported business purpose for subsequently liquidating Sub 6 was that Sub 6 was no longer necessary when Sub 3 was re-domiciled from State A to State B in Year 4.

LAW AND ANALYSIS

Sub 3 may not recognize, upon liquidation of Sub 6, the capital loss of $a from its sale of b% of its Sub 6 stock to LLC. This loss should continue to be deferred under I.R.C. § 267(f)(2) and the regulations thereunder.

Section 267(f)(2) generally defers losses from the sale or exchange of property between members of the same controlled group until the property is transferred outside the controlled group and there would be recognition of the loss under consolidated return principles. Sub 3 and LLC are members of the same controlled group pursuant to I.R.C. § 267(f)(1) and therefore the $a capital loss on Sub 3's sale of its b% of Sub 6 should be deferred until Sub 3 and LLC are no longer in the controlled group. The regulations under I.R.C. § 267(f)(2) promote the purpose of preventing members of a controlled group from taking into account a loss or deduction solely as a result of a transfer of property between a selling member, ("S"), and a buying member, ("B"). Treas. Reg. § 1.267(f)-1(a)(1).

Under Treas. Reg. § 1.267(f)-1(a)(1), Sub 3's loss from the sale of Sub 6 is taken into account under the timing principles of Treas. Reg. § 1.1502-13, treating such a sale as an intercompany transaction. For this purpose, the matching and acceleration rules of Treas. Reg. § 1.1502-13(c) and (d) apply with the adjustments in Treas. Reg. § 1.267(f)-1(b) and (c) to reflect that Treas. Reg. § 1.1502-13 applies on a controlled group basis and affects only the timing of a loss or deduction, and not its attributes. Treas. Reg. § 1.267(f)-1(a)(2).

Although Treas. Reg. § 1.267(f)-1(c)(1) generally provides that Sub 3's loss is deferred until it is taken into account under the timing principles of the matching and acceleration rules of Treas. Reg. § 1.1502-13(c) and (d), to the extent Sub 3's loss would be redetermined to be a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13, Sub 3's loss continues to be deferred and is not taken into account until Sub 3 and LLC are no longer in a controlled group relationship. Treas. Reg. § 1.267(f)-1(c)(1)(iv).

The Preamble to the final regulations under I.R.C. § 267(f) elaborates that although the attribute redetermination provisions of Treas. Reg. § 1.1502-13 generally do not apply under I.R.C. § 267(f), to the extent that Treas. Reg. § 1.1502-13 treats S's loss as a noncapital, nondeductible amount, S's loss must be deferred until S and B are no longer in a controlled group relationship, rather than taken into account as a result of nonapplication of the attribute redetermination rules:

> Several technical changes have been incorporated into the final regulations under section 267. For example, the regulations clarify that to the extent S's loss would have been treated as a noncapital, nondeductible amount under the attribute rules of the regulations under §1.1502-13, the loss is deferred under section 267(f) until S and B are no longer in a controlled group relationship with each other. Section 267 is intended to prevent a taxpayer from taking a loss into account from the sale or exchange of property when the property continues to be held by a member of the same controlled group. Under §1.1502-13, S's loss might be taken into account but redetermined to be noncapital or nondeductible, permanently preventing the loss from being taken into account. It could be argued that this is the result of the attribute provisions of §1.1502-13, which do not apply under section 267(f), not a result of the timing provisions of § 1.1502-13, and thus, a controlled group member could take its loss into account. The change made in the final regulations assures that the purpose of section 267 is not defeated as a result of the non-application of the attribute redetermination rules of §1.1502-13 for purposes of section 267(f).

See T.D. 8597, 1995-2 C.B. 147, 154.

In order for Treas. Reg. § 1.267(f)-1(c)(1)(iv) to apply to the transaction, the following requirements must be satisfied:

1. S's loss must not be redetermined because of Treas. Reg. § 1.267(f)-1(c)(2) (providing that attributes are not affected unless the sale is also an intercompany transaction); and

2. Treas. Reg. § 1.267(f)-1(c)(1)(iii) (dealing with subsequent transfers by B to nonmembers that are related to any member of the controlled group) must not apply.

Sub 3's sale of Sub 6 stock to LLC is not an intercompany transaction because LLC and Sub 3 were not members of the same consolidated group. Therefore, the transaction is generally not subject to attribute redetermination under Treas. Reg. § 1.1502-13. In addition, Treas. Reg. § 1.267(f)-1(c)(1)(iii) does not apply because the Sub 6 stock was not transferred by LLC to nonmembers of the controlled group that were related to any member of the controlled group. Therefore, if Sub 3's loss would have been redetermined to be a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13 if it were between members of a consolidated group, any loss recognized on the sale of the Sub 6 stock is further deferred even after the liquidation of Sub 6 until the parties to the sale of the Sub 6 stock (i.e., Sub 3 and LLC) are no longer in a controlled group relationship. Deferral of Sub 3's loss in this case appropriately satisfies the purposes of the I.R.C. § 267 regulations considering Sub 4 and Sub 5 continue to be held by Sub 3 and LLC. We express no opinion about the taxpayer's purported business purposes or any other issues raised by the facts of this transaction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-7550 if you have any further questions.

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