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From:
Sent: Thursday, August 30, 2012 4:29:26 PM
To:
Cc:
Subject: Netting of intercompany transactions between consolidated group members

This replies to your emails requesting more information on the issue of whether "netting" of intercompany sales between members of a consolidated group will produce a distortion of consolidated tax liability. We apologize for our late response to your requests.

We have been thinking that if some of the assets were depreciated at a higher useful life than the other assets, there would be a distortion of consolidated tax liability at the end of a given taxable year. However, when we developed the example presented below, in which one asset was depreciated over 5 years and the other over 15 years, we found that the net effect on consolidated tax liability at the end of a given year was the same net tax benefit, whether the assets were valued at the correct values (100 for the 5-year asset and 400 for the 15-year asset), or the intercompany sales were averaged so each asset was deemed sold for 250 each.

We also considered situations in which, after the intercompany sales, one asset was sold outside the consolidated group and the other asset with a different value was retained by the group. Whether the values were netted or not, the consolidated gain came out the same. When the buying member sells an asset to an unrelated party for fair market value, both the intercompany gain and the corresponding (buying member's) gain are triggered simultaneously, so any error in the intercompany gain is corrected.

At this point, our thinking is that location matters only when the treatment of items at one location would be different from their treatment at another location. Examples of such cases might include where the selling or buying member has losses limited by § 382 or the SRLY rules of § 1.1502-21(c). We are continuing to examine such cases, but perhaps they are not present in the case of the taxpayer you are currently dealing with.

Please feel free to call us directly to discuss this netting matter. can be reached at , and can be reached at . (but not) will be in the office tomorrow (Friday, August 31), and (but not) will be in the office the week of September 4 - 7. We will both be in the office the following week (September 10 - 14).

Issue 1: Will consolidated depreciation deductions be distorted if assets with different useful lives are sold from S to B in intercompany sales, and S allocates an equal part of the total values of the asset to each intercompany sale rather than the actual values of the asset sold?

Facts: P is the common parent of a consolidated group and owns first-tier subsidiaries S and B.

On January 1, 2010, S purchased depreciable Asset 1 for 100 and Asset 2 for 300.

During 2010 and 2011 S deducted straight-line depreciation for the assets:

Asset 1	5-year useful life	100 cost basis	20 depreciation per year
Asset 2	15-year useful life	300 cost basis	20 depreciation per year

The two years of depreciation reduce S's basis to 60 in Asset 1 and 260 for Asset 2. Also, during 2011 and 2012 Asset 2 appreciates in value from 300 to 400.

On January 1, 2012, S sells to B Assets 1 and 2 for a total sale price of 500. The basis to S, the fair market value, and useful lives of each asset is as follows:

Asset 1:	Basis 60	Value 100	5-year useful life
Asset 2:	Basis 260	Value 400	15-year useful life

<u>Alternative 1</u>: To compute depreciation for 2012, S allocates the correct values to the sales of each of the four assets. B will therefore have the correct basis for depreciation of each asset.

B after the intercompany sales splits its depreciation under § 168(i)(7). B continues S's depreciation to the extent of A's basis in each asset: To the extent B's cost basis exceeds S's basis, B is treated as acquiring a new asset with a new useful life. See Example 4 in Reg. § 1.1502-13(c)(7)(ii).

Asset 1: S's basis "inherited" by B: 60.
 Depreciation in 2012: 20 (60 basis / 3 years left in A's useful life)
 B's basis exceeding A's basis: 40
 Depreciation in 2012; 8 (40 basis / B's new 5-year useful life)
 B's total depreciation: 28

Asset 2: S's basis "inherited" by B: 260
 Depreciation in 2012: 20 (260 basis / 13 years left in A's useful life)
 B's basis that exceeds S's basis 140
 B's depreciation of "new" asset: 9.33 (140 basis / 15-year useful life)
 B's total depreciation for Asset 2: 29.33

S's deferred gain: B's depreciation deductions cause S to recognize part of its deferred gain, to the extent B's depreciation exceeds the depreciation S and B would have if they were divisions of one corporation. (S -B would continue 20 depreciation for each asset based on their original basis and useful lives).

B's depreciation for Asset 1: 28
S-B's single-entity" depreciation: 20
Gain triggered to S for Asset 1: 8
B's depreciation for Asset 2: 29.33.
S-B's "single-entity" depreciation: 20
Gain triggered to S for Asset 2: 9.33.

Consolidated result:
B's total depreciation of Assets 1 and 2: 57.33
S's triggered deferred gain from B's depreciation for Assets 1 and 2: 17.33.
Net consolidated tax benefit: 40 deduction.

Alternative 2: To compute depreciation for 2012, S allocates an equal amount (250) of the 500 total sale price to each of the two assets B then claims that each asset has a basis for depreciation of 250.

B, as explained above, continues A's depreciation to the extent of A's basis in each asset. To the extent B's cost basis exceeds S's basis, B treats that basis as a new asset with a new useful life.

Asset 1: A's basis "inherited" by B: 60.
Depreciation in 2012: 20 (60 basis / 3 years left in A's useful life)
B's basis exceeding A's basis: 190
Depreciation in 2012; 38 (190 basis / B's new 5-year useful life)
B's total depreciation for Asset 1: 58

Asset 2: A's basis "inherited" by B: 250 (not 260, because B only has 250 basis)
Depreciation in 2012: 19.23 (250 basis / 13 years left in A's useful life)
B has no basis exceeding A's basis, so B has no additional depreciation of a "new" asset.

B's total depreciation for Asset 2: 19.23

S's deferred gain: B's depreciation deductions cause S to recognize part of its deferred gain, to the extent B's depreciation exceeds the depreciation S and B would have if they were divisions of one corporation. (S -B would continue 20 depreciation for each asset based on their original basis and useful lives). In Situation 2, Asset 2's depreciation by B is less than the "single-entity" depreciation by S-B.

B's depreciation for Asset 1: 58
S-B's single-entity" depreciation: 20
Gain triggered to S for Asset 1: 38
B's depreciation for Asset 2: 19.23.
S-B's "single-entity" depreciation: 20
Loss triggered to S for Asset 2: (0.77).

Consolidated result:
B's total depreciation of Assets 1 and 2: 77.23
S's net triggered deferred gain from B's depreciation (38 gain for Asset 1 minus 0.77 triggered loss from Asset 2:: 37.23

Net consolidated tax benefit: 40 deduction (the same as Situation 1).