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Memorandum

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to:

Associate Area Counsel ( )
(Large Business & International)

Attorney ( )
(Large Business & International)

from:

General Attorney (Tax)
(Corporate)

Special Counsel
Office of Associate Chief Counsel (Corporate)

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subject:

This Chief Counsel Advice responds to your request for assistance dated May 12, 2015. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Parent =

Seller =

Buyer =

X =

Y =

Accounting Firm =

$A =

$B =

$C =

$D =

$E =

$F =

Year 1 =

Year 5 =

ISSUE

When a sale of subsidiary stock is a transfer subject to Treas. Reg. § 1.1502-36 (the Unified Loss Rule or ULR)[1] and there is an amount realized on the sale, may the attribute reduction amount under section 1.1502-36(d) be computed by reference to a purported "fair market value" of the subsidiary's stock?

CONCLUSION

No. The computation of the attribute reduction amount is made by reference to the "value" of the stock, and, for purposes of the ULR, the term "value" is defined in section 1.1502-36(f)(11) to mean the amount realized, if any, and only if there is no amount realized does it mean the fair market value. Where, as here, there is an amount realized, a taxpayer may not compute the attribute reduction amount using another measure.

FACTS

In Year 1, Seller, a wholly owned subsidiary of Parent, the common parent of a consolidated group, acquired all of the stock of Taxpayer. Subsequently, Seller disposed of its entire interest in Taxpayer. In Year 5, Seller entered into negotiations

[1] T.D. 9424, 2008-44 I.R.B. 1012, 73 Fed. Reg. 53934-01 (Sept. 17, 2008).

with X, an unrelated party, to sell its stock of Taxpayer. The price range under negotiation included $A. Those negotiations failed and were terminated in mid-November of Year 5. However, shortly before the end of Year 5, Seller sold the stock to Buyer, a holding company, owned by Y. Y is a senior managing partner of X. The sale price was $B, an amount considerably less than $A. Although Buyer paid $B for the Taxpayer stock, Taxpayer secured valuation estimations from Accounting Firm attesting to a purported fair market value of $A.

Pursuant to the sale, Seller entered into a stock purchase agreement whereby Seller agreed to make, and made, a cash payment and certain payments to cover Taxpayer's operating expenses during a transition period. Those amounts were treated by Seller as capital contributions. In total, the payments were $E. Taxpayer and the examining agent do not agree on the characterization or treatment of those payments.

Taxpayer and the examining agent agree that Seller's sale of its Taxpayer stock to Buyer was a transfer of a loss share subject to the ULR. Further, they agree that, after taking into account the application of sections 1.1502-36(b) and 1.1502-36(c), Seller's stock basis was $C.

Parent computed a net stock loss of $D on Seller's sale of its Taxpayer stock on the group's consolidated return, calculated as the excess of Seller's basis in the Taxpayer stock ($C) over its amount realized ($B). No election was made by Parent under section 1.1502-36(d)(6) to reattribute attributes or reduce stock basis under section 1.1502-36(d)(6). Parent therefore claimed the entire loss of $D on Seller's sale of Taxpayer's stock on the group's consolidated return.

Taxpayer and the examining agent agree that the net stock loss would exceed Taxpayer's aggregate inside loss regardless of the manner in which value is measured and, thus, the attribute reduction amount is equal to Taxpayer's aggregate inside loss.

Taxpayer and the examining agent do not agree as to whether, in computing the aggregate inside loss, the value of the Taxpayer stock is the amount realized ($B) or the fair market value (which Taxpayer asserts is $A).

TAXPAYER'S ARGUMENTS

Taxpayer argues that under the "extremely unusual set of circumstances involved in the acquisition" of Taxpayer by Buyer, treating Taxpayer's value as $B "would amount to an overly literal interpretation which does not comport with the intent of the regulations or the true economics of the transaction." Taxpayer points to the use of the term "amount paid" in I.R.C. § 382(h)(8) and asserts that, if the drafters of the ULR meant to measure value by "nominal" amounts received, they would have used "amount paid" instead of "amount realized" in section 1.1502-36(f)(11). Taxpayer argues that "amount realized" should not be interpreted to include nominal amounts that are merely meant to facilitate a transaction, because, in such cases, there is effectively no amount exchanged. Taxpayer also argues that Seller's expenditures made pursuant

to the stock purchase agreement resulted in a negative amount realized of $F, and that the term "amount realized" should not be interpreted to include a negative amount. Accordingly, Taxpayer argues that, under these unique circumstances, "value" should not be treated as meaning "amount realized," but rather as meaning "fair market value" for purposes of determining its aggregate inside loss.

LAW

Section 1.1502-36, the ULR

When a loss share of subsidiary stock is transferred, all members' bases in shares of that subsidiary's stock are subject to adjustment and the subsidiary's attributes are subject to reduction under the ULR. The adjustments are made to the extent necessary to further the ULR's two principal objectives: (1) preventing the reduction of consolidated taxable income through the creation and recognition of noneconomic loss on subsidiary stock and (2) preventing members (including former members) from collectively obtaining more than one tax benefit from a single economic loss. See section 1.1502-36(a)(2). It is the second objective at issue in this case.

The introductory language in section 1.1502-36(f) provides that, in addition to other definitions in the ULR or other regulations, the definitions in section 1.1502-36(f) apply for purposes of the ULR. Section 1.1502-80(a)(1) provides that the Internal Revenue Code, or other law, applies to consolidated groups to the extent the regulations do not exclude or modify its application.

Section 1.1502-36(f)(10) provides that a "transfer" occurs on the first of several specified events. One, found in section 1.1502-36(f)(10)(i)(A), is if the member ceases to own the share as a result of a transaction in which, but for the application of the ULR, the member would recognize income, gain, loss or deduction with respect to the share. Another, found in section 1.1502-36(f)(10)(i)(B), is if the member and the subsidiary cease to be members of the same consolidated group. A third, found in section 1.1502-36(f)(10)(i)(C), is if a nonmember acquires the share.

Section 1.1502-36(f)(7) defines a "loss share" as one with a basis in excess of value.

Section 1.1052-36(f)(11) provides that "value means the amount realized, if any, or otherwise the fair market value."

I.R.C. section 1001(b) provides that the term "amount realized" means "the sum of any money received plus the fair market value of the property (other than money) received."

Section 1.1502-36(a)(3) provides that the determination of whether a share is a loss share is made as of the transfer, but any adjustments required under the ULR are given effect immediately before the transfer.

Once it is determined that the ULR applies, its three principal operating rules apply sequentially.

First to apply is the basis redetermination rule of section 1.1502-36(b). Under that rule, investment adjustments previously made under section 1.1502-32 are reallocated in a manner that redirects investment adjustments to shares with unrecognized built-in gain or loss reflected in their bases.

If the transferred share is still a loss share after any basis redetermination under section 1.1502-36(b), the stock basis reduction rule of section 1.1502-36(c) applies. Under this rule, the member's basis in the transferred loss share is reduced by the lesser of the net built-in gain reflected in the basis of the share (the disconformity amount) and the net amount that section 1.1502-32 increased the basis of the share (the net positive adjustment) in order to eliminate noneconomic loss reflected in the stock basis.

If the transferred share is still a loss share after any basis reduction required by section 1.1502-36(c), the attribute reduction rule of section 1.1502-36(d) applies to eliminate the potential for the group and its members (including former members) to obtain more than one tax benefit from a single economic loss.

Section 1.1502-36(d) provides that the subsidiary's attributes are reduced by the "attribute reduction amount," which is defined as the lesser of the net loss in members' transferred shares and the subsidiary's aggregate inside loss. Section 1.1502-36(d)(3)(ii) defines net stock loss as the excess of the aggregate basis of transferred shares over the aggregate value of those shares. Section 1.1502-36(d)(3)(iii) defines aggregate inside loss as the excess of the subsidiary's net inside attribute amount (which is generally defined as the excess of the subsidiary's attributes over its liabilities) over the value of the subsidiary.

Under the general rule in section 1.1502-36(d), the duplicative use of economic loss is prevented by applying the attribute reduction amount (which identifies the extent to which there is a duplicative economic loss) to reduce the subsidiary's attributes. Such reductions are effective immediately before the transfer to prevent the duplicative loss from being subsequently available to the subsidiary.

However, section 1.1502-36(d)(6) also allows the group to prevent the duplicative use of economic loss by electing to reduce members' bases in transferred loss shares, to reattribute the subsidiary's realized losses (net operating and capital loss carryforwards and deferred deductions), or some combination of stock basis reduction and reattribution.

Section 1.1502-36(a)(2) provides that the provisions of the ULR must be interpreted and applied in a manner that is consistent with, and reasonably carries out these purposes.

The Plain Meaning Doctrine

Under the Plain Meaning Doctrine, unless the language of a statute is ambiguous, a court's analysis must end with the statute's plain language. King v. Burwell, 135 S. Ct. 2480, 2483 (2015) ("If the statutory language is plain, the Court must enforce it according to its terms.") (citing Hardt v. Reliance Standard Life Ins. Co., 560 U.S. 242, 251 (2010); United States v. Lexington Mill & Elevator Co., 232 U.S. 399, 409-10 (1914) (quoting Lake Cnty. v. Rollins, 130 U.S. 662, 670-71 (1889) ("Where a law is expressed in plain and unambiguous terms, whether those terms are general or limited, the legislature should be intended to mean what they have plainly expressed, and consequently no room is left for construction."); Hamilton v. Rathbone, 175 U.S. 414, 421 (1899) ("[T]he cases are so numerous in this court to the effect that the province of construction lies wholly within the domain of ambiguity, that an extended review of them is quite unnecessary.")).

Because a court is construing a statute, not isolated provisions, to determine whether there is ambiguity, words must be read " 'in their context and with a view to their place in the overall statutory scheme.' " King, 135 S. Ct. at 2483 (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 133 (2000)). Under the Plain Meaning Doctrine, all words used in the statute are given significance and effect. Market Co. v. Hoffman, 101 U.S. 112, 115-16 (1879).

Two narrow exceptions to the Plain Meaning Doctrine exist. First, the plain meaning is "conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.' " United States v. Ron Pair Enters., 489 U.S. 235, 242 (1989) (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)). The second exception is when the plain meaning "results in an outcome that can truly be characterized as absurd, i.e., that is 'so gross as to shock the general moral or common sense.' " Sigmon Coal Co., v. Apfel, 226 F.3d 291, 304 (4th Cir. 2000) (quoting Maryland State Dep't of Educ. v. United States Dep't of Veterans Affairs, 98 F.3d 165, 169 (4th Cir. 1996)).

The identical Plain Meaning Doctrine applies to regulatory interpretation. Howard Hughes Co. v. Commissioner, 142 T.C. 355, 385 (2014); Tesoro Hawaii Corp. v. United States, 405 F.3d 1339, 1346-47 (Fed. Cir. 2005) ("We construe a regulation in the same manner as we construe a statute, by ascertaining its plain meaning."); Reno v. NTSB, 45 F.3d 1375, 1379 (9th Cir. 1994). Regulations are construed to give effect to all its provisions, so no part of a regulation is inoperative or superfluous. United States v. Higgins, 128 F.3d 138, 142 (3d Cir. 1997); see also, Hercules Inc. v. United States, 516 U.S. 417, 429 (1996); Jewett v. Commissioner, 455 U.S. 305, 316 (1982) (Supreme Court declined to adopt interpretations of agency regulations which render words superfluous).

Agent of the Group

Section 1.1502-77 (Agent of the Group regulation) provides that the common parent for a consolidated group is the sole agent of the group with respect to all matters relating to the tax liability for the consolidated return. Section 1.1502-77(a) provides non-exhaustive examples of matters subject to the consolidated parent's agency. Among such examples is the exercise of any election or similar permissible option available to a subsidiary in the computation of its separate taxable income. Section 1.1502-77(a)(2)(i). Included in the consolidated parent's agency is a parent's determination regarding the group's use of net operating loss carryovers for the consolidated group. See Craigie, Inc. v. Commissioner, 84 T.C. 466 (1985).

ANALYSIS

The definition of "value" for purposes of the ULR, including for purposes of computing amounts under section 1.1502-36(d), sets forth two possible meanings, amount realized and fair market value. But the definition clearly establishes an order of priority among those two possible meanings. If there is an amount realized, then value means the amount realized ("the amount realized, if any . . . "). In that case, value means amount realized for all purposes of the ULR. Only if there is no amount realized does the second choice come into play ("otherwise the fair market value . . . ") (emphasis added).

There is no ambiguity in the regulation. Thus, there is no room for interpretation; whether such interpretation would look to the (irrelevant) provisions of section 338, the purported nominal nature of the amount realized, or the argument that the other payments by Seller give rise to a negative amount realized. Under the general rule of the Plain Meaning Doctrine, the analysis should end here.

Furthermore, neither of the exceptions to the Plain Meaning Doctrine applies to cause a different result. First, the literal application of the words of section 1.1502-36(f)(11) does not produce a result at odds with the purpose of the ULR. The very purpose for computing the attribute reduction amount is to identify the extent to which the selling member recognizes a stock loss that would remain available to the group. Where, as here, the selling member (properly) computed its loss as the excess of its basis in the Taxpayer stock over its amount realized, the goal of identifying (and eliminating) Taxpayer's ability to get a tax loss that duplicates Seller's tax loss can only be achieved if the measure of "value" is the same both for purposes of computing the net stock loss and the aggregate inside loss. Allowing Taxpayer to claim a significantly smaller value effectively preserves duplicated loss to the extent that Taxpayer's claimed value exceeds the value actually used by Seller to compute its loss.

Second, the literal application of the words of section 1.1502-36(f)(11) does not produce an outcome that could be characterized as absurd. In fact, just the opposite is

true. If Seller is allowed a tax loss because the "value" of Taxpayer is $B, but the attribute reduction amount measures Taxpayer's duplicated loss by reference to $A, the excess of $C over $A avoids characterization as duplicated loss. As a result, Taxpayer would be allowed to obtain the tax benefit of that excess even though Seller has already done so. This is the very outcome that section 1.1502-36(d) is intended to prevent.

Finally, we note that, in light of the purposes described above, any arguments that the language of section 1.1502-36(f)(11) would be ambiguous when considered in context are equally meritless.

Taxpayer's arguments regarding the meaning of "amount realized"

In addition to arguing that the term "value" can be interpreted to mean "fair market value" in this case, Taxpayer also appears to be arguing that notwithstanding section 1001(b) the term "amount realized" means something other than "the sum of any money received plus the fair market value of the property (other than money) received." But Taxpayer has produced no authority for the proposition that the term "amount realized" does not include nominal amounts.

As for Taxpayer's arguments based on the assertion that the additional payments by Seller give rise to a "negative amount realized" (which Taxpayer would also exclude from the term "amount realized"), Taxpayer again has produced no supporting authority. Moreover, although the character and treatment of those payments remains at issue, it does not appear that any resolution would give Taxpayer the result they seek. Whether the payments are properly treated as capital contributions, or as operating or some other expenses, the tax benefit of those expenditures would accrue to Seller. The fact remains that Buyer paid $B to Seller for the Taxpayer stock, and that is the amount realized, and thus the "value" of such stock for purposes of applying the ULR.

Agent of the Group

We note that even if there were merit in any of Taxpayer's arguments regarding discretion in the manner in which the ULR computations and elections were made (which there is not), Taxpayer, as a former member of the Parent group, is bound by the actions Parent, the agent of that group, took with respect to the group's transaction. See section 1.1502-77.

Taxpayer was a member of the Parent consolidated group at the time of the stock sale. Parent calculated the consolidated group's loss as the excess of Seller's basis in Taxpayer stock over $B, the amount realized. Any argument that an amount other than $B should be treated as the value of the stock was settled at that point. Further, Parent made no election to reduce Seller's basis in its Taxpayer stock or to reattribute Taxpayer's attributes, and thus foreclosed any other avenue for reducing the amount of attribute reduction applicable to Taxpayer's attributes. Accordingly, these matters were settled before Taxpayer became a subsidiary of Buyer. See section 1.1502-36(a)(3) (all adjustments given effect immediately prior to transfer). Taxpayer

simply has no authority to revise its former parent's tax determinations or treat its attribute reduction as reduced by an election not made by such former parent.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Special Counsel
Office of Associate Chief Counsel (Corporate)