Office of Chief Counsel
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Memorandum

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to: Associate Area Counsel
(, Group 2)
(Large & Mid-Size Business)

from: Associate Chief Counsel
(Corporate)

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subject:

This Chief Counsel Advice responds to your request for assistance dated November 17, 2006. This advice may not be used or cited as precedent.

LEGEND

Target =
Acquiring =
Date 1 =
Acquiring Sub =
Target Sub =

ISSUE

If the Target group is allowed a loss on the sale of Target Sub stock, should the losses subsequently recognized on the sale of Target Sub's assets be available for use on the Acquiring group return?

CONCLUSION

To the extent that any loss on Target Sub's assets reflects the same economic loss that the Target group claimed and was allowed on the sale of the Target Sub stock, that loss is not allowed to the Acquiring group.

FACTS

Target was the common parent of a consolidated group and Acquiring is the common parent of a second consolidated group. On Date 1, Target and Acquiring entered into a binding agreement pursuant to which the Target group would be acquired by a member of the Acquiring group (Acquiring Sub) in a transaction that qualified as a reorganization subject to section 361 of the Code (and described in section 381(a)(2) of the Code).

In preparation for the acquisition, Target and its subsidiaries engaged in the following steps. First, members of the Target group transferred loss assets to a member of the Target group (Target Sub), in exchange for new shares of Target Sub stock (the "loss shares"). Second, and shortly after the first step, Target Sub issued new shares to unrelated third persons and to a member of Acquiring group. The stock issuance caused Target Sub, in form, to cease to be a member of the Target group. Third, the Target Sub loss shares acquired in the first step were sold to unrelated third persons.

Within six months of Date 1 and in the same tax year, Acquiring Sub acquired Target (and thus the Target group). The combination of the Target Sub shares acquired in the direct issuance (in the second step above) and the Target Sub shares acquired as a result of the acquisition of the Target group was sufficient to cause Target Sub to become a member of the Acquiring group.

Early in the following tax year (and therefore after Target Sub became a member of the Acquiring group), loss assets that were transferred in the first step were either sold by Target Sub (and the losses were recognized directly by Target Sub) or transferred to a partnership (after which Target Sub recognized the losses indirectly, either by selling its partnership interest or by causing the partnership to sell the assets). The losses recognized, directly and indirectly, represented the same economic loss that was reflected in the basis of the Target Sub shares when they were purportedly deconsolidated in the second step and when they were sold in the third step. (We note that the partnership was liquidated almost immediately, but we do not address whether its existence should be respected because the anti-loss reimportation rule applies to reimported losses whether realized directly or indirectly.) A portion of the loss recognized on the assets was carried back to the final return(s) for the Target group and a portion of the loss recognized on the assets was reported on the Acquiring group return(s).

LAW AND ANALYSIS

As a preliminary matter, we understand that the issue of whether the Target group is allowed to claim a deduction for loss on the sale of Target Sub stock is currently under consideration in another case (the Target group case). The position of this office is that the stock loss is not allowable to the Target group. If the position of this office prevails, losses subsequently realized (directly or indirectly) on the assets are not subject to disallowance under Reg. §1.1502-35T. However, if the position of this office does not prevail and the stock loss is allowed to the Target group, the losses subsequently realized (directly or indirectly) on the assets are disallowed to the Acquiring group for the reasons set forth below. (In addition, such losses may not be carried back to a tax year of the Target group. That issue, however, is to be addressed in the Target group case.)

Because the Acquiring group's deductibility of the losses on the Target Sub assets is subject to Reg. §1.1502-35T only if the Target group is allowed the stock loss, this memorandum presumes (but does not concur) that a portion of the stock loss is (or will be) allowed to the Target group.

Loss duplication and Reg. §1.1502-35T

The tax treatment of otherwise allowable losses recognized on the sale of subsidiary stock is subject to the provisions of Reg. §1.1502-35T. Reg. §1.1502-35T(a) describes the purpose of this regulation:

> The purpose of [Reg. §1.1502-35T] is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of [Reg. §1.1502-35T] shall be construed in a manner consistent with that purpose and in a manner that reasonably carries out that purpose.

Reg. §1.1502-35T contains several provisions designed to prevent groups (including their successors and their successor groups) from obtaining more than one tax benefit from a single economic loss. The terms predecessor and successor are defined in Reg. §1.1502-35T(d)(5)(i) to include parties to a transaction to which section 381(a) applies (which includes reorganizations under section 361). The term successor group is defined in Reg. §1.1502-35T(d)(6)(i) to include a group that acquires the stock of a common parent of another group or that (in a reorganization under section 381(a)(2)) acquires the assets of the common parent of another group.

The principal provisions of Reg. §1.1502-35T apply to limit (or eliminate) the extent to which a group can claim an otherwise allowable loss on the disposition of stock of a subsidiary member. Very generally, they do this by redetermining members' bases in subsidiary stock (Reg. §1.1502-35T(b)) and by suspending any stock loss recognized in a non-deconsolidating sale (Reg. §1.1502-35T(b)). The taxpayer applied Reg. §1.1502-35T(b)(2) and made minimal adjustments to its basis in Target Sub stock effective

immediately prior to the sale. Taxpayer claims, and for purposes of this discussion we assume, that the loss recognized on the sale of the Target Sub stock received in the first step is fully allowable to the Target group and that the stock loss is not suspended under Reg. §1.1502-35T(c).

The dispute in this case is the extent to which the Acquiring group, the Target group's successor in a section 381(a) transaction, is allowed a loss on the subsequent sale of the assets that were transferred to Target Sub in the first step if the stock loss is allowed to the Target group. The taxpayer does not dispute that the loss on the assets duplicates the loss on the stock or that the Acquiring group is a successor or successor group to the Target group under Reg. §1.1502-35T.

Reg. §1.1502-35T(g)(3): anti-loss reimportation

In very general terms, Reg. §1.1502-35T(g)(3), the anti-loss reimportation rule, prevents taxpayers from claiming a loss on subsidiary stock, reimporting the loss (that is, bringing it back into the group, including as asset basis that reflects the same economic loss that the group claimed on the stock), and then *directly or indirectly* claiming a second (duplicative) tax benefit by selling the asset. Mechanically, it works by disallowing the second loss (to the extent it duplicates the stock loss), see Reg. §1.1502-35T(g)(3)(iii), and then treating the disallowed loss as a noncapital, nondeductible expense in the year it would otherwise have been absorbed, see Reg. §1.1502-35T(g)(3)(iv). Reg. §1.1502-35T(g)(3)(i)(B) applies the anti-loss reimportation rule to members and to their successors (thus including successor groups) in order to prevent taxpayers from avoiding the rule by selling subsidiary stock and then merging into another group to claim the asset loss.

In this case, the taxpayer structured its transaction such that, at the time that it sold the loss shares of Target Sub, the issuances of new stock had (in form) caused Target Sub to cease to be a member of the Target group. Taxpayer argues that the anti-loss reimportation rule therefore cannot apply to prevent the successor group (Acquiring) from claiming the duplicative inside losses because, at the time that the Target Sub stock was sold, Target Sub was no longer a "subsidiary" of the Target group.

This office agrees that, if the individual steps of the overall transaction could be properly respected, the taxpayer's transaction would not be subject to the anti-loss reimportation rule. However, for the reasons discussed below, we do not believe it is proper to respect the individual steps of this transaction. Rather, we believe that the Step Transaction Doctrine requires the amalgamation of the contribution of loss assets in exchange for loss shares of Target Sub stock, the issuances of Target Sub stock (including to the Acquiring group), the sale of the loss shares, and the consolidation of Target Sub with the successor group. Thus, Target Sub cannot be viewed as being anything but a subsidiary member of the Target group (including its successor group) and the anti-loss reimportation rule applies to losses recognized, directly or indirectly, on the disposition of Target Sub's assets.

The Step Transaction Doctrine

"The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of a transaction." McDonald's Restaurants of Illinois, Inc., v. Commissioner, 688 F.2d 520, 524 (7th Cir, 1982).

Under the Step Transaction Doctrine,

> [I]nterrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus "linking together all interdependent steps with legal or business significance, rather than taking them in isolation," federal tax liability may be based "on a realistic view of the entire transaction."

Commissioner v. Clark, 489 U.S. 726, 738 (1989).

Courts have articulated three formulations of the Step Transaction Doctrine: the "end-result" test, the "interdependence" test, and the "binding-commitment" test. We believe that, under any of these formulations, the individual steps of the transaction must be viewed together. However, only one of the tests needs to be satisfied in order for the doctrine to apply. True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999).

Under the end-result test, purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction, each intended from the outset to be taken for the purpose of reaching the ultimate result. In this case, the transfer of loss assets to Target Sub, the deconsolidation of Target Sub, the sale of the loss stock, and the consolidation of Target Sub with the Target group's successor (the Acquiring group) were done (and in that order) only as component parts of a single overall transaction, the acquisition of the entire Target group—including Target Sub. The clear intent, from the outset, in taking each of these component steps was solely to circumvent the anti-loss duplication rules of Reg. §1.1502-35T and, thereby, duplicate a single economic loss within the same economic group, namely, the Target group and its successor, the Acquiring group. There was no other purpose for the component parts and there was clearly no intent for Target Sub to be, in the end, anything other than a member of the group. Under the Step Transaction Doctrine, these steps must be amalgamated and Target Sub's purported (and fleeting) status as a nonmember must be disregarded. Accordingly, the Target group's successor, the Acquiring group, is subject to the anti-loss reimportation rule and cannot deduct the duplicated losses. (Note that, if the deconsolidation and sale were done in the reverse order, the stock loss would have been prevented under Reg. §1.1502-35T(b)(1) and so duplication would not have been possible in any event.)

The interdependence test focuses on whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. This test is more practical and less legalistic than the binding-commitment test (discussed below). It concentrates on the relationship between the steps, rather than on the end result. The inquiry here would be whether the transfer of loss assets to Target Sub, the deconsolidation of Target Sub, and the sale of the Target Sub stock would have taken place without the guarantee (inherent in the reorganization agreement) that Target Sub would not permanently leave the group. The answer is certainly no. Again, the only real transaction is the acquisition of the Target group (including Target Sub), and the only reason for creating loss Target Sub stock and causing the temporary deconsolidation of Target Sub (while the method for its reconsolidation was guaranteed) was to duplicate group losses free from the restrictions of the anti-loss reimportation rule. Thus, under the interdependence test, the steps of the transaction are amalgamated with the result that the Target group is treated as selling "subsidiary stock" and the Target group's successor, the Acquiring group, is subject to the anti-loss reimportation rule.

The third test, the binding-commitment test, is the most restrictive and generally forbids the use of the Step Transaction Doctrine unless there is a binding (contractual) commitment to take the later steps. This test is the most rigorous because it was formulated to deal with the characterization of a transaction that in fact spanned several tax years and could have remained not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen. In the McDonald's case, supra, the terms of the taxpayers' agreement made it extremely likely, but not completely certain, that the transaction would occur. But, in that case, all of the steps of the transaction were completed in six months and fell entirely within a single tax year. The McDonald's court found that, given the short period of time in which the steps were completed, the terms of the agreement were sufficient to satisfy the spirit, if not the letter, of the binding-commitment test.

We believe that the material facts of this case are indistinguishable from the material facts of the McDonald's case. Thus, although the contractual obligation here pertained to the acquisition of the Target group, the events intended to duplicate loss all took place in several months and all within one tax year. Moreover, there was no uncertainty that, once the first steps (the transfer of loss assets and issuances of Target Sub stock) were taken, the steps necessary to duplicate the loss and reconsolidate Target Sub would follow. And follow they did. Thus we believe that here, as in the McDonald's case, the spirit, if not the letter, of the binding-commitment test is satisfied.

Accordingly, under any of the three applicable tests, the transfer of the loss assets to Target Sub, the deconsolidation of Target Sub, the sale of the loss shares, and the subsequent consolidation of Target Sub with the Target group's successor group, must be treated as one transaction, which includes the sale of "subsidiary stock." Further, even if your office concludes that this transaction does not satisfy the criteria of each of the tests, the Step Transaction Doctrine applies as long as the criteria of one of the

tests are satisfied. Because this transaction clearly satisfies the criteria of at least one of the tests, the asset losses realized directly or indirectly by the Acquiring group (through the partnership) are disallowed to the Acquiring group under the anti-loss reimportation rule in Reg. §1.1502-35T(g)(3) to the extent that they duplicate a loss allowed to the Target group on the sale of the Target Sub stock. Further, the disallowed losses are noncapital, nondeductible expenses of each member of the Acquiring group that directly or indirectly recognizes such losses.

Please call Theresa Abell at (202) 622-7700 if you have any further questions.