

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR HARMON B. DOW, SPECIAL LITIGATION ASSISTANT
DISTRICT COUNSEL CC:MSR:ILD:CHI

FROM: STEVEN J. HANKIN
CHIEF, CORPORATE BRANCH
FIELD SERVICE DIVISION CC:DOM:FS

SUBJECT: Deduction of a Claimed Loss Based on the Transfer of Certain
Notes From Taxpayer to a Subsidiary Corporation Which is Not
Part of the Consolidated Group

This Field Service Advice responds to your memorandum dated September 16, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Sub 1 =
Lower-tier =
subs =
Newco =

Year 1 =
 Year 2 =
 \$b =
 \$c =
 x% =
 y% =
 #t =

ISSUE:

Whether Taxpayer properly claimed a loss upon the distribution of notes from lower-tier subs to Sub 1, followed by a contribution by Sub 1 of such notes to a newly-formed corporation, Newco, which was not a member of Taxpayer's consolidated group (because there were other (possibly) unrelated transferors). You have also raised a question of whether these transferors were in fact unrelated to Taxpayer. If they were not (because they were in fact acting on behalf of Taxpayer), then Newco would be a member of Taxpayer's consolidated group and Taxpayer would not recognize a loss upon the contribution of the notes by Sub 1 to Newco.

CONCLUSION:

Provided Newco was not a member of Taxpayer's consolidated group, Taxpayer properly claimed a loss upon the distribution of notes from lower-tier subs to Sub 1, followed by a contribution by Sub 1 of such notes to Newco. We express no opinion in this memo as to whether the transferors were acting on behalf of Taxpayer.

FACTS:

Taxpayer owned all of the stock of Sub 1, which was the general partner in a number of real estate limited partnerships. Lower-tier subs lent money to the partnerships to cover fees related to the formation of the partnerships (the Anotes®). The notes earned normal interest, but were to be repaid only after the limited investors received all their capital back. By Year 1, it became apparent that the notes would never be repaid.

In Year 2, the notes were distributed by the lower-tier subs to Sub 1. The lower-tier subs' basis in the notes was approximately \$c; the fair market value at the time of the distribution was approximately \$b. Sub 1 and #t officers (of either Sub 1 or Taxpayer) formed Newco. Sub 1 contributed cash to Newco in exchange for x% of the common stock of Newco, and the officers contributed cash to Newco in exchange for y% of the common stock of Newco. Sub 1 also transferred the notes to Newco in exchange for all of the Newco preferred stock. Taxpayer argues that this I.R.C. ' 351 exchange triggered the intercompany loss of the lower-tier subs resulting from the distribution of the notes to Sub 1.

LAW AND ANALYSIS

Law:

I.R.C. ' 311(a) provides that, with an exception not applicable here, no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of: (1) its stock, or (2) property.

I.R.C. ' 311(b)(1) provides that if

(A) a corporation distributes property to a shareholder in a distribution to which subpart A applies (I.R.C. ' ' 301 - 307), and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

I.R.C. ' 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by a person solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation.

Treas. Reg. ' 1.1502-13:

(a) In general--

(1) Purpose. This section provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing

intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

(b) Definitions. For purposes of this section

(1) Intercompany transactions--(i) In general. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include: * * * (D) S's distribution to B with respect to S stock.

(2) Intercompany items--(i) In general. S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. For example, S's gain from the sale of property to B is intercompany gain. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.

(3) Corresponding items--(i) In general. B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss; alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

(4) Recomputed corresponding items. The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. For example, if S sells property with a \$70 basis to B for \$100, and B later sells the property to a nonmember for \$90, B's corresponding item is its \$10 loss, and the recomputed corresponding item is \$20 of gain (determined by comparing the \$90 sales price with the \$70 basis the property would have if S and B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or

regulations that would affect its timing or attributes).

(c) Matching rule. For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

* * *

(2) TimingB

(ii) S's items. S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

(7) Examples

(i) In general

(ii) Matching rule. The matching rule of this paragraph (c) is illustrated by the following examples.

Example 1. Intercompany sale of land followed by sale to a nonmember. (a) Facts. S holds land for investment with a basis of \$70. S has held the land for more than one year. On January 1 of Year 1, S sells the land to B for \$100. B also holds the land for investment. On July 1 of Year 3, B sells the land to X for \$110.

(b) Definitions. Under paragraph (b)(1) of this section, S's sale of the land to B is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraphs (b)(2) and (3) of this section, S's \$30 gain from the sale to B is its intercompany item, and B's \$10 gain from the sale to X is its corresponding item.

(c) Attributes. Under the matching rule of paragraph (c) of this section, S's \$30 intercompany gain and B's \$10 corresponding gain are taken into account to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. In addition, the holding periods of S and B for the

land are aggregated. Thus, the group's entire \$40 of gain is long-term capital gain. Because both S's intercompany item and B's corresponding item on a separate entity basis are long-term capital gain, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(d) Timing. For each consolidated return year, S takes its intercompany item into account under the matching rule to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$70 basis in the land and would have a \$40 gain from the sale to X in Year 3, instead of a \$10 gain. Consequently, S takes no gain into account in Years 1 and 2, and takes the entire \$30 gain into account in Year 3, to reflect the \$30 difference in that year between the \$10 gain B takes into account and the \$40 recomputed gain (the recomputed corresponding item). Under Treas. Reg. ' ' 1.1502-32 and 1.1502-33, P's basis in its S stock and the earnings and profits of S and P do not reflect S's \$30 gain until the gain is taken into account in Year 3.

* * *

(j) Intercompany sale followed by I.R.C. ' 351 transfer to nonmember. The facts are the same as in paragraph (a) of this Example 1, except that, instead of selling the land to X, B transfers the land to X in a transaction to which I.R.C. ' 351(a) applies and X remains a nonmember. There is no difference in Year 3 between B's \$0 corresponding item taken into account and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the I.R.C. ' 351(a) transfer. However, S's entire gain is taken into account in Year 3 under the acceleration rule of paragraph (d) of this section (because X, a nonmember, reflects B's \$100 cost basis in the land under I.R.C. ' 362).

(d) Acceleration rule. S's intercompany items and B's corresponding items are taken into account under this paragraph (d) to the extent they cannot be taken into account to produce

the effect of treating S and B as divisions of a single corporation. For this purpose, the following rules apply:

(1) S's items--(i) Timing. S takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. The items are taken into account immediately before it first becomes impossible to achieve this effect. For this purpose, the effect cannot be achieved

(A) To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or consolidated tax liability) under the matching rule (for example, if S or B becomes a nonmember, or if S's intercompany item is no longer reflected in the difference between B's basis (or an amount equivalent to basis) in property and the basis (or equivalent amount) the property would have if S and B were divisions of a single corporation); or

(B) To the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under I.R.C. ' 362 following a I.R.C. ' 351 transaction).

(f) Stock of members--

(1) In general. In addition to the general rules of this section, the rules of this paragraph (f) apply to stock of members.

(2) Intercompany distributions to which I.R.C. ' 301 applies

(i) In general. This paragraph (f)(2) provides rules for intercompany transactions to which I.R.C. ' 301 applies (intercompany distributions). For purposes of determining whether a distribution is an intercompany distribution, it is treated as occurring under the principles of the entitlement rule of paragraph (f)(2)(iv) of this section.

(ii) Distributee member. An intercompany distribution is not included in the gross income of the distributee member (B).

However, this exclusion applies to a distribution only to the extent there is a corresponding negative adjustment reflected under Treas. Reg. ' 1.1502-32 in B's basis in the stock of the distributing member (S). For example, no amount is included in B's gross income under I.R.C. ' 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under Treas. Reg. ' 1.1502-32(a) which is treated as negative basis under Treas. Reg. ' 1.1502-19. B's dividend received deduction under I.R.C. ' 243(a)(3) is determined without regard to any intercompany distributions under this paragraph (f)(2) to the extent they are not included in gross income. See Treas. Reg. ' 1.1502-26(b) (applicability of the dividends received deduction to distributions not excluded from gross income, such as a distribution from the common parent to a subsidiary owning stock of the common parent).

(iii) Distributing member. The principles of I.R.C. ' 311(b) apply to S's loss, as well as gain, from an intercompany distribution of property. Thus, S's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember. However, I.R.C. ' 311(a) continues to apply to distributions to nonmembers (for example, loss is not recognized).

(iv) Entitlement rule--(A) In general. For all Federal income tax purposes, an intercompany distribution is treated as taken into account when the shareholding member becomes entitled to it (generally on the record date). For example, if B becomes entitled to a cash distribution before it is made, the distribution is treated as made when B becomes entitled to it. For this purpose, B is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under I.R.C. ' 305(c)). To the extent a distribution is not made, appropriate adjustments must be made as of the date it was taken into account.

(B) Nonmember shareholders. If nonmembers own stock of the distributing corporation at the time the distribution is treated as occurring under this paragraph (f)(2)(iv), appropriate adjustments must be made to prevent the acceleration of the

distribution to members from affecting distributions to nonmembers.

Analysis:

The distribution of the notes by the lower-tier subs (i.e., AS under the regulations) to Sub 1 (i.e., AB under the regulations) is an intercompany transaction. Treas. Reg. ' 1.1502-13(b)(1)(i)(D). Normally, the loss realized by the lower-tier subs upon the distribution of the notes would be disallowed under I.R.C. ' 311(a)(2). However, as noted above, Treas. Reg. ' 1.1502-13(f)(2)(iii) provides that the principles of I.R.C. ' 311(b) apply to S's loss, as well as gain, from an intercompany distribution of property. Thus, that loss would be an intercompany item. Treas. Reg. ' 1.1502-13(b)(2)(i).

Section 311(b) provides that a corporation distributing appreciated property with respect to its stock will recognize gain as if it sold such property to its shareholder at the property's fair market value. Under Treas. Reg. ' 1.1502-13(f)(2)(iii) a corporation distributing depreciated property with respect to its stock will recognize loss as if it sold such property to its shareholder at the property's fair market value. However, the timing of the recognition of that loss will depend upon the application of other rules of Treas. Reg. ' 1.1502-13. For example, Treas. Reg. ' 1.1502-13(f)(2)(iii) further provides that AS's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember.

In the instant case, where the property is transferred outside the group in a I.R.C. ' 351 exchange (i.e., from Taxpayer to Newco), the application of the matching rule does not result in S's taking the loss into account. See Treas. Reg. ' 1.1502-13(c)(7)(ii), example 1(j). In that example, reproduced above, S sells to B for \$100 land in which S has a basis of \$70. In Year 3, B transfers the land to X in a transaction to which I.R.C. ' 351(a) applies and X remains a nonmember. The example notes that: AThere is no difference in Year 3 between B's \$0 corresponding item taken into account [the \$0 gain or loss recognized on the I.R.C. ' 351 transfer] and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the I.R.C. ' 351(a) transfer. However, S's entire gain is taken into account in Year 3 under the acceleration rule of paragraph (d) of this section (because X, a non-member, reflects B's \$100 cost basis in the land under I.R.C. ' 362.)

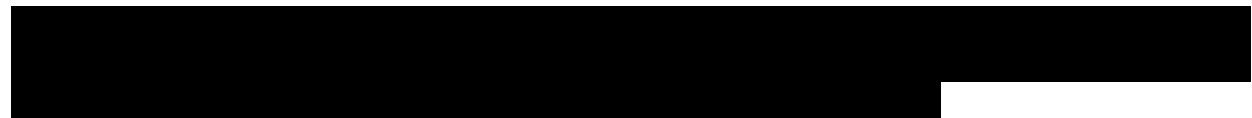
Treas. Reg. section 1.1502-13(d)(1) provides that: AS takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. . . . The effect cannot be achieved . . . [t]o the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under I.R.C. ' 362 following a I.R.C. ' 351 transaction.)

In the instant case, Newco's basis in the notes reflects the fair market value basis that the notes had in Sub 1's hands following the distribution. I.R.C. ' 301(d). That is, a nonmember reflects an aspect of the intercompany transaction, and the effect of treating the lower tier subs and Sub 1 as divisions of a single corporation cannot be achieved, and the lower tier subs will take the loss into account. Thus, under Treas. Reg. ' 1.1502-13 the lower-tier subs recognize the loss resulting from the distribution of the notes to Sub 1, following the contribution of those notes by Sub 1 to Newco.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Section 351 Agency Issue

If the other transferors of property to Newco, i.e., the officers, are not acting on their own, but instead are acting on behalf of Taxpayer or Sub 1, then we agree with you that Newco would be treated as a member of Taxpayer's consolidated group. In that case, the distribution of the notes would not result in the recognition of the loss by the lower-tier subs. Accordingly, as long as the notes distributed by the lower-tier subs to Sub 1 remain in Taxpayer's consolidated group, there is no provision in Treas. Reg. ' 1.1502-13 which would allow the lower-tier subs to claim the loss upon the distribution of such property. Treas. Reg. ' 1.1502-13(d)(1)(i)(A).



Other Issues

1) You have not asked us to consider whether the notes in substance represent a partnership interest in the partnerships (rather than a debt interest in the partnership). If that were the case, the distributions by the lower-tier subs would represent a distribution of partnership interests. CC:DOM:FS:P&SI would be the office to consider the consequences of such a distribution to the partners and partnerships.



4) Of course, there is no issue if Taxpayer-s valuations are incorrect. For the purpose of discussing Treas. Reg. ' 1.1502-13, we have assumed that they are.