



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER  
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)  
CC:DOM:FS

SUBJECT: Redemption of Intercompany Note

This Field Service Advice responds to your memorandum dated March 25, 1999. 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:

P =  
S =  
X =

Year 1 =  
Year 2 =  
Year 3 =  
Year 4 =

x% =  
y% =

\$x =  
\$y =  
\$z =

ISSUE:

Whether X's claimed loss, upon the redemption of an intercompany note, is properly disallowed under Treas. Reg. § 1.1502-14(d)(4), as then in effect.

CONCLUSION:

X's claimed loss, upon the redemption of an intercompany note, is properly disallowed under Treas. Reg. § 1.1502-14(d)(4), as then in effect.

FACTS:

For the years at issue, P was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. From Year 1 through Year 3, S was a member of the P group.

In Year 1, X acquired x% of the stock of S. As of the date of the acquisition, X was not a member of the P group or otherwise affiliated with any member of the P group. Since P owned y% of the stock of S, S was still a member of the P group. Later in Year 1, S acquired all of the stock of X. Thus, X became a member of the P group.

In Year 2, X surrendered its S stock to S in exchange for a note issued by S. The face amount of the note (\$x) equaled the fair market value of the S stock that X surrendered in exchange therefor. However, \$x was less than \$y, which was X's basis in the S stock. The difference was \$z. Pursuant to Treas. Reg. § 1.1502-14(b)(1), X recognized no gain or loss on the exchange of the stock for the note. Pursuant to Treas. Reg. § 1.1502-31(b)(2)(ii), X took the same basis in the note that it had in the S stock.

In Year 3, X surrendered the note to S in exchange for cash equal to the face amount of the note. X realized (and claimed) a loss in the amount of \$z, which was reported in the Year 3 consolidated return of P. The question is whether X properly claimed that loss.

In Year 4, X was liquidated into S tax-free pursuant to I.R.C. § 332.

LAW AND ANALYSIS

Law:

Treas. Reg. § 1.1502-14(b)(1) provides, with exceptions not applicable here, that no gain or loss shall be recognized on the receipt, during a consolidated return year, by one member (the “distributee member”) of property distributed in cancellation or redemption of all or a part of the stock of another member (the “distributing member”). For purposes of this paragraph, a distribution is in cancellation or redemption of all or a part of stock only if \* \* \* (iii) it is a distribution in redemption of the stock of the distributing corporation to which I.R.C. § 302(a) applies, and such corporation remains a member of the group immediately after the distribution.

Treas. Reg. § 1.1502-14(d)(1) provides that, to the extent gain or loss is recognized under the Code to a member (the “creditor member”) during a consolidated return year because of a sale or other disposition (other than a redemption or cancellation) of an obligation of another member (the “debtor member”), such gain or loss shall be deferred.

Treas. Reg. § 1.1502-14(d)(2) provides that, if an obligation described in subparagraph (1) of this paragraph is sold or disposed of to a nonmember (or if the member holding the obligation becomes a nonmember), each member with deferred gain or loss with respect to such obligation under subparagraph (1) of this paragraph shall, except as provided in subparagraph (3) of this paragraph, take such gain or loss into account ratably over the remaining term of the obligation.

Treas. Reg. § 1.1502-14(d)(3) provides that each member's gain or loss deferred with respect to an obligation under subparagraph (1) which has not been taken into account under subparagraph (2) of this paragraph shall be taken into account immediately before the occurrence of the earliest of several specified events.

Treas. Reg. § 1.1502-14(d)(4)(i) provides that, if: (a) a member received an obligation of another member in exchange for property; (b) the basis of the obligation was determined in whole or in part by reference to the basis of the property exchanged, and (c) the obligation has never been held by a nonmember, then any gain or loss of any member on redemption or cancellation of such obligation shall be deferred, and subparagraph (3) of this paragraph shall not apply.

Treas. Reg. § 1.1502-14(d)(4)(ii) provides that gain or loss deferred by a member under subdivision (i) of this subparagraph, and under subparagraph (1) of this paragraph with respect to an obligation to which this subparagraph applies, shall be taken into account immediately before the occurrence of the earlier of the following two events: (a) when such member ceases to be a member, or (b) when the stock of the debtor member is considered to be disposed of by any member (as defined therein).

Treas. Reg. § 1.1502-14(d)(4)(iii) provides that this subparagraph may be illustrated by the following example:

Example. Corporation P forms a subsidiary, S, in a transaction to which I.R.C. § 351 applies and receives as a result of such transaction, in addition to stock, a security with a face value of \$100 and a basis of \$50. If the security is redeemed for \$100, the \$50 gain on redemption is deferred and is not taken into account until P ceases to be a member or the stock of S is treated as disposed of under this subparagraph.

Treas. Reg. § 1.1502-14(e)(2) provides that paragraphs (b)(3)(i), (d)(3)(i), and (d)(4)(ii)(a) of this section shall not apply if a member with deferred gain or loss ceases to be a member because its assets are acquired by one or more members in an acquisition to which I.R.C. § 381(a) applies.

Treas. Reg. § 1.1502-31(b)(2)(ii) provides that the aggregate basis of all property acquired in a distribution in cancellation or redemption of stock (as defined in Treas. Reg. § 1.1502-14(b)(1)) by a member to another member, other than a liquidation to which I.R.C. § 332 applies, shall be the same as the adjusted basis of the stock exchanged therefor.

Analysis:

The issue in this case is whether the consolidated return regulations disallow the loss claimed by X (and reported on the P group consolidated return) as a result of a redemption of an intercompany note for cash. Since X's basis in the note is greater than the face amount of the note, X would properly claim the loss, unless Treas. Reg. § 1.1502-14(d)(4) applied to disallow it.

As noted above, in Year 2, X surrendered its S stock to S in exchange for a note with a face amount equal to the then fair market value of X's S stock. Pursuant to Treas. Reg. § 1.1502-14(b)(1), X recognized no gain or loss on this exchange. In addition, pursuant to Treas. Reg. § 1.1502-31(b)(2)(ii), X took the same basis in the note as it had in its S stock.

In Year 3, X surrendered its note to S in exchange for cash in an amount equal to the face amount of the note. Because, as noted above, X's basis in the note was greater than the face amount of the note, X claimed a loss on this exchange, which was reported on the consolidated return filed by P for Year 3.

In support of its position, P argues that Treas. Reg. § 1.1502-14(d), dealing with gains and losses on obligations of members, is inapplicable. P notes that Treas. Reg. § 1.1502-14(d)(1) only applies to the sale or other disposition (other than a cancellation/ redemption) by one member of an obligation of another member and

further provides that such gain or loss shall be deferred. Since X's surrender of its S note to S is a redemption of such note, P argues that Treas. Reg. § 1.1502-14(d)(1) is inapplicable. In that case, P argues that none of the other provisions of Treas. Reg. § 1.1502-14(d) apply.

P characterizes all of these other provisions as exceptions to Treas. Reg. § 1.1502-14(d)(1). More specifically, P argues that Treas. Reg. § 1.1502-14(d)(2) and (3) describe the circumstances under which the gain or loss that is deferred under Treas. Reg. § 1.1502-14(d)(1) shall be restored (i.e., recognized). P further argues that Treas. Reg. § 1.1502-14(d)(4) describes the circumstances under which Treas. Reg. § 1.1502-14(d)(3) does not apply (when it otherwise would). Since, as noted above, P argues that Treas. Reg. § 1.1502-14(d)(1) does not apply, then under its analysis, none of the exceptions to that provision, contained in Treas. Reg. § 1.1502-14(d)(2), (3) and (4), apply. Consequently, P argues that, pursuant to Treas. Reg. § 1.1502-80(a), it properly recognized the loss in Year 3 under I.R.C. § 1001 from the redemption of the note.

By contrast, the Service takes the position that Treas. Reg. § 1.1502-14(d)(4) can apply even if Treas. Reg. § 1.1502-14(d)(1) does not. As noted above, Treas. Reg. § 1.1502-14(d)(4)(i) provides that if: (a) a member received an obligation of another member in exchange for property; (b) the basis of the obligation was determined in whole or in part by reference to the basis of the property exchanged, and (c) the obligation has never been held by a nonmember, then any gain or loss of any member on cancellation/redemption of such obligation shall be deferred, and Treas. Reg. § 1.1502-14(d)(3) shall not apply.

In this case, X received an obligation of S in exchange for X's S stock, the basis of the obligation in the hands of X was determined wholly by reference to X's basis in its S stock and the obligation was never held by a nonmember. Therefore, under Treas. Reg. § 1.1502-14(d)(4)(i), X's loss was deferred.

Treas. Reg. § 1.1502-14(d)(4)(ii) provides rules for the restoration of a loss deferred under Treas. Reg. § 1.1502-14(d)(4)(i). Such loss is restored upon the earlier of when X ceases to be a member of the P group or when the stock of S is considered to have been disposed of by P (as defined therein). With respect to the second restoration rule, we note that, for the year that the P group claimed the loss, S was still a member of the P group. Therefore, this restoration rule does not apply.

With respect to the first restoration rule, we note that, in Year 4, X was liquidated into S tax-free under I.R.C. § 332. Thus, it might seem that X ceased to be a member of the group. In that case, the first restoration rule would apply to restore X's loss to the P group in Year 4 (but not in Year 3, the year the P group claimed the loss).

However, Treas. Reg. § 1.1502-14(e)(2) provides an exception to this restoration rule in the case in which a member ceases to be a member because its assets are acquired by another member of the group in an acquisition to which I.R.C. § 381(a) applies (such as a liquidation to which I.R.C. § 332 applies). Since X ceased to be member of a group as a result of a liquidation into S to which I.R.C. § 332 applies, this restoration rule does not apply. Consequently, under Treas. Reg. § 1.1502-14(d)(4), the P group cannot report the loss X claimed as a result of the redemption by S of the S note.

As noted above, P argues that Treas. Reg. § 1.1502-14(d)(4) does not apply if Treas. Reg. § 1.1502-14(d)(1) is inapplicable. On the other hand, the position of the Service is that Treas. Reg. § 1.1502-14(d)(4) can apply even if Treas. Reg. § 1.1502-14(d)(1) does not.

As also noted above, Treas. Reg. § 1.1502-14(d)(1) provides that any gain or loss recognized to a member upon the sale or other disposition of an obligation of another member shall be deferred. Treas. Reg. § 1.1502-14(d)(2) and (3) provide rules by which this deferred gain or loss shall be restored (i.e., recognized).

In addition, Treas. Reg. § 1.1502-14(d)(4) provides a special rule in a case in which gain or loss is recognized to a member upon the cancellation/redemption of an obligation that was acquired by that member in a tax-free exchange. However, since Treas. Reg. § 1.1502-14(d)(1) does not apply to gain or loss realized upon the cancellation/redemption of a note, Treas. Reg. § 1.1502-14(d)(4) addresses a fact pattern not addressed by Treas. Reg. § 1.1502-14(d)(1).

The example found in Treas. Reg. § 1.1502-14(d)(4) (the “Example”) supports this analysis. In the Example, P formed a subsidiary, S, in a transaction to which I.R.C. § 351 (as in effect prior to October 2, 1989) applied. P transferred property to S and received stock of S and a security with a face amount of \$100 and a basis of \$50.<sup>1</sup> Thus, P received the security in a tax-free exchange. The Example further states that if the security is redeemed for \$100, the \$50 gain is deferred and not taken into account until P ceases to be a member of the group or the stock of S is treated as disposed of (as defined therein).

Because the security in the Example was redeemed, Treas. Reg. § 1.1502-14(d)(1) would not apply. Thus, under the taxpayer’s analysis, the gain would be recognized at the time of the redemption. Yet, the Example clearly provides that the gain is deferred under Treas. Reg. § 1.1502-14(d)(4)(i) until a restoration event specified in Treas. Reg. § 1.1502-14(d)(4)(ii) occurs. This result is only possible if Treas. Reg.

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<sup>1</sup> For transfers after October 2, 1989, I.R.C. § 351 was amended to provide that only stock (and no longer securities) could be received tax-free.

§ 1.1502-14(d)(4) is interpreted as applying even if Treas. Reg. § 1.1502-14(d)(1) does not.

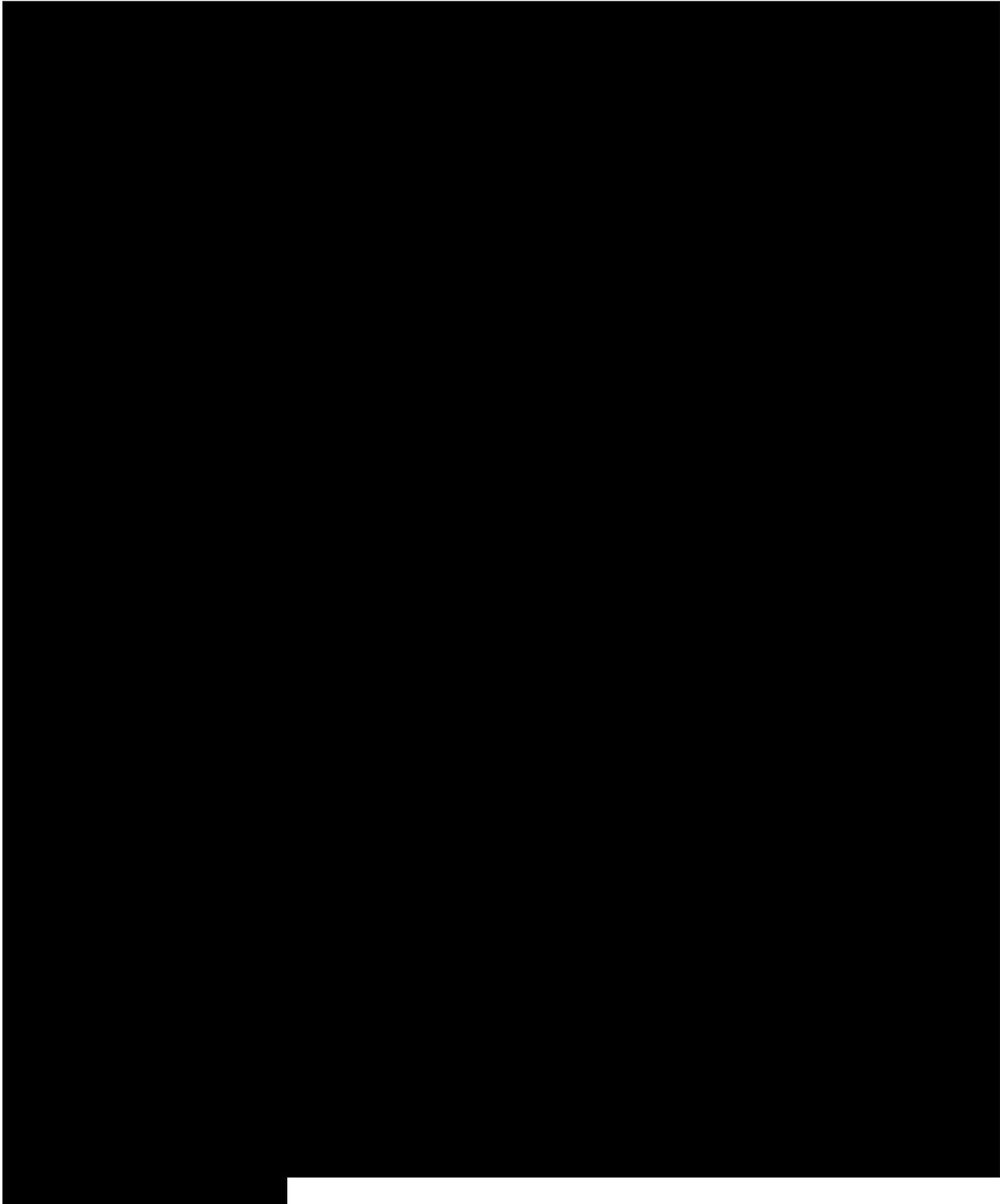
The taxpayer provided an example (“TP Example”) which it believes supports its position. However, if the TP Example is properly analyzed, it in fact supports the Service’s position. In the TP Example, P transfers property to S in exchange for S stock and a security in a transaction qualifying under I.R.C. § 351. The security has a basis different from its face amount. P then sells the security to another member (“X”). P’s gain/loss is deferred under Treas. Reg. § 1.1502-14(d)(1). X takes a basis in the security equal to its value. X then transfers the security to S in exchange for property (a redemption).

The taxpayer argues that, but for Treas. Reg. § 1.1502-14(d)(4), P’s deferred gain/loss would be restored under Treas. Reg. § 1.1502-14(d)(3)(iii). However, the taxpayer points to language in Treas. Reg. § 1.1502-14(d)(4)(i) which provides that, if the elements of that provision are met, any gain or loss on the cancellation/redemption of the obligation shall be deferred and Treas. Reg. § 1.1502-14(d)(3) shall not apply. The taxpayer argues that this language indicates that Treas. Reg. § 1.1502-14(d)(4) is an exception to the restoration rule of Treas. Reg. § 1.1502-14(d)(3). Thus, under the taxpayer’s interpretation of these provisions, P’s deferred gain/loss (in the TP Example) would not be restored under Treas. Reg. § 1.1502-14(d)(3)(iii) because Treas. Reg. § 1.1502-14(d)(4)(i) would override that restoration provision.

However, we take the position that, under the facts of the TP Example, Treas. Reg. § 1.1502-14(d)(4)(i) would not apply since X had no gain/loss on the redemption. Further, P’s gain/loss that was deferred under Treas. Reg. § 1.1502-14(d)(1) would be restored under Treas. Reg. § 1.1502-14(d)(3)(iii). Treas. Reg. § 1.1502-14(d)(4) would not override that gain/loss (because it was not attributable to the redemption). Thus, the result of the Example (gain recognized to P upon the redemption of the security held by P) and of TP Example (gain/loss recognized to P upon the redemption of the security now held by X) is the same.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED]



Please call if you have any further questions.

By: \_\_\_\_\_  
ARTURO ESTRADA  
Acting Branch Chief  
Corporate Branch

cc: