

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Revenue Agent  
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from:  
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subject: Application of SRLY provisions after a reattribution election under section 1.1502-36(d)(6)

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

#### LEGEND

Company A =

Company B =

Company E =

Date 1 =

Date 2 =

Date 3 =

\$X =

\$Y =

\$Z =

#### ISSUES

1. Where liabilities of disregarded entities are nonrecourse to the owner of the disregarded entities, whether the discharge of those liabilities in bankruptcy should be treated as a taxable exchange.
2. Whether the taxpayer's basis in the stock of the subsidiary is reduced as a result of an election under section 1.1502-36(d)(6) to reattribute the subsidiary's net operating losses.

3. Whether the insolvency limitation under section 1.1502-36(d)(6)(iv)(B) limits the amount of losses that may be reattributed.
4. Whether Company B is a “successor” under section 1.1502-21(f)(1).
5. Whether the tax attributes of Company A are property of the Company E bankruptcy estate and, therefore, Company B is prevented by the automatic stay from making this election.

## CONCLUSIONS

1. Where the liabilities are nonrecourse to the owner, upon discharge of those liabilities in bankruptcy, the owner is treated as selling assets of the disregarded entities in exchange for release of the liabilities of the disregarded entities.
2. Pursuant to sections 1.1502-36(d)(6)(iv)(A) and 1.1502-32(b)(2)(iii), the taxpayer’s basis in the stock of the subsidiary is reduced as a result of an election under section 1.1502-36(d)(6) to reattribute the subsidiary’s net operating losses because such reattribution is a noncapital, nondeductible expense.
3. While the entities that owned Company A were insolvent, the insolvency exception under section 1.1502-36(d)(6)(iv)(B) does not apply because these entities were disregarded entities and not “subsidiaries.”
4. Company B is a “successor” because Company B is treated as receiving the NOLs in a section 381 transaction. See Treas. Reg. §§ 1.1502-21(f)(1), 1.1502-1(f)(4), 1.1502-36(d)(6)(iv)(A). This treatment is in accordance with the “as the context may require” provision of section 1.1502-21(f)(1) since the treatment is consistent with the purpose of section 1.1502-36(d)(6), provided that Company B includes only its post-separation taxable income in the SRLY register.
5. Since Company A is not in bankruptcy, its tax attributes are not property of the bankruptcy estate and the automatic stay does not prevent Company B from making an election under section 1.1502-36(d)(6).

## FACTS

## LAW AND ANALYSIS

### Issue 1

Treas. Reg. § 301.7701-2(b)(1) provides that a single member limited liability company (“LLC”) that does not elect otherwise is disregarded as an entity separate from its owner. A disregarded LLC’s “activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.” Treas. Reg. § 301.7701-2(a). Therefore, the assets and liabilities of a disregarded entity are treated as the assets and liabilities of its owner. Where the disregarded entity is personally liable on the debt, but its sole member is not (i.e., the creditor may proceed only against the assets of the disregarded entity), the debt is treated as nonrecourse with respect to the sole member. Cf. Treas. Reg. § 1.465-27(b)(6), Ex. 6.

I.R.C. § 61(a) provides that “gross income means all income from whatever source derived, including ... (3) [g]ains derived from dealings in property ... [and] (12) [i]ncome from discharge of indebtedness” (“CODI”). The distinction between these two categories is important as section 108(a)(1) provides an exception to the inclusion of CODI in income where “(A) the discharge occurs in a title 11 case, [or] (B) the discharge occurs when the taxpayer is insolvent.”<sup>1</sup> This income exclusion does not apply to gains determined under sections 1001 and 61(a)(3). See Gehl v. Commissioner, 102 T.C. 784, 785-86 (1994).

Where the discharge of indebtedness occurs as a result of property being transferred to the creditor, the character of the income depends upon whether the debt is recourse or nonrecourse. See Frazier v. Commissioner, 111 T.C. 243, 245 (1998). In the case of recourse debt, the amount of the discharge is bifurcated into gain or loss treatment under sections 1001 and 61(a)(3) and CODI treatment under section 61(a)(12). The

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<sup>1</sup> Consistent with the principle that the assets and liabilities of a disregarded entity are treated as belonging to its sole member, Prop. Treas. Reg. § 1.108-9(a) provides that for purposes of applying section 108(a)(1)(A) and (B) to discharge of indebtedness income of a disregarded entity, the disregarded entity shall not be considered to be the “taxpayer.” Instead, the owner of the disregarded entity is the taxpayer. Thus, if the disregarded entity is discharged in a Title 11 case, section 108(a)(1)(A) will apply only to an owner of the disregarded entity that is under the jurisdiction of the court in a Title 11 case. 76 Fed. Reg. 20593-01 (Apr. 13, 2011).

gain or loss component is measured by the difference between the asset's fair market value and basis and the CODI component is measured by the difference between the asset's value and the debt's unpaid balance. See Treas. Reg. § 1.1001-2(a)(2), (c) Ex. 8; Frazier, 111 T.C. at 245; Gehl, 102 T.C. at 786-88. In the case of nonrecourse debt, the entire gain or loss component is measured by the difference between the debt's unpaid balance and the asset's basis. See Treas. Reg. § 1.1001-2(a)(1), (b), (c) Exs. 2, 7; Frazier, 111 T.C. at 245. Thus, the full amount of the discharge is characterized as gain or loss under sections 1001 and 61(a)(3) if the debt is nonrecourse.

Because Company E is disregarded for federal income tax purposes, the assets and liabilities of Company E are treated as the assets and liabilities of Company B. The liabilities are nonrecourse to Company B since the creditors have recourse only to the assets of Company E. Therefore, upon discharge of the liabilities in bankruptcy, Company B is treated as selling the Company E assets in exchange for discharge of the liabilities. Included in the Company E assets were the shares of Company A. Thus, Company B is treated as if it sold the Company A shares in exchange for \$Z (the amount of debt relief calculated by Company B to be attributable to the Company A shares).

Therefore, Company B must treat the discharge of the liabilities as sales proceeds under section 1001 and 61(a)(3) as opposed to CODI under section 61(a)(12).

## Issue 2

Treas. Reg. § 1.1502-36 “provides rules for adjusting members’ bases in stock of a subsidiary (S) and for reducing S’s attributes when a member (M) transfers a loss share of S stock.” The purpose of this section is, first, “to prevent the consolidated return provisions from reducing a group’s consolidated taxable income through the creation and recognition of noneconomic loss on S stock,” and, second, “to prevent members (including former members) of the group from collectively obtaining more than one tax benefit from a single economic loss.” Treas. Reg. § 1.1502-36(a)(2). “The rules of this section must be interpreted and applied in a manner that is consistent with and reasonably carries out the purposes of this section.” Id.

Paragraph (b) of section 1.1502-36 applies first. Then, if the transferred share is still a loss share, section (c) applies. Then, if the transferred share is still a loss share, section (d) applies. Treas. Reg. § 1.1502-36(a)(3)(i).

Paragraph (d) reduces S’s attributes by S’s attribute reduction amount immediately before the transfer. Treas. Reg. § 1.1502-36(d)(2)(i). S’s attribute reduction amount is the lesser of the net stock loss and S’s aggregate inside loss. Treas. Reg. § 1.1502-36(d)(3)(i). The net stock loss is the excess, if any, of the aggregate basis of all shares of S stock transferred by members in the transaction over the aggregate value of those shares. Treas. Reg. § 1.1502-36(d)(3)(ii). The aggregate inside loss is the excess, if any, of S’s net inside attribute amount over the value of all outstanding shares of S

stock. Treas. Reg. § 1.1502-36(d)(3)(iii)(A). S’s attributes available for reduction are (A) Category A. Capital loss carryovers; (B) Category B. Net operating loss carryovers; (C) Category C. Deferred deductions; and (D) Category D. Basis of assets other than assets identified as Class I assets in section 1.338-6(b)(1). Treas. Reg. § 1.1502-36(d)(4)(i).

“S’s attribute reduction amount is first allocated and applied to reduce the attributes in Category A, Category B, and Category C.” Treas. Reg. § 1.1502-36(d)(4)(ii)(A). “If S’s attribute reduction amount is less than S’s total attributes in Category A, Category B, and Category C, all of S’s attribute reduction amount will be applied to reduce such attributes.” Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(i). However, P may elect to specify the allocation of S’s attribute reduction amount among such attributes. To the extent that P does not specify an allocation of S’s attribute reduction amount, Category A attributes not reduced as a result of a specific allocation are reduced first, from oldest to newest, until eliminated. Then Category B attributes not reduced as a result of a specific allocation are reduced, from oldest to newest, until eliminated. Any remaining attribute reduction amount will be applied to reduce any Category C attributes not reduced as a result of a specific allocation, proportionally. Id.

However, “[n]otwithstanding the general operation of this paragraph (d), P may elect to reduce the potential for loss duplication, and thereby reduce or avoid attribute reduction.” Treas. Reg. § 1.1502-36(d)(6)(i). Thus, to the extent of S’s attribute reduction amount,

P may elect –

- (A) To reduce all or any portion (including any portion in excess of a specified amount) of members’ bases in transferred loss shares of S stock;
- (B) To reattribute all or any portion (including any portion in excess of a specified amount) of S’s Category A, Category B, and Category C attributes (including the attributes of lower-tier subsidiaries ), to the extent they would otherwise be subject to reduction under this paragraph (d); or
- (C) Any combination thereof.

Id.

Section 1.1502-36(d)(6)(iv) provides special rules for reattribution elections. In general:

Because the reattribution election is intended to provide the group a means to retain certain S attributes and not to change the location of attributes where S continues to be a member of the same group as P, the election to reattribute attributes may only be made if S becomes a nonmember (within the meaning of section 1.1502-19(c)(2)) as a result of

the transaction and S does not become a member of any group that includes P. The election to reattribute S's attributes can only be made for attributes in Category A, Category B, and Category C. The attributes that would otherwise be reduced under paragraph (d)(4) of this section may be reattributed to P. Accordingly, P may specify the attributes in Category A, Category B, and Category C to be reattributed. Such an election is made in the manner provided in paragraph (e)(5) of this section. To the extent that P elects to reattribute attributes but does not specify the attributes to be reattributed, any attributes not specifically reattributed will be reattributed in the default amount, order, and category described in paragraph (d)(4)(ii)(A)(1) of this section. P succeeds to reattributed attributes as if such attributes were succeeded to in a transaction to which section 381(a) applies. Any owner shift of the subsidiary (including any deemed owner shift resulting from section 382(g)(4)(D) or section 382(l)(3)) in connection with the transaction is not taken into account under section 382 with respect to the reattributed attributes. (See section 1.1502-96(d) for rules relating to section 382 and the reattribution of losses under this paragraph (d)(6).) The reattribution of S's attributes is a noncapital, nondeductible expense described in section 1.1502-32(b)(2)(iii).<sup>[2]</sup> See section 1.1502-32(c)(1)(ii)(A) regarding special allocations applicable to such noncapital, nondeductible expense. If P elects to reattribute S attributes (including attributes of a lower-tier subsidiary) and reduce S stock basis, the reattribution is given effect before the stock basis reduction.

Treas. Reg. § 1.1502-36(d)(6)(iv)(A).

An election under paragraph (d)(6) is irrevocable. Treas. Reg. § 1.1502-36(d)(6)(ii).

Section 1.1502-36(g)(1) contains an anti-abuse rule and provides that, “[i]f a taxpayer acts with a view to avoid the purposes of this section or to apply the rules of this section to avoid the purposes of any other rule of law, appropriate adjustments will be made to carry out the purposes of this section or such other rule of law.”

Section 1.1502-36(d)(6)(i) allows the parent to elect to reattribute all or any portion of a subsidiary's net operating losses to the extent of the subsidiary's attribute reduction amount. Therefore, Company B may elect to reattribute Company A's net operating losses up to Company A's attribute reduction amount. Any such reattribution is a noncapital, nondeductible expense and Company B's basis in Company A's stock will be decreased by this amount. See Treas. Reg. §§ 1.1502-32(b)(2)(iii), 1.1502-36(d)(6)(iv)(A).

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<sup>2</sup> Section 1.1502-32(b)(2)(iii) provides that M's basis in S's stock is decreased by noncapital, nondeductible expenses.

Issue 3

“If S, or any higher-tier subsidiary is insolvent within the meaning of section 108(d)(3) at the time of the transfer, S’s losses may be reattributed only to the extent they exceed the sum of the separate insolvencies of any subsidiaries (taking into account only S and its higher-tier subsidiaries) that are insolvent.” Treas. Reg. § 1.1502-36(d)(6)(iv)(B).

I.R.C. § 108(d)(3) defines “insolvent” as “the excess of liabilities over the fair market value of assets,” which is determined immediately before any discharge.

Treas. Reg. § 1.1502-1(c) defines “subsidiary” as “a corporation other than the common parent which is a member of such group.”

The entities that owned Company A were insolvent. See I.R.C. § 108(d)(3). However, they are not “subsidiaries” because they are disregarded entities and not corporations. See 1.1502-1(c). Therefore, the insolvency limitation in section 1.1502-36(d)(6)(iv)(B) does not apply.

Issue 4

If a parent makes a reattribution election, the parent “succeeds to reattributed attributes as if such attributes were succeeded to in a transaction to which section 381(a) applies.” Treas. Reg. § 1.1502-36(d)(6)(iv)(A).

The IRS and Treasury department intended elections under section 1.1502-36(d)(6) “to be as flexible as possible.” Unified Rule for Loss on Subsidiary Stock, 73 Fed. Reg. 53934-01, 2008-44 I.R.B. 1012 (Sep. 17, 2008).

I.R.C. § 381(a) applies to certain corporate acquisitions and allows the acquiring corporation to succeed to the tax attributes of the distributor or transferor corporation, including net operating loss carryovers.

Treas. Reg. § 1.1502-21(a) provides that “[t]he consolidated net operating loss deduction (or CNOL deduction) for any consolidated return year is the aggregate of the net operating loss carryovers and carrybacks to the year. The net operating loss carryovers and carrybacks consist of – (1) Any CNOLs . . . of the consolidated group; and (2) Any net operating losses of the members arising in separate return years.”

Section 1.1502-21(c) provides limitations on NOL carryovers and carrybacks from SRLYs. Section 1.1502-21(c)(1)(i) provides that

Except as provided in paragraph (g) of this section (relating to an overlap

with section 382<sup>3</sup>), the aggregate of the NOL carryovers and carrybacks of a member arising (or treated as arising) in SRLYs that are included in the CNOL deductions for all consolidated return years of the group under paragraph (a) of this section may not exceed the aggregate consolidated taxable income for all consolidated return years of the group determined by reference to only the member's items of income, gain, deduction, and loss.

Section 1.1502-21(f)(1) provides that “[f]or purposes of this section, any reference to a corporation, member, common parent, or subsidiary, includes, as the context may require, a reference to a successor or predecessor, as defined in section 1.1502-1(f)(4).”

Section 1.1502-1(f)(4) defines predecessor and successor as follows: “The term predecessor means a transferor or distributor of assets to a member (the successor) in a transaction – (i) to which section 381 applies; or (ii) That occurs on or after January 1, 1997, in which the successor's basis for the assets is determined, directly or indirectly, in whole or in part, by reference to the basis of the assets of the transferor or distributor.”

IRS CCA 200924042<sup>4</sup> stated that “the well-established purpose of the SRLY rules is to prevent the offsetting of separate return year attributes of one member against income of different members.” IRS CCA 200924042 held that, where a subsidiary with SRLY losses liquidated into the parent, the parent was a successor and only the post-liquidation income of the parent could be included in the SRLY register pursuant to the “as the context may require” provision of section 1.1502-21(f)(1).

If Company B makes a reattribution election under section 1.1502-36(d)(6), Company B will succeed to the reattributed NOLs as if the NOLs were succeeded to in a transaction to which section 381(a) applies. See Treas. Reg. § 1.1502-36(d)(6)(iv)(A). Because Company B is treated as receiving the NOLs in a section 381 transaction, Company B is a successor to Company A. See Treas. Reg. §§ 1.1502-21(f)(1), 1.1502-1(f)(4).

This treatment is in accordance with the “as the context may require” provision of section 1.1502-21(f)(1). This treatment is consistent with the purpose of section 1.1502-36(d)(6). First, elections under section 1.1502-36(d)(6) are intended to be as flexible as possible. See Unified Rule for Loss on Subsidiary Stock, 73 Fed. Reg. 53934-01, 2008-

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<sup>3</sup> If an ownership change occurs with respect to a loss corporation, section 382(a) limits the amount of the loss corporation's taxable income for a post-change year which may be offset by pre-change losses to an amount referred to as the section 382 limitation. Thus, section 382 and the SRLY rules both limit net operating loss carryforwards in certain circumstances and, as recognized by the regulation, may overlap. Section 1.1502-96 provides rules relating to the interaction of section 1.1502-36(d) and section 382.

<sup>4</sup> While CCA 200924042 is not precedential the detailed analysis of the SRLY rules, as set forth in the CCA, equally applies in this case.



44 I.R.B. 1012 (Sep. 17, 2008). Second, section 1.1502-36(d)(6)(iv)(A) clearly intends Company B to be treated like any other successor in a section 381 transaction. Finally, section 1.1502-36 includes specific limitations related to insolvent subsidiaries, which indicates that restrictions beyond these limitations should not be imposed. See Treas. Reg. § 1.1502-36(d)(6)(iv)(B). Therefore, the context requires Company B to be treated as a successor provided that Company B includes only its post-separation taxable income in the SRLY register. See IRS CCA 200924042.

### Issue 5

A debtor's tax attributes are property of the bankruptcy estate. See Segal v. Rochelle, 382 U.S. 375 (1966); In re Feiler, 218 F.3d 948 (9<sup>th</sup> Cir. 2000); Barowsky v. Serelson (In re Barowsky), 946 F.2d 1516, 1518-19 (10<sup>th</sup> Cir. 1991). In In re Prudential Lines Inc., 028 F.2d 565 (2d Cir. 1991), the Court of Appeals for the Second Circuit held that the debtor's NOL carryforward was property of the bankruptcy estate and that the parent corporation's claiming of a worthless stock deduction with respect to that debtor subsidiary, which would effectively eliminate the value of the debtor's NOL carryforward, would be an act to exercise control over estate property in violation of the automatic stay.

In Kreisler v. Goldberg, 478 F.3d 209 (4<sup>th</sup> Cir. 2007), the court held that the automatic stay does not apply to actions against the debtor's non-bankruptcy subsidiary corporation; the debtor's interest in the subsidiary did not extend to the subsidiary's assets, including the subject property; and the fact the debtor's interest in subsidiary might lose value if ejectment action were successful did not render the automatic stay applicable to the ejectment action. See also In re Furlong, 660 F.3d 81, 89-90 (1<sup>st</sup> Cir. 2011) (agreeing "with the bankruptcy court that an automatic stay 'does not extend to the assets of a corporation in which the debtor has an interest, even if the interest is 100% of the corporate stock'"); Mar. Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1205-06 (3d Cir. 1991) ("[F]ormal distinctions between debtor-affiliated entities are maintained when applying the stay. A proceeding against a non-bankrupt corporation is not automatically stayed by the bankruptcy of its principal."); In re Winer, 158 B.R. 736, 743 (N.D. Ill. 1993) (doctrine that automatic stay "does not proscribe actions brought against nondebtor entities . . . applies with equal force even where the nondebtor is a corporation wholly owned by the debtor); Pers. Designs, Inc. v. Guymar, Inc., 80 B.R. 29, 30 (E.D. Pa. 1987) (automatic stay does not bar proceeding against a non-bankrupt corporate co-defendant even if the bankrupt defendant owns 100% of the stock of such co-defendant).

The court in Kreisler stated that "[t]he fact that a parent corporation has an ownership interest in a subsidiary, however, does not give the parent any direct interests in the assets of the subsidiary." 478 F.3d at 214. The assets of a subsidiary belong to the subsidiary and do not form part of the owner's bankruptcy estate; therefore, an action to obtain possession or exercise control over such assets is not an action to obtain possession or exercise control over property of the owner's bankruptcy estate. Id. The

court noted that the automatic stay does not prevent a non-debtor company from taking an action that might affect the value of a debtor’s stock where the debtor’s interests in the stock remain unchanged. Id.

Since Company A is not in bankruptcy, its tax attributes are not property of the bankruptcy estate and the automatic stay does not prevent Company B from making an election under section 1.1502-36(d)(6). See, e.g., Kreisler, 478 F.3d 209. The fact the election may lessen the value of Company A does not change this conclusion as Company E’s interest in the shares remains unchanged. Id.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call \_\_\_\_\_ if you have any further questions.

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