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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: Separate Return Limitation Years

This Field Service Advice responds to your memorandum dated October 18, 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

$B =

$C =

$D =

$E =

$F =

$G =

$H =

$J =

$K =

$M =

YearB	=
YearC	=
YearD	=
%B	=
%C	=
DateB	=
DateC	=
DateD	=
DateE	=
DateF	=
DateG	=
DateH	=
DateJ	=
DateK	=
Foreign ParentB	=
PurchasingCorp	=
Domestic SubB	=
Target	=
TargetCorp	=
Domestic SubD	=
SubF	=
NewSubF	
DivisionE	=
Product AreaB	=
Product AreaC	=

Product AreaD	=
LineE	=
OperationB	=
OperationC	=
OperationD	=
OperationE	=
OperationF	=
OperationG	=
OperationH	=
ProductO	=
ProductP	=
ProductQ	=
ProductR	=
ProductU	=
AgreementB	=
AgreementC	=
Amended AgreementB	=
AgreementD	=
StateB	=

CityC	=	
CountryX	=	
PeriodB	=	

ISSUES

1. Whether an allocation of income under I.R.C. section 482 is appropriate between PurchasingCorp, the parent corporation of the PurchasingCorp consolidated group, and TargetCorp, a member of the PurchasingCorp consolidated group?

2. Whether TargetCorp's use of NOL carryovers are limited by the separate return limitation year (SRLY) rules.

CONCLUSIONS

1. It is appropriate under I.R.C. section 482 for the Secretary to allocate income to PurchasingCorp, the parent corporation of the PurchasingCorp consolidated group, and TargetCorp, a member of the PurchasingCorp consolidated group, where PurchasingCorp has treated its current income as the current income of TargetCorp in order to avoid or evade income tax.

2. TargetCorp's net operating loss (NOL) carryovers are limited by the SRLY rules under I.R.C. section 1502 and the regulations promulgated thereunder.

FACTS

PurchasingCorp is a StateB corporation, with its principal business offices located in CityC. At relevant times, PurchasingCorp was a publicly held corporation. PurchasingCorp maintained its books and filed consolidated federal income tax returns on the accrual method of accounting, using a PeriodB year end.

At relevant times, PurchasingCorp manufactured and sold products in three broad product areas: Product AreaB; Product AreaC; and Product AreaD. The Product AreaB line included OperationB. The Product AreaC line included OperationC. The Product AreaD line included OperationD.

PurchasingCorp's Product AreaD Group was responsible for the DivisionE Division(s). These groups/divisions were responsible for the OperationE, including, among other things, ProductO.

On DateB, PurchasingCorp entered into a formal contractual arrangement (AgreementB), wherein the parties agreed to jointly OperationH of ProductO. The agreement involved PurchasingCorp, Domestic SubB, a StateB corporation, and a "OperationG" corporation, (Target). AgreementB contemplated that Target would be owned %B by PurchasingCorp and %C by Domestic SubB. Domestic SubB is a wholly owned subsidiary of a CountryX entity, identified as Foreign ParentB. At a time not certain or established in the current record, Domestic SubB transferred and assigned its interest in AgreementB and Target to its wholly owned StateB subsidiary, identified as Domestic SubD.

Since PurchasingCorp and Domestic SubB each owned less than 80% of Target, neither included the annual results in their respective consolidated returns. We understand that Target filed its own corporate income tax returns, Forms 1120. Through the tax year ending in YearD, Target had in excess of $B in unused net operating losses available for carry over to subsequent years.

On DateC, Domestic SubD, PurchasingCorp and Target executed an AgreementC. This agreement acknowledged that market conditions were such that it was no longer economically viable to maintain the original AgreementB. AgreementC also provided a blueprint of the sequential steps contemplated in a corporate restructuring of the original relationship created by AgreementB. Accordingly, Domestic SubB, Domestic SubD and PurchasingCorp agreed to modify AgreementB and executed the Amended AgreementB. On or about DateC, the parties entered into this new agreement, which resulted in the original business activities of Target being divided among and between the parties. The initial step required Target to incorporate a new OperationG corporation as a wholly owned subsidiary, under the name SubF.

Target subsequently transferred to SubF specific business assets and rights that related to the ProductP and ProductQ-ProductO programs, previously conducted by Target, in exchange for all of the outstanding shares of SubF. This transfer would enable SubF to exclusively carry-out all OperationF functions for the ProductP and ProductQ-ProductO programs. In this regard, Target transferred net (book value) assets of $C and liabilities of $D to SubF. Target retained Accounts Receivable of $F and net Fixed Assets of $M, generally relating to the ProductR and ProductU-ProductO Programs. Thereafter, pursuant to AgreementC, Target declared a dividend of SubF stock, which served to transfer full ownership of SubF to PurchasingCorp and Domestic SubD as of DateC. Subsequently, this new OperationG corporation (SubF),[1] then jointly owned by Domestic SubD and PurchasingCorp, was renamed NewSubF.

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[1]Since its inception, Target has solely engaged in OperationG related activities.

Another simultaneous step required under AgreementC and the restructuring process called for Domestic SubD and PurchasingCorp to execute an AgreementD, wherein Domestic SubD agreed to sell its %C interest in Target to PurchasingCorp for $E. This stock sale was consummated with PurchasingCorp's transfer of a promissory note made payable to Domestic SubD, with the following payment schedule:

DateE	$H
DateG	$K
DateH	$K
DateJ	$K
DateK	$K

Thereafter, following the Target stock sale to PurchasingCorp, the original Target changed its name to TargetCorp and became a wholly owned subsidiary of PurchasingCorp.

TargetCorp distributed all of its assets, except for accounts receivables, on or about DateC, to PurchasingCorp. After DateC, TargetCorp had no employees nor income. All income generated with respect to the ProductR and ProductU ProductO Programs after this date was generated by PurchasingCorp.

In all subsequent tax periods, PurchasingCorp included the reported results of TargetCorp business activities in its consolidated return (Form 1120). PurchasingCorp allocated income generated by current OperationG against the NOL's previously generated by TargetCorp in SRLYs.[2]

LAW AND ANALYSIS

I. I.R.C. section 482

I.R.C. section 482 May Apply to Avoid a Misallocation of Separate Taxable Income in Order to Use Up SRLY/NOLs

This case involves whether the PurchasingCorp consolidated group can utilize $B worth of NOL's generated by TargetCorp in its SRLY years prior to its acquisition by

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[2]PurchasingCorp also allocated LineE OperationG income to TargetCorp for which TargetCorp never previously engaged in such line of business.

PurchasingCorp or whether the PurchasingCorp consolidated group is limited to using the TargetCorp SRLY NOL's up to TargetCorp's current income. If TargetCorp did not generate current income after it was acquired by the PurchasingCorp consolidated group, the NOL's generated by TargetCorp in SRLYs cannot be used by the PurchasingCorp consolidated group.

PurchasingCorp has attempted to allocate its current income to TargetCorp to offset TargetCorp's NOLs from TargetCorp's separate return years. PurchasingCorp has not provided an explanation as to why the current income earned by PurchasingCorp should be treated as if earned by TargetCorp.

To the extent PurchasingCorp is attempting to assign income to TargetCorp, which clearly has no current income for years after it joined the PurchasingCorp consolidated group, the issue arises as to whether the Service can utilize IRC section 482 to reallocate income back to PurchasingCorp (or, in the alternative, prevent PurchasingCorp from allocating its current income to TargetCorp) in order to prevent PurchasingCorp and TargetCorp from avoiding taxes.

It is the Service's position that it is proper under the circumstances to use IRC section 482 to either reallocate the current income back to PurchasingCorp or prevent PurchasingCorp from allocating its current income to TargetCorp.

Law

The regulations under I.R.C. section 482 have long included the following provision:

> I.R.C. section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the consolidated taxpayer must be determined consistently with the principles of a consolidated return.[3]

This provision was construed in Likins-Foster Honolulu Corp. v. Commissioner, 417 F.2d 285 (10th Cir. 1969), cert. denied, 397 U.S. 987 (1970). In that case, Likins-Foster Topeka Corporation (LFTC) conveyed in excess of 400 real estate parcels to four of its subsidiary corporations on July 1, 1956, which then resold the parcels prior to the end of fiscal 1957. These subsidiaries had substantial NOL carryovers

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[3] Treas. Reg. § 1.482-1(f)(1)(iv); Treas. Reg. § 1.482-1T(d)(1)(iv). See Likins-Foster Honolulu Corp., supra, for predecessor provisions.

from years in which each had filed separate returns. These NOLs were due to expire in the 1957 fiscal year. After the parcel sales, and the receipt of down payments and additional payments, the subsidiaries realized a gain and thus had income for fiscal 1957 with which to offset their NOL carryovers. The subsidiaries then distributed the purchasers' installment contracts to LFTC as dividends. The Tax Court found that the Commissioner had the power under I.R.C. section 482 to reallocate the subsidiaries' gain on the parcel sales back to LFTC. The Tenth Circuit upheld the Commissioner's reallocation, noting that the same result was also necessarily required by implication under the predecessor SRLY/NOL provisions.[4]

The facts in this case indicate that an allocation under IRC section 482 is warranted. That is, the income allocated by PurchasingCorp to TargetCorp can be reallocated back to PurchasingCorp under the authority of IRC section 482.

II. Separate Return Limitation Years-

As previously discussed, this case involves whether the PurchasingCorp consolidated group can utilize $B worth of NOL's generated by TargetCorp in its SRLY years prior to its acquisition by PurchasingCorp or whether the PurchasingCorp consolidated group is limited to using the TargetCorp SRLY NOL's up to TargetCorp's current income.

Because the TargetCorp did not generate current income after it was acquired by the PurchasingCorp consolidated group, the NOL's generated by TargetCorp in SRLYs cannot be used by the PurchasingCorp consolidated group.

<u>Law</u>

A "Separate return year" is defined in Treas. Reg. section 1.1502-1(e). The term separate return year means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

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[4] The court stated: "Whether this is accomplished by a direct transfer of loss carry-overs from the loss corporation to the consolidation to offset the group's income (specifically prohibited and recognized as prohibited by the taxpayers) or whether this is accomplished by transferring group income to the loss corporation (the method employed here) should make little difference. In either case, the result works the same tax distortion and cannot be sustained." 417 F.2d at 293.

A “Separate return limitation year” is defined in Treas. Reg. section 1.1502-1(f). The term separate return limitation year (SRLY) means any separate return year of a member or of a predecessor of such member.

Treas. Reg. § 1.1502-21A(b)(1) permits a consolidated group to use net operating losses sustained by any members of the group in "separate return years" if the losses could be carried over pursuant to I.R.C. section 172. As a general rule, net operating losses reported on a separate return can be carried over and used on a consolidated return. An exception to this rule is found in Treas. Reg. § 1.1502-21A(c). This section provides that the NOL of a member of an affiliated group arising in a SRLY may be included in the consolidated NOL deduction of the group provided that such loss does not exceed the amount of the consolidated taxable income contributed by the loss sustaining member for the taxable year at issue.

Losses incurred by a corporation before it becomes a member of an affiliated group filing a consolidated return can only be carried forward and used on the consolidated return to the extent that the corporation that incurred the losses has current income reflected on the consolidated return. See Wolter Construction v. Commissioner, 634 F.2d 1029 (6th Cir. 1980).

Analysis

The SRLY limitations are designed to discourage an affiliated group of corporations from acquiring a loss corporation merely to use the NOL carryover. TargetCorp had $B worth of unused NOL’s prior to its acquisition by PurchasingCorp. TargetCorp’s $B NOL is subject to the SRLY rules.

After PurchasingCorp’s acquisition of TargetCorp and TargetCorp’s distribution of all of its operating assets to PurchasingCorp, TargetCorp had no income producing assets nor employees. All current income generated to offset the TargetCorp’s SRLY NOL’s was from PurchasingCorp. NOL’s incurred by TargetCorp before it became a member of the PurchasingCorp consolidated return can be carried forward and used on the PurchasingCorp consolidated return only to the extent TargetCorp has current income in the years it is a member of PurchasingCorp’s consolidated group. See Treas. Reg. section 1.1502-21A(c) and Wolter Construction v. Commissioner, 634 F.2d 1029 (6th Cir. 1980). After TargetCorp became a member of PurchasingCorp’s consolidated group, TargetCorp did not have any current income and therefore cannot utilize the NOL’s generated from its SRLYs.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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[redacted][5]

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5 [redacted]

[redacted][6]

[redacted]

[redacted]

[redacted][7] [redacted][8] [redacted][9] [redacted]

[redacted]

[6] [redacted]

[7] [redacted]

[8] [redacted]

[9] [redacted]

[redacted][10] [redacted]

[redacted]

[redacted]

Please call us at (202) 622-7930 if you have any further questions.

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By: ______________________________
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[10] [redacted]