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

OFFICE OF
CHIEF COUNSEL

February 12, 2001

Number: **200121013**
Release Date: 5/25/2001
CC:CORP:BR6
TL-N-5928-99
UILC: 351.00-00
357.00-00
358.03-00
1502.13-02
1502.20-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Senior Attorney

FROM: Jasper L. Cummings, Jr.
Associate Chief Counsel CC:CORP

SUBJECT: Guidance For Case Development

This Field Service Advice responds to your memorandum dated August 24, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Pcorp =

SubCorp1 =

SubCorp2 =

SubCorp3 =

UCompany =

XCompany =

StateA =

Year1 =

Year2 =

Year3 =

MonthA, Year3 =

MonthB Year3 =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

#a =

#b	=
#c	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
$ttt	=

%a =

ISSUE

Whether the taxpayer, the common parent of a consolidated group, may deduct a loss purportedly realized on the sale of stock of one of its subsidiaries.

CONCLUSION

The taxpayer has incorrectly computed its basis and in fact has realized no loss. Further, even if the taxpayer's basis computation were correct, any loss realized is subject to section 1.1502-20 of the Income Tax Regulations and other disallowance provisions.

FACTS

Pcorp is a corporation organized under the laws of StateA and the common parent of a controlled group of corporations that filed a life, non-life consolidated income tax return (Form 1120L) for the years under examination, Year1 through Year3.

SubCorp1 is a first-tier, wholly owned non-life insurance company subsidiary of Pcorp. SubCorp2 is a second-tier non-life insurance company subsidiary of Pcorp that has one class of common stock outstanding, all of which is owned by SubCorp1.

Pcorp undertook the following steps in MonthB Year3. First, on Date1, Pcorp transferred $a cash to SubCorp1 in exchange for SubCorp1 common stock. SubCorp1, in turn, transferred $a cash to SubCorp2 in exchange for #b shares of SubCorp2 common stock on Date2.

Also on Date2, Pcorp transferred $b cash to SubCorp2 in return for #a shares of mandatorily redeemable SubCorp2 preferred stock and SubCorp2's agreement to assume certain nonqualified deferred compensation liabilities of Pcorp, to pay said liabilities as they became due, and to indemnify Pcorp and hold Pcorp harmless from those liabilities.[1] In addition, Pcorp entered into a support agreement with SubCorp2 on Date2.

The assumption agreement provided that Pcorp would transfer to SubCorp2 cash in an amount actuarially estimated to be sufficient to fund the deferred compensation liabilities as they became due, plus an amount equal to the estimated operating costs for administering the liabilities. The support agreement provided that in consideration for a fee of $l, Pcorp was obligated to make capital contributions to SubCorp2 sufficient to ensure that SubCorp2's net worth did not fall below $m. The support agreement recites that the SubCorp2 preferred stock is not an obligation of, or guaranteed by, Pcorp, and that the support agreement itself is not a guarantee of SubCorp2's obligations under the preferred stock. The support agreement also provides that it is enforceable only by SubCorp2.

The nonqualified deferred compensation liabilities were apparently estimated to be $c at the time of the transfer, but were valued in MonthA, Year3 at a lower figure (approximately $g) by an independent actuary. As a result, the amount of the cash payment to SubCorp2 was readjusted from the closing amount of $b to $d.

Of the proceeds received, SubCorp2 loaned $f to SubCorp3, a non-life insurance company subsidiary of Pcorp and a member of the consolidated group, in exchange for a non-amortizing #c-year note having a maturity date of Date3, and bearing interest at a rate of %a per annum payable annually. SubCorp2 invested approximately $e in various equity and/or growth funds and the remainder in other investments.

On Date4, Pcorp sold its #a shares of SubCorp2 preferred stock to an unrelated third party purchaser, UCompany, for approximately $a. Using $d as its basis in the preferred stock, Pcorp claimed a $p short term capital loss on the sale of the stock.

The SubCorp2 preferred stock has a par value of $h per share and a liquidation preference of $i per share (for a total of $a at #a shares), and bears dividends at the rate of $j per annum. It is required to be redeemed on Date5 (#c years from the

[1] A legal opinion obtained by Pcorp concluded that Pcorp and SubCorp2 could lawfully agree to have SubCorp2 assume and pay the liabilities, and that upon consummation of the foregoing exchange, SubCorp2 lawfully assumed and agreed to pay the liabilities. The opinion also concluded that SubCorp2 lawfully could indemnify Pcorp and hold Pcorp harmless from any failure by SubCorp2 to pay the liabilities, and that although Pcorp would remain liable to the participants in the nonqualified deferred compensation liabilities, any failure by SubCorp2 to pay the liabilities would constitute a breach under the assumption agreement entitling Pcorp to invoke its right to be indemnified and held harmless by SubCorp2.

date of purchase by UCompany). The preferred stock has voting rights only if accrued dividends are not paid or declared, or SubCorp2 fails to make the mandatory redemption.

The Examination Team believes that the nonqualified deferred compensation liabilities are recourse liabilities arising exclusively under the nonqualified deferred compensation plans of Pcorp, and not of other members of the Pcorp group.

The basic framework of the foregoing transactions was initially presented to the taxpayer as early as Year2 by a third party. As initially marketed to the taxpayer, the transaction was claimed to produce a duplicated loss that would not be subject to disallowance under the loss disallowance rules of § 1.1502-20. The taxpayer attached to its return for the Year3 taxable year the statement required by § 1.1502-20(c)(3) with respect to the loss claimed on the disposition of the preferred stock in SubCorp2. The statement reported a loss disallowed under § 1.1502-20(a)(1) of $0.00.

Pcorp claims that it entered into the exchange because of criticism by rating agencies of its high cost structure and low capital growth. Pcorp states that it aimed to reduce its operating expenses associated with nonqualified deferred compensation and minimize the unfavorable risk-based capital effect of the deferred compensation liabilities.[2] In addition, Pcorp explained that it expected the exchange to significantly increase its surplus for statutory accounting purposes. Pcorp also claims that the exchange provided the former pension plan administration department of Pcorp an opportunity to develop a market niche independent of Pcorp. Finally, Pcorp states that the exchange provided SubCorp3 with funds necessary to purchase a minority interest in XCompany.

LAW AND ANALYSIS

The instant transaction is the same as or substantially similar to those described in I.R.S. Notice 2001-17, 2001-09 I.R.B. 1. This memorandum addresses first the proper computation of Pcorp's basis in the stock of SubCorp2 and then the application of § 1.1502-20 and other provisions to any loss realized.

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[2] Pcorp claims that if it had invested in the assets needed to track the investment choices of the plan participants, that would have a negative impact on its risk-based capital ratio, a measure used by ratings services. The taxpayer has indicated that the risk-based capital ratio is not relevant for non-insurance subsidiaries.

I. Overview of Code Provisions

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and, immediately after the exchange, such person or persons are in control of the corporation. For purposes of section 351, control is defined as ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c).

The word “property” as used in section 351 includes money. See Rev. Rul. 69-357, 1969-1 C.B. 101. Cash has a basis equal to face value.

Section 351(b) provides that if section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under section 351(a), other property or money, then gain (if any) to such recipient shall be recognized, but not in excess of the amount of money received plus the fair market value of such other property received, and no loss to such recipient shall be recognized.

Section 357(a) provides in relevant part that except as provided in sections 357(b) and (c), if the taxpayer (i.e., the transferor) receives property that would be permitted to be received under section 351 without the recognition of gain if it were the sole consideration (i.e., the stock of the transferee corporation) and, as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption or acquisition shall not be treated as money or other property and shall not prevent the exchange from being within the provisions of section 351.

Section 357(b) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in section 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange. Section 357(b)(2) provides that the burden is on the taxpayer to prove by the clear preponderance of the evidence that such assumption is not to be treated as money received by the taxpayer.

Section 357(c)(1) provides in relevant part that, in the case of an exchange to which section 351 applies, if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Section 357(c)(2)(A) provides that section 357(c)(1) shall not apply to any exchange to which section 357(b)(1) applies.

Section 357(c)(3)(A) provides that if a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either would give rise to a deduction, or would be described in section 736(a), then, for purposes of section 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

Section 357(c)(3)(B) provides that section 357(c)(3)(A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or increase in, the basis of any property.

Section 358(a)(1) provides in relevant part that, in the case of an exchange to which section 351 applies, the basis of property permitted to be received under such section without the recognition of gain or loss (i.e., the stock of the transferee corporation) shall be the same as that of the property exchanged, decreased by the fair market value of any other property received by the taxpayer, the amount of money received by the taxpayer, and the amount of loss to the taxpayer that was recognized on the exchange, and increased by the amount that was treated as a dividend and the amount of gain to the taxpayer which was recognized on such exchange (other than the dividend amount).

Section 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of section 358, be treated as money received by the taxpayer on the exchange.

Section 358(d)(2) provides that section 358(d)(1) shall not apply to the amount of any liability excluded under section 357(c)(3).

Section 357(d)(1)(A) provides in general that for purposes of section 357, section 358(d), section 362(d), section 368(a)(1)(C), and section 368(a)(2)(B), except as provided in regulations, a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability. Section 357(d) applies to section 351 transfers after October 18, 1998.

II. Analysis.

As of the writing of this field service advice, the taxpayer has not articulated the grounds for how it arrived at the claimed loss in issue. Presumably the taxpayer is relying on sections 351, 357 and 358, as well as the inapplicability of § 1.1502-20, to arrive at the claimed loss.

The transaction is purported to qualify as an exchange under section 351, and the basis of the transferee stock received is purported to be equal to the basis of the transferred asset, unreduced by the liability assumed by the transferee corporation. See sections 358(d)(2), 357(c)(3). Although liabilities assumed by a transferee corporation in a section 351 exchange ordinarily are treated as money received by the transferor for purposes of section 358, and reduce basis in the transferee stock accordingly, presumably the taxpayer either is arguing that the deferred payment obligation is not a liability within the meaning of section 357 or is relying on section 357(c)(3)(A) and the exception under section 358(d)(2) as grounds for not reducing the basis of the stock received in the purported exchange.

A. Preliminary Points.

1. Liabilities for Purposes of Sections 357 and 358

As a threshold matter, the position of this office is that the nonqualified deferred compensation liabilities in this case are liabilities for purposes of sections 357 and 358.

Congress enacted section 357(c)(3) in response to several court cases that had developed different approaches to prevent the application of section 357(c)(1) to an assumption of a liability that had not produced a financial or tax benefit for the transferor. See Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976), rev'g in part and aff'g in part 61 T.C. 28 (1973); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), rev'g T.C. Memo. 1971-262 (reasoning that the term "liability" under section 357(c) was meant to be limited to what might be called "tax liabilities", i.e., liens in excess of tax costs); Focht v. Commissioner, 68 T.C. 223 (1977) (reasoning that the term "liability" under section 357 should be limited to those obligations which, if transferred, cause gain recognition under Crane v. Commissioner, 331 U.S. 1 (1947), and an obligation should not be treated as a liability to the extent that its payment would have been deductible if made by the transferor).

In contrast to the approaches developed by the courts, however, Congress did not define (or redefine) the term "liabilities" for purposes of section 357(c) or section 357 in general. Rather, under section 357(c)(3), Congress excluded certain "liabilities" from the section 357(c)(1) determination; specifically "liabilities" the payment of which would give rise to a deduction, unless the "liability" had generated, or would generate, a tax benefit for the transferor. Further, the Senate Finance Committee Report accompanying the Revenue Act of 1978, which enacted section 357(c)(3), states that the provision "is not intended to affect the definition of the term liabilities for any other provision of the Code, including sections 357(a) and 357(b)." S. Rep. No. 1263, 95th Cong., 2d Sess. 185 (1978), 1978-3, Vol 1 C.B. 481, 483.

Accordingly, an argument that the very liabilities described by section 357(c)(3)(A) are not "liabilities," or are not to be taken into account, for purposes of sections 357 and 358 is unpersuasive. Any other interpretation would render sections 357(c)(3) and 358(d)(2) superfluous.

2. Assumption for Purposes of Section 357

The information provided to us indicates that the nonqualified deferred compensation liabilities were "assumed" by SubCorp2. Under section 357(d)(1)(A), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability.[3]

The description of the assumption agreement in the materials provided to us reflects that SubCorp2 (i) agreed to assume and pay the nonqualified deferred compensation liabilities, (ii) would indemnify Pcorp and hold Pcorp harmless from any failure by SubCorp2 to pay the liabilities, and (iii) that although Pcorp would remain liable to the participants in the nonqualified deferred compensation liabilities, any failure by SubCorp2 to pay the liabilities would constitute a breach under the assumption agreement entitling Pcorp to invoke its right to be indemnified and held harmless by SubCorp2.[4]

Accordingly, because SubCorp2 has agreed to pay and satisfy the nonqualified deferred compensation liabilities, and indemnify and hold harmless Pcorp if it fails to do so, the nonqualified deferred compensation liabilities properly are treated as assumed by SubCorp2 for purposes of section 357. Section 357(d)(1).

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[3] As an example of an assumption under the standard of section 357(d)(1), the legislative history to the newly enacted section 358(h) states that if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of such an obligation, then the amount that is agreed to be indemnified is treated as assumed for purposes of the provision, whether or not the transferor has been relieved of such liability. H. Rept. No. 1033, 106th Cong., 2d Sess. (P.L. 106-554), 2000 TNT 251-14.

[4] We have not reviewed the assumption agreement itself, or any other documentation that may bear on that issue, however.

3. Section 358(h)

Finally, the newly enacted section 358(h) is effective for assumptions of liabilities on or after October 19, 1999, and therefore does not apply in the instant case.[5] See § 309 of the Community Renewal Tax Relief Act of 2000, P.L. 106-554.

B. Arguments.

Following is a discussion of potential arguments based upon the facts as currently developed. Further factual development may suggest additional arguments, including some arguments set forth in Notice 2001-17.

1. Section 357(b)(1)(B)

In the instant case, the nature of the liability and the circumstances under which the arrangement for the assumption was made strongly suggest that the principal purpose of the taxpayer with respect to the assumption was not a bona fide business purpose. Consequently, section 357(b)(1)(B) applies to treat the assumption as money received by the transferor on the exchange. Section 358(a)(1)(A)(ii) then applies to reduce the basis in the transferee stock by the amount of the deemed money received.

Section 357(b)(1)(B) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to an assumption described in section 357(a) was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange. Section 357(b)(2) provides that the burden is on the taxpayer to prove by the clear preponderance of the evidence that such assumption is not to be treated as money received by the taxpayer.

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[5] In general, under the newly enacted section 358(h), if the basis of stock (determined without regard to section 358(h)) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption. § 358(h)(1). However, except as provided by the Secretary of the Treasury, section 358(h)(1) does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets with which the liability is associated are transferred to the corporation as part of the exchange. § 358(h)(2).

Application of section 357(b)(1) supersedes application of both sections 357(a) and 357(c). Sections 357(a), 357(c)(2)(A). Section 357(a) provides for application of the general rule of section 357, "[e]xcept as provided in subsection (b) and (c)". Section 357(c)(2)(A) expressly provides that section 357(c)(1) shall not apply to any exchange to which section 357(b)(1) applies. This necessarily extends to section 357(c)(3), which simply excludes certain liabilities "for purposes of" applying section 357(c)(1). Thus, in an exchange to which section 357(b)(1) applies, section 357(c)(1) does not apply and therefore section 357(c)(3) is rendered moot. Accordingly, neither the general rule of section 357(a), nor section 357(c)(1) and (3), apply to an exchange to which section 357(b)(1) applies. Section 357(a), 357(c)(2)(A).

Turning to the instant case, no trade or business, or any assets to which the assumed liabilities related, were transferred. The only asset transferred was cash in an amount slightly in excess of the liabilities assumed. In return therefor, the transferee assumed said liabilities and issued preferred stock having a fair market value equal to the net amount of cash transferred (i.e., equal to the amount of cash transferred in excess of the liabilities assumed). The transferor then promptly sold the preferred stock for a huge loss.

The taxpayer has articulated several as of yet unsubstantiated business reasons for the exchange, the plausibility of which we do not speculate on here. In any event, while the transferor may have had some business benefit from the assumption (such as centralized administration of claims), the overall circumstances of the assumption strongly suggest that the principal purpose for it was not a bona fide business reason. Therefore, absent a clear preponderance of evidence establishing otherwise, application of section 357(b)(1) should be given strong consideration in this case.

The application of section 357(b)(1) will result in the assumption of the nonqualified deferred compensation liabilities being treated as the receipt of money by the transferor on the exchange, and its basis in the transferee preferred stock will be reduced to that extent under section 358(a)(1)(A)(ii).[6]

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[6] Even if an assumed liability otherwise would qualify as an excludible liability under section 357(c)(3), if section 357(b) applies to the exchange then section 358(d)(2) would not apply. Functionally, the provision currently set forth in section 358(d)(1) (formerly section 358(d) of the 1954 Code, which was formerly section 113(a)(6) of the 1939 Code) has never had application when the provision currently set forth in section 357(b) (formerly section 112(k) of the 1939 Code) applies. By its terms, assumed liabilities to which section 357(b) applies are considered as money received by the transferor. Thus, when section 357(b) applies to a section 351 exchange, section 358(a)(1)(A)(ii) applies without resort to section 358(d)(1) (in effect, section

2. Sections 357(c)(3), 358(d) and 358(a)(1)(A)(ii)

Even assuming section 357(b) does not apply, the taxpayer's reliance on the exception under section 358(d)(2) for not reducing the basis of the transferee preferred stock received in the exchange, based upon section 357(c)(3)(A), is misplaced.[7]

Specifically, section 357(c)(3)(A) does not apply to the nonqualified deferred compensation liabilities assumed in this case because we presume that the transferor remains entitled to take the deduction arising from payment of the liabilities subsequent to the exchange.[8] Therefore, section 358(d)(2) does not apply, and the transferor's basis in the transferee stock must be decreased by the amount of the liabilities assumed. Sections 358(d)(1) and 358(a)(1)(A)(ii).

Section 357(c)(3)(A) provides in relevant part that if a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which "would give rise to a deduction," then, for purposes of section 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed. Section 357(c)(3)(A)(i). Conversely, section 357(c)(3)(A) does not apply to exclude a liability to the extent the liability has already been deducted by the transferor.[9] Section 357(c)(3)(A)(i). Nor does section 357(c)(3)(A) apply to exclude any liability

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358(d)(1) is rendered moot). Stated otherwise, section 358(d)(1) only has application when section 357(b) does not apply to the exchange. As an exception to section 358(d)(1), therefore, section 358(d)(2) does not apply when section 357(b) applies to an exchange, because section 358(d)(1) has no application.

[7] Without the benefit of a statement of the taxpayer's position, we are assuming the taxpayer is interpreting § 1.1502-80(d) as excluding the application of section 357(c)(1), but not section 357(c)(3), to any transaction to which § 1.1502-13, 1.1502-13T, 1.1502-14, or 1.1502-14T applies. We do not address the correctness of this interpretation here.

[8] For purposes of this argument, we presume that the deduction for satisfaction of the nonqualified deferred compensation liabilities remains with the transferor rather than the transferee. Cf. Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), with Rev. Rul. 95-74, 1995-2 C.B. 36. However, this question requires further factual and legal development.

[9] This is implicit in section 357(c)(3)(A)(i), and is expressly stated in the Senate Finance Committee Report accompanying the Technical Corrections Act of 1979, which amended section 357(c)(3). See S. Rep. No. 96-498, 1980-1 C.B. 517, 546.

to the extent that the incurrence of the liability resulted in the creation of, or increase in, the basis of any property. Section 357(c)(3)(B).

By logical extension, section 357(c)(3)(A)(i) does not apply to exclude a liability to the extent the transferor remains entitled to claim the deduction subsequent to the exchange. This is consistent with the function of section 357(c)(3). Congress enacted section 357(c)(3) to prevent inappropriate gain recognition resulting from the application of section 357(c)(1) to certain liabilities. In general, the assumption of a deductible liability in a section 351 exchange should be a nonrealizable event, because it is improper to treat the assumed liability as income to the transferor when he is denied the tax benefit for its satisfaction. Focht v. Commissioner, 68 T.C. 223, 237 (1977). To prevent such inappropriate gain recognition under section 357(c)(1), Congress enacted section 357(c)(3). See section 103(a)(12) of the Technical Corrections Act of 1979 (P.L. 96-222, 1980-1 C.B. 499, 509); S. Rep. No. 96-498, 1980-1 C.B. 517, 546. Conversely, it follows that section 357(c)(3)(A)(i) does not apply to exclude a liability when the transferor remains entitled to claim the deduction for its payment subsequent to the exchange (i.e., the transferor is not denied the tax benefit for its satisfaction).

In the instant case, the taxpayer has indicated that the transferee will not claim any deduction that will arise from satisfaction of the nonqualified deferred compensation liabilities; presumably it will be claimed by the transferor. Under section 83(h), the service recipient is generally the entity that is entitled to a deduction. Similarly, under section 404(a)(5), the common law employer is the entity entitled to receive a deduction for deferred compensation payments. In both cases, if a successor entity is the successor employer (for example, the successor takes over both the assets and the employees that give rise to the deferred compensation deduction), then the successor entity may be entitled to the deduction. Here, however, the transferee did not acquire a trade or business, nor take over any assets or employees related to the nonqualified deferred compensation liabilities. Consequently, the transferee will not be entitled to a deduction upon satisfaction of the liabilities. See Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946);[10] Cf. Rev. Rul. 95-74,

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[10] The case of Holdcroft Transp. Co. v. Commissioner, supra, involved a transfer of a business and its assets, pursuant to the predecessor to section 351, in exchange for common stock and the assumption of the liabilities of the transferor, two of which were lawsuits that arose prior to the transfer. Although the transferor partnership would have been entitled to deductions for the payments had it actually made them, the court found that the expense of settling the claims of the predecessor entity was not an operating expense or loss of the business of the transferee, but was part of the cost of acquiring the predecessor's property. The fact that the claims were contingent and unliquidated at the time of the acquisition was not of controlling consequence. Consequently, the court held that they were nondeductible capital

1995-2 C.B. 36, Rev. Rul. 80-198, 1980 C.B. 113. Rather, consistent with sections 83(h) and 404(a)(5), and the facts as currently developed, we presume that the transferor remains entitled to the deduction for the liabilities in the taxable year in which the employees recognize income.

That being the case, section 357(c)(3)(A)(i) does not apply to the nonqualified deferred compensation liabilities, and the transferor's basis in the transferee stock must be reduced by the amount of the liabilities assumed.[11] Sections 358(d)(1) and 358(a)(1)(A)(ii). To apply section 357(c)(3)(A)(i) to these liabilities would grossly pervert Congressional intent for section 357(c)(3) because it would effectively operate to manufacture a double deduction. See §§ 1.161-1, 1.1016-6(a).

3. The Loss is Not a Bona Fide Loss Allowable Under Section 165

The loss claimed by the taxpayer on the sale of the preferred stock is not a bona fide economic loss representing a real change of position in a true economic sense, and therefore is not allowable under section 165.

Section 165 provides that "a taxpayer may deduct any loss sustained during the taxable year for which the taxpayer is not indemnified by insurance or otherwise." The loss must be a bona fide loss representing a real change of position in a true economic sense; substance rather than form governs in determining a deductible loss. Section 1.165(b). A deduction for a loss must be based on an actual economic loss. See, e.g., Scully v. U.S., 840 F.2d 478 (7th Cir. 1988).

Focusing exclusively on the property involved in the exchange, immediately prior thereto the transferor possessed $d in cash and $g (estimated) in nonqualified

expenditures.

[11] This result also is consistent with several revenue rulings regarding the treatment of the assumption of deductible liabilities in a valid section 351 exchange. See Rev. Rul. 95-74, 1995-2 C.B. 36, Rev. Rul. 80-199, 1980 C.B. 122, and Rev. Rul. 80-198, 1980 C.B. 113. Each of these rulings involved an exchange, for bona fide business purposes, of substantially all of the assets associated with a business, and an assumption of deductible liabilities that related to an asset transferred. Each ruling concluded that the assumed liabilities properly were not included in determining the amount of liabilities assumed for purposes of section 357(c)(1). Further, Rev. Rul. 95-74 and Rev. Rul. 80-198 also each concluded that the transferee corporation, which (unlike here) acquired substantially all of the assets associated with a business, including the assets associated with the assumed liabilities, would be entitled to a deduction upon satisfaction of the assumed liabilities (this latter issue was not addressed by Rev. Rul. 80-199).

deferred compensation liabilities (yielding a net positive economic position of approximately $a). Immediately after the exchange (in which said cash and liabilities were transferred), the transferor possessed $a in transferee preferred stock (yielding a net positive economic position of $a). Next, immediately after the sale of the transferee preferred stock, the transferor possessed $a cash (yielding a net positive economic position of $a). As discussed, presumably the transferor will not lose any deduction that will arise from the payment or satisfaction of the nonqualified deferred compensation liabilities. Thus, the transferor has suffered no economic detriment.

The "loss" on the sale of the preferred stock effectively is nothing more than an acceleration of, and duplication of, the deduction associated with payment of the nonqualified deferred compensation liabilities. Accordingly, given that the claimed loss is not a bona fide loss representing a real negative change of position in a true economic sense, it is not allowable under section 165.

4. Business Purpose and Section 351

The business purpose doctrine applies to section 351 exchanges. See Rev. Rul. 55-36, 1955-1 C.B. 340; see also Caruth v. United States, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). The facts indicate that the taxpayer may have asserted a business purpose, however, it is not clear that the facts indicate whether in fact the taxpayer's claimed business purpose was genuine. Consequently, should none of the taxpayer's claimed business purposes for the exchange be substantiated, it can be argued that the exchange does not qualify for section 351 nonrecognition treatment for lack of business purpose.

5. Section 1.1502-20

If, despite the arguments discussed above, the taxpayer is treated as having realized a loss, such loss is subject to § 1.1502-20 and other provisions and principles of law, as discussed below.

(a) Relevant Facts

On Date2 (in a purported section 351 exchange), Pcorp transferred approximately $o to its second tier subsidiary, SubCorp2, in return for #a shares of SubCorp2 preferred stock and SubCorp2's agreement to assume $n of Pcorp's nonqualified deferred compensation liabilities. Pcorp entered into a support agreement with SubCorp2 that ensured that SubCorp2's net worth did not fall below $m. At the same time, Pcorp's first tier subsidiary, SubCorp1, transferred $a cash to SubCorp2 in exchange for #b shares of SubCorp2 common stock. Of the proceeds received, SubCorp2 invested approximately $e in various investment funds, approximately $f was loaned to SubCorp3, a non-life insurance company subsidiary of Pcorp and a member of the consolidated group, and the remaining cash was invested by SubCorp2 in other investments. The security evidencing the $f loan pays interest at a rate of %a and has a maturity date of Date3.[12]

On Date4, Pcorp sold its #a shares of SubCorp2 preferred stock to an unrelated third party purchaser for approximately $a. Claiming a $o basis in the preferred stock, Pcorp reported a $n short term capital loss on the stock sale. The transaction was initially marketed to the taxpayer as producing a duplicated loss that would not be subject to disallowance under the loss disallowance rules ("LDR") of § 1.1502-20.

The taxpayer has indicated that the transferee will not claim any deduction that will arise from satisfaction of the nonqualified deferred compensation liabilities.

(b) Overview

The structure of the transaction outlined above was carefully designed to try to avoid the Loss Duplication portion of the loss disallowance rules of § 1.1502-20. Under the Loss Duplication provision, which will be discussed more fully below, Duplicated Loss is determined immediately after a disposition (or deconsolidation) of subsidiary stock, and equals the amount by which the sum of SubCorp2's:

a. aggregate adjusted asset basis (other than its basis in another subsidiary's stock and securities),
b. loss carryforwards, and
c. deferred deductions

exceed the sum of SubCorp2's

a. stock value,
b. liabilities, and
c. any other relevant items.

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[12] It will be necessary to look at the specific terms of the note and other investments to determine whether they qualify as another subsidiary's "stock or securities" within the meaning of § 1.1502-20(c)(2)(vi)(A)(1). For purposes of this memorandum, we assume the note and other investments are in another subsidiary's securities. If you discover that the investments are in another subsidiary's stock, we recommend you seek supplemental field service advice. Note that to the extent SubCorp2's investments are not in another subsidiary's securities or stock, the amounts would not be excluded from SubCorp2's asset basis calculation for purposes of the Duplicated Loss formula (even absent the application of § 1.1502-20(e), § 1.1502-13(g), or § 1.1502-13(h)(1) (see below).

We expect that the sole reason Pcorp invested SubCorp2's assets in other members' securities was that, under the Duplicated Loss formula, such items would be excluded from SubCorp2's aggregate adjusted asset basis. Under the facts of the current case, it appears that SubCorp2 has minimal, if any, loss carryforwards or deferred deductions. Further, it appears that nearly 100% of SubCorp2's assets are invested in other members' securities. Accordingly, if SubCorp2's investments in other members' securities are excluded from, and not otherwise reflected in, the top portion of the Duplicated Loss formula, SubCorp2 would have, as it claimed, a Duplicated Loss amount of zero.

This portion of the memorandum explains why the consolidated return regulations actually result in disallowing nearly the entire loss claimed by Pcorp on the sale of the SubCorp2 preferred stock. In particular, we believe that SubCorp2's investments in other subsidiaries' securities are Intercompany Obligations (i.e., an obligation between members of a consolidated group) that are subject to the Intercompany Obligation provisions of § 1.1502-13(g). That provision provides, inter alia, that if a member realizes an amount of income or loss directly or indirectly, from the assignment or extinguishment of an Intercompany Obligation, the Intercompany Obligation is treated as satisfied under § 1.1502-13(g)(3)(ii) (see § 1.1502-13(g)(3)(i)), and, if the Intercompany Obligation remains outstanding, it is treated as reissued immediately after the transaction. Section 1.1502-13(g)(3)(iii).

As we discuss more fully below, we believe Pcorp's sale of the SubCorp2 preferred stock resulted in an indirect realization of the Intercompany Obligations held by SubCorp2. Accordingly, at that time, there was a deemed satisfaction of any Intercompany Obligations held by SubCorp2. Thus, at the time the Duplicated Loss amount on the sale of the SubCorp2 stock was calculated (i.e., immediately after the SubCorp2 stock sale), SubCorp2 is deemed to hold the proceeds from the deemed satisfaction of the Intercompany Obligations, rather than the securities themselves. Thus, for purposes of the Duplicated Loss formula, SubCorp2's aggregate adjusted asset basis includes the deemed proceeds from the other members' securities ($k). Since the fair market value of SubCorp2's stock is $e (and, as discussed more fully below), Service position is that SubCorp2's liabilities should not be taken into account for purposes of the Duplicated Loss formula because they had not yet been taken into account for tax purposes, SubCorp2's Loss Duplication amount would be $p, rather than zero (which is reflective of the amount of loss duplication that is preserved for the Pcorp group [or any of its members] upon SubCorp2's payment of Pcorp's nonqualified deferred compensation liabilities).

Finally, as will be discussed more fully below, we note that in addition to the foregoing technical arguments, Pcorp's claimed loss on the SubCorp2 preferred stock sale should also be disallowed through application of the anti-avoidance rules of § 1.1502-13(h)(1) and § 1.1502-20(e)(1).

(c) Law

All consolidated group members are subject to the provisions of the loss disallowance rules under § 1.1502-20. Section 1.1502-20(a) in relevant part provides that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of another member. Section 1.1502-20(c)(1) modifies the broad disallowance rule of § 1.1502-20(a) by providing that the amount of loss disallowed with respect to a share of stock is limited to the sum of the subsidiary's extraordinary gain dispositions ("EGD"),[13] positive investment adjustments ("PIA"),[14] and duplicated loss amount with respect to the disposed of shares. From the incoming facts, it appears that only the loss duplication component of the LDR is applicable to the present case.[15]

Under § 1.1502-20(c)(2)(vi), duplicated loss is determined immediately after a disposition or deconsolidation, and equals the excess (if any) of --

(A) The sum of --

(1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and

---

[13] The amount of income or gain, net of directly related expenses, that is allocated to the share from "extraordinary gain dispositions," as defined in § 1.1502-20(c)(2)(i)).

[14] The positive adjustments made pursuant to §§ 1.1502-32(b)(2)(i) through (iii) for each consolidated return year during which the subsidiary was a member of the group, determined without taking distributions into account that are allocated to the share, but only to the extent such amount exceeds the amount described in § 1.1502-20(c)(1)(i) for the year.

[15] For purposes of this memorandum, we assume the amount of extraordinary gain dispositions ("EGD") and positive investment adjustments ("PIA") to be allocated to the SubCorp2 preferred stock is zero. Under the incoming facts, Pcorp held SubCorp2's preferred shares a very brief period of time. Since only EGD and PIA directly or indirectly reflected in the basis of the share immediately before the disposition or deconsolidation (i.e., those occurring during the brief period the shares were outstanding) are taken into account under the LDR (see § 1.1502-20(c)(2)(iii)), it is likely there were few, if any, EGD or PIA with respect to the preferred shares. However, further factual development will be needed to determine the exact amounts of EGD and PIA to be allocated to the shares.

(2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and

(3) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary, over

(B) The sum of --

(1) The value of the subsidiary's stock, and

(2) Any liabilities of the subsidiary, and

(3) Any other relevant items.

Section 1.1502-20(e) provides that the rules of the LDR must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments must be made to carry out their purposes.

In addition to the § 1.1502-20 regulations, all transactions between consolidated group members are subject to the Intercompany Transactions provisions of § 1.1502-13. In particular, transactions involving Intercompany Obligations are subject to the provisions of § 1.1502-13(g). An Intercompany Obligation is an obligation between members, but only for the period during which both parties are members. For this purpose, the term “obligation” is defined broadly and includes any obligation of a member constituting indebtedness under general principles of Federal income tax law.

If a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an Intercompany Obligation, the Intercompany Obligation is treated for all Federal income tax purposes as satisfied under § 1.1502-13(g)(3)(ii) (see § 1.1502-13(g)(3)(i)). If the Intercompany Obligation remains outstanding, it is treated as reissued immediately after the transaction. Section 1.1502-13(g)(3)(iii).

§ 1.1502-13(h)(1) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13, including, for example, by avoiding treatment as an Intercompany Transaction, adjustments must be made to carry out the purposes of this section.

(d) Discussion

Under the facts of this case, Pcorp attempts to accelerate and duplicate a single operating loss (i.e., Pcorp's nonqualified deferred compensation liabilities) by recognizing a loss on the sale of the SubCorp2 stock, while preserving the same loss for the Pcorp group's later use. Loss recognized on the disposition of subsidiary stock is typically duplicated if it is attributable to a loss or expense that has not been recognized and absorbed by a group (such as the future payment of the nonqualified deferred compensation liabilities at issue here), and that very same loss is preserved for later recognition by the group or any of its members when such amount is properly taken into account for tax purposes. This is the exact abuse the Loss Duplication formula was designed to disallow. However, despite duplicating its single loss, Pcorp hoped to circumvent the impact of the Loss Duplication factor by investing SubCorp2's assets in the securities of other Pcorp subsidiaries. By so doing, Pcorp hoped to take advantage of the literal language of the Duplicated Loss formula, which excludes from SubCorp2's aggregate adjusted asset basis the amount of basis it has in another subsidiary's securities. If the Duplicated Loss amount is so calculated, there would be no Duplicated Loss disallowed on the sale of the SubCorp2 stock. This result is wholly inconsistent with the intent and purposes of the regulation, and must be challenged.

As we discussed above, because we believe that SubCorp2's investments in other subsidiaries' securities are Intercompany Obligations within the meaning of § 1.1502-13(g), our position is that the SubCorp2 preferred stock sale resulted in an indirect realization of those Intercompany Obligations. Accordingly, at the time SubCorp2's Duplicated Loss amount is calculated, SubCorp2 is deemed to hold the proceeds from the deemed satisfaction of the Intercompany Obligations, rather than the securities themselves, and thus, for purposes of the Duplicated Loss calculation, SubCorp2's aggregate adjusted asset basis includes the deemed proceeds from the other members' securities. Accordingly, nearly all of the loss Pcorp claimed on the SubCorp2 preferred stock sale is disallowed. This result is likewise supported by the anti-avoidance rules of § 1.1502-13(h)(1) and § 1.1502-20(e)(1). An overview of certain purposes and theories of the consolidated return regulations that support these arguments follows.

Although an affiliated group is, economically, one business unit, subsidiary stock is in fact a separate and distinct asset on which gain or loss can be recognized. Under tax principles generally applicable to corporations, a disposition of a corporation's assets and its stock would produce gain or loss on both the assets and the stock. Outside the consolidated setting, where the group members are generally viewed as separate taxpayers, this duplication of gain and loss is not inappropriate. Once a group elects to file a consolidated return, however, the group is more generally viewed and taxed as a single entity. Under this single entity theory, the duplication of both gain and loss by transactions in member stock is an inappropriate distortion of the income of a consolidated group.

Section 1502 directs the IRS and Treasury to prescribe such regulations as necessary in order that the tax liability of the group and of each corporation in the group, both during and after the period of affiliation, is determined in a manner that clearly reflects its income tax liability and that prevents the avoidance of such liability. The purpose of the LDR is to prevent the inappropriate deduction of loss. Its formula is designed to take into account several types of losses considered inappropriate. One such inappropriate loss is that which enables consolidated taxpayers to circumvent the repeal of the General Utilities doctrine. The PIA and EGD factors address this type of loss. Another is a loss that is recognized on member stock but that is attributable to the group's unrecognized, or recognized but unutilized, losses that are preserved for a later, and thus "duplicative", recognition or use. The Loss Duplication component of the LDR addresses this latter loss.

Duplicated loss occurs typically, but not exclusively, when a subsidiary has an asset that declines in value, or when a subsidiary pays or accrues an expense, but the loss or expenditure has not reduced the basis of the subsidiary stock, because, e.g., the loss has not been utilized by the group or the deduction was deferred. Duplication can occur whether or not the subsidiary remains a member of the group and whether or not the loss or expense will be deductible by the subsidiary the stock of which is sold.

The determination of loss duplication with respect to a share of subsidiary stock is made by comparing the subsidiary's potential tax benefits with the value of its assets. The potential tax benefits include the aggregate adjusted basis of the subsidiary's assets, the losses carried to the subsidiary's first taxable year following the disposition, and the subsidiary's deferred deductions. The value of the assets is extrapolated from the consideration paid for the stock, plus the subsidiary's liabilities. The excess (of the potential tax benefits over the value of the assets) reflects the amount of loss that is preserved and may be duplicated by the group.

Applying the terms of § 1.1502-20 to the current case, Duplicated Loss is the amount by which the sum of SubCorp2's aggregate adjusted basis in its assets (other than any basis it has in the stock and securities in another subsidiary), loss carryforwards, and deferred deductions exceed the sum of SubCorp2's stock value, liabilities, and any other relevant items. Such amounts include SubCorp2's allocable share of corresponding amounts with respect to all lower tier subsidiaries. This computation is made immediately after the disposition of the SubCorp2 preferred stock.

In making its LDR calculation, Pcorp apparently takes the position that its purported loss on the SubCorp2 preferred stock sale is fully allowed.[16] In calculating its LDR amount, Pcorp presumably excluded from its inside asset basis amount the security SubCorp2 received in exchange for the SubCorp3 loan, as well as SubCorp2's investments in any other subsidiary's securities because, under § 1.1502-20(c)(2)(vi)(A)(1), Pcorp presumably concluded that such items are excluded from the Duplicated Loss formula. Thus, Pcorp presumably calculated its loss disallowance amount as follows (dollar amounts in $ttt):

EGD		$0[17]
PIA		$0[18]
Duplicated Loss Amount, excess of:		
the sum of:		
inside asset basis (excluding member securities and stock)	$0[19]	
NOLs	$0	
deferred deductions	$0	
subtotal:	$0	
over the sum of:		
FMV of stock	$q[20]	

[16] As we noted previously, for purposes of this memorandum, we assume SubCorp2 has zero EGD and PIA to be allocated to the SubCorp2 preferred stock. We further assume that in applying the Loss Duplication formula, SubCorp2 had no loss carryforwards or deferred deductions (since it is not entitled to a deduction on the payment of Pcorp's nonqualified deferred compensation liabilities). Furthermore, we assume that SubCorp2's stock value is $e.

[17] In view of the prompt sale of the preferred stock, it is assumed for purposes of this advisory that the extraordinary gain disposition and positive investment adjustment amounts with respect to the preferred stock are zero. However, this needs to be verified. (See footnote 15.)

[18] See footnote 15.

[19] Although $d was transferred by Pcorp to SubCorp2 and the $a was transferred by SubCorp1 to SubCorp2, we assume for purposes of this memorandum that 100% of this amount was invested in other subsidiaries' securities.

[20] This is the sum of the $a paid by SubCorp1 for the SubCorp2 common stock and the net $a given by Pcorp to SubCorp2 for the SubCorp2 preferred stock.

liabilities assumed	$ 0	
subtotal:	$q	
total duplicated loss amount (not less than $0)		$0
Total Loss Disallowance Amount:		$0

We believe this is an incorrect measure of SubCorp2's Duplicated Loss. For purposes of applying the duplicated loss formula, SubCorp2's aggregate adjusted asset basis must include the basis of any securities SubCorp2 owns in another subsidiary. There are several rationales that support this position. As we noted above, and discuss more fully below, since we believe that any amount Pcorp realized on the SubCorp2 stock sale is an amount indirectly realized on any Intercompany Obligations held by SubCorp2, the SubCorp2's stock sale is within the scope of § 1.1502-13(g). Accordingly, at the time of the Duplicated Loss calculation, SubCorp2's aggregate adjusted asset basis includes the proceeds from the deemed satisfaction of the Intercompany Obligations, thereby significantly increasing the amount of the disallowed Duplicated Loss.

As noted above, § 1.1502-13(g) is not limited to transactions involving a direct realization on an Intercompany Obligation, but applies as well to amounts "realized . . . indirectly" with respect to an Intercompany Obligation. Neither the Intercompany Transaction regulations nor the Preambles to the regulations address the intended scope of the term "realizes . . . indirectly". It appears, however, that there is but a narrow range of transactions for which such a clause would be necessary.[21] Only those transactions in which the amount realized is a function of the inherent attributes of the obligation, but that neither involves the obligation directly nor effects a deconsolidation, necessitate the "realizes . . . indirectly" clause.

[21] First, if a transaction actually involves an Intercompany Obligation, there is a direct realization and no need for the "indirect" clause. Second, if a transaction does not involve a member obligation directly, but rather an interest in the entity holding the obligation, most cases are otherwise covered by § 1.1502-13(g) and so would have no need for the "indirect" clause. For example, if a transaction involves a member obligation that is held by a person or entity that is not a member of the group, § 1.1502-13(g) has no application at all because the obligation is not an Intercompany Obligation. And, if the holder is a member but a disposition of its stock deconsolidates the holder, the regulation provides for a satisfaction of the obligation at fair market value, so again the "indirectly" clause is not needed.

Where, as here, a stock interest represents virtually nothing other than Intercompany Obligations, the sale or disposition of such stock is clearly an indirect realization of the Intercompany Obligations within the meaning of the regulation. Under the circumstances, this transaction is within the intended scope of the "indirect" clause of § 1.1502-13(g)(3)(i). Thus, the amount Pcorp realized on the sale of the SubCorp2 preferred stock was an amount indirectly realized on the Intercompany Obligations held by SubCorp2.

Under § 1.1502-13(g)(3)(i), if a member realizes a loss directly or indirectly from the assignment or extinguishment of an Intercompany Obligation, the obligation is treated as satisfied under § 1.1502-13(g)(3)(ii); if it remains outstanding, it is treated as reissued immediately after the transaction. Section 1.1502-13(g)(3)(iii). Accordingly, for Federal income tax purposes, the sale of the SubCorp2 preferred stock is treated as follows. Under § 1.1502-13(g)(3)(ii), the issuers of any Intercompany Obligation are treated as having satisfied their Intercompany Obligations for their face amount immediately before Pcorp's sale of SubCorp2's preferred stock. At the time of the stock sale, SubCorp2 is treated as holding proceeds of the issuers' deemed satisfaction of the obligations, not the obligations themselves. Immediately after the sale, before any other transaction occurs or is deemed to occur (including the deemed reissuance of the notes), the Loss Duplication factor is calculated. Thus, SubCorp2 is treated as holding the deemed satisfaction proceeds at the time the Duplicated Loss amount is calculated. Under this model, the amount of loss disallowed under the LDR would be calculated as follows (dollar amounts in $ttt):

EGD		$0[22]
PIA		$0[23]
Duplicated Loss Amount, excess of:		
the sum of:		
inside asset basis (including the proceeds from the deemed satisfaction of any Intercompany Obligations under § 1.1502-13)	$r[24]	
NOLs	$0	

[22] See footnote 17.

[23] See footnote 16.

[24] This is the sum of the $d transferred by Pcorp to SubCorp2 and the $a transferred by SubCorp1 to SubCorp2. For purposes of this memorandum, we assume all of this amount was invested in Intercompany Obligations within the meaning of § 1.1502-13(g). You will need to verify this assumption. See footnote 12.

deferred deductions	$0	
subtotal:		$r
over the sum of:		
FMV of stock	$q[25]	
liabilities assumed	$0[26]	
subtotal:	$q	
total duplicated loss amount:		$s
Total Loss Disallowance Amount:		$s

Note that all of the duplicated loss amount is being allocated to the SubCorp2 preferred stock sold to UCompany. Since this transaction was structured to give rise to the preferred stock loss, and since the liability assumption which played a central role with respect to this loss was undertaken at least formally in exchange for that stock, the duplicated loss amount is allocated entirely to such stock. See § 1.1502-20(c); § 1.1502-20(e)(3), Example 1.

The foregoing technical interpretation of the § 1.1502-13(g) regulation results in a significant portion of Pcorp's claimed loss on the sale of its SubCorp2 preferred stock being disallowed under § 1.1502-20. In addition, the loss is disallowed through application of the anti-avoidance rules of § 1.1502-13(h)(1) and § 1.1502-20(e)(1).

Any interpretation and application of a regulation must be guided by the policy concerns and objectives of the regulation. But, in the case of the consolidated return provisions at issue here, such inquiry is not only mandated by principles of statutory and regulatory interpretation, it is mandated by the provisions themselves.

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[25] This is the sum of the $a paid by SubCorp1 for the SubCorp2 common stock and the net $a given by Pcorp to SubCorp2 for the SubCorp2 preferred stock.

[26] In terms of determining the correct amount of liabilities to be included in the Loss Duplication formula, Service position is that "liabilities" are not taken into account for the duplicated loss calculation if they have not been taken into account for tax purposes. Since the instant nonqualified deferred compensation liabilities had not been taken into account for tax purposes at the time Pcorp sold the SubCorp2 preferred stock, Service position would support excluding those liabilities for purposes of calculating the duplicated loss component of the LDR.

Beginning in 1991, the consolidated return regulations underwent a major revision that produced, among other things, the LDR and Intercompany Transaction regulations applicable to the present case. These regulations differ substantially from the prior ones in that they rely less on inflexible, mechanical rules and more on a flexible, principle driven approach. The reason for this change was to render the regulations more capable of readily and timely accommodating changes in the tax law, as well as other economic and policy considerations. Because the regulations rely heavily on broad principles, direction in the interpretation and application of these provisions was provided to ensure they would be applied always in a manner that furthers their policy.

The Intercompany Transaction regulations are intended to ensure the clear reflection of the taxable income (and tax liability) of a consolidated group as a whole by preventing Intercompany Transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). Section 1.1502-13(a)(1). Section 1.1502-13(g) seeks to preserve the location of economic gain or loss on member obligations and to prevent tax avoidance through the use of Intercompany Obligations. Section 1.1502-13(h)(1) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13, including, for example, by avoiding treatment as an Intercompany Transaction, adjustments must be made to carry out the purposes of that section.

The only apparent accomplishments of the current transactions were the creation of high basis, low value stock and the sale of that stock in a transaction expected to escape characterization as a transaction with respect to an Intercompany Obligation. By avoiding that characterization of the transaction, Pcorp would avoid the satisfaction and reissuance provisions of § 1.1502-13(g). As such, Pcorp would argue that at the time the Loss Duplication calculation was made, the basis of the securities SubCorp2 held in another subsidiary would be excluded from SubCorp2's aggregate adjusted asset basis under the literal terms of the Duplicated Loss formula. Since Pcorp, if successful, would avoid any disallowance of the loss on the stock, the tax benefit of the future payments on their nonqualified deferred compensation liabilities would be effectively accelerated (and duplicated). However, if the sale of the SubCorp2 stock is treated as an indirect realization of the Intercompany Obligations held by SubCorp2, the attempt to accelerate (and duplicate) the loss would be thwarted.

Acceleration of deductions, not yet permitted to be taken into account under generally applicable tax accounting rules, by moving assets and liabilities between members of a consolidated group, is wholly inconsistent with the purpose of clearly reflecting the group's consolidated taxable income. Accordingly, since Pcorp acted with a principal purpose of avoiding the purposes of the Intercompany Transaction regulations, proper adjustment must be made to avoid the recognition of loss on the sale of SubCorp2's preferred stock.

Similarly, the first sentence of the anti-avoidance rules of § 1.1502-20(e)(1) mandates that the rules of § 1.1502-20 be applied in a manner that is consistent with and reasonably carries out their purposes. The second sentence provides that if a taxpayer acts with a view to avoid the effect of the rules of § 1.1502-20, adjustments must be made as necessary to carry out their purposes. As previously discussed, the purpose of the Loss Duplication factor is to limit a consolidated group's ability to deal in member stock in order to realize, and yet preserve for later use, the underlying unrecognized or unutilized losses of the member.

Pcorp's loss on the SubCorp2 stock is solely attributable to the economic recognition of the diminution of value resulting from known, but unpaid, operating expenses that were not yet taken into account for tax purposes. Such a loss falls squarely within the intended scope of the loss duplication provision. However, because Pcorp carefully structured the SubCorp2 stock sale to avoid the provisions of § 1.1502-20, and, absent the application of § 1.1502-13(g), the regulation would appear to result in a loss disallowance amount of zero. This is because the Duplicated Loss formula excludes from SubCorp2's aggregate adjusted asset basis amount the basis it has in any other subsidiary's securities. Thus the stock sale transaction effectively circumvents the LDR, effectively avoiding their purposes. This result would be clearly prohibited under the first sentence of § 1.1502-20(e).

Finally, the second sentence of the anti-avoidance rules of § 1.1502-20(e) requires that if Pcorp structured this transaction and acted with a view to avoid the LDR, then adjustments must be made to carry out their purposes. In this case, it appears that Pcorp had sophisticated tax planning advice from outside accounting and investment firms. These parties proposed the plan, and then advised and assisted Pcorp in carrying it through to completion. We need to evaluate Pcorp's claimed non-tax goal in carrying out this complex set of transactions. However, we believe the overwhelming purpose was to provide Pcorp with an immediate basis in the SubCorp2 stock that would, absent LDR and general tax avoidance principles, permit a large, duplicated loss on the sale of the stock. As such, if you determine that Pcorp structured this transaction and acted with a view to avoid LDR, then the resulting loss must be disallowed under the second sentence of § 1.1502-20(e)(1).

In conclusion, the mandate of § 1.1502-20(e) requires that, irrespective of any language in § 1.1502-20(c)(2)(vi)(A)(1) seemingly to the contrary, intragroup securities must be included in the Loss Duplication calculation.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

6. [redacted][27]

[redacted]

[redacted][28] [redacted]

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[redacted] [redacted][32] [redacted]

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[31] [redacted]

[32] [redacted]

[redacted]

7. [redacted]

[redacted]

[redacted]

8. [redacted]

9. [redacted]

10. [redacted]

[redacted][33] [redacted][34] [redacted]

[redacted]

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[33] [redacted]

[34] [redacted]

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[redacted]

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[redacted]

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[redacted] [35] [redacted]

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[35] [redacted]

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Please call if you have any further questions.

Assistant Chief Counsel (Corporate)
By: Alfred C. Bishop
Branch Chief (CC:CORP:6)

36 [redacted]