

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 461.06-00
CASE-MIS No.: TAM-107814-20

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Business 1 =

Business 2 =

Business 3 =

Product 1 =

Product 2 =

Clause 1 =

Clause 2 =

Government Agency =

MSA 1 =

MSA 2 =

MSA 3 =

Order 1 =

Order 2 =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Month 1 =

A =

B =

C =

D =

E =

F =

G =

H =

J =

K =

L =

M =

N =

O =

P =

Q =

R =

S =

T =

U =

V =

W =

X =

Y =

Z =

ZZ =

ISSUES:

1. May H (the subsidiary of A) deduct the amount of the Product 2 product liability under § 162 of the Internal Revenue Code ("Code")
Treas. Reg. § 1.461-4(d)(5), , satisfying economic performance under

?

2.

CONCLUSIONS:

1. H may deduct the amount of Product 2 liabilities in Year 2 under § 162 of the Code because economic performance is satisfied under Treas. Reg. § 1.461-4(d)(5).

2.

FACTS:

B, a publicly-traded corporation, is the parent corporation of a worldwide corporate group engaged in Business 1, including Business 2 and Business 3. Taxpayer is engaged in Business 1. A is a second-tier subsidiary of Taxpayer. Taxpayer is the common parent of B's U.S. group and files a consolidated tax return with, among other members, A, C, E, and F.

On Date 1, A acquired all of the outstanding shares of C, a publicly-traded manufacturer of Product 1 . Within C's corporate structure at the time, D was the operating entity that manufactured and sold products through Business 2 and Business 3. After the acquisition, D was owned partially by A, and partially by E, another member of Taxpayer's consolidated group.

D's Business 3 manufactured and sold Product 2. As of the date of A's acquisition of D, approximately V product liability suits had been filed against D. As a result of _____, and as of Date 4, over W product liability claims for Product 2 had been asserted against A, F, C, and D. Claims against A included allegations of both product liability

On Date 2, the Judicial Panel on Multidistrict Litigation created a multidistrict litigation ("MDL") proceeding to coordinate all pending federal claims asserted against A, F, C, and D. As part of the MDL, A, F, and C negotiated an agreement with plaintiffs' counsel, _____ in D's MDLs.

This agreement was reduced to an agreed upon draft order, which the MDL Court approved, adopted, and entered as Order 1 on Date 3.

Order 1

In compliance with Order 1, to resolve the claims against D efficiently, X Master Settlement Agreements ("MSAs") were entered into with various groups of claimants. All Z of the MSAs at issue in this TAM (totaling \$Y of the liabilities assumed) were fully executed prior to Date 4. Taxpayer has agreed that the remaining ZZ MSAs executed after Date 4 are not included in this TAM request.

The MSAs set forth the terms for the settlement of Product 2 product liability claims under the MDL. This settlement process was described in Order 2.

The MSAs generally provide that a specified payment be made All Z of the MSAs at issue in this TAM state that they are between D, C, A, and F, collectively referred to in the MSAs as G and the respective claimants. The MSAs state that G will pay certain amounts to the claimants, and that entities other than D are intended third party beneficiaries of the MSAs.

Three of the MSAs at issue in this TAM, MSA 1, MSA 2, and MSA 3, contain additional language. These three MSAs contain Clause 2 as to the parties thereto.

Finally, all of the MSAs provide that they do not constitute an admission of liability or wrongdoing or of any position whatsoever in connection with any matters in any pending or potential litigation, and contain an express denial of such liability or wrongdoing.

This disclaimer prohibits claimants, including those parties to the particular MSAs in the event of a failure of G to make payments _____, from asserting that the MSAs amount to an admission of liability by A, F, and C.

As the MSAs became final, the MDL court issued orders regarding the MSAs.

. D did, in fact, make payments pursuant to the MSAs.

_____, three C subsidiaries – J, K, and D – converted from _____ corporations to _____ LLCs (the “Conversions”) to become L, M, and N, respectively. Subsequently, L, M, and N were classified for U.S. federal income tax purposes as disregarded entities owned by C.

D checked the box to become a disregarded entity, and all of D’s assets and liabilities were transferred to C for Federal income tax purposes.

_____, on Date 8,

Throughout Month 1, C contributed Business 3 operations to a newly created limited liability company, P, which was classified from its formation as a disregarded entity for U.S. federal income tax purposes. C also changed its name to H.

Liquidation of H

As part of a plan of liquidation, on Date 4, H converted from a corporation into a LLC, resulting in it becoming a disregarded entity owned by A, for federal income tax purposes, and changed its name to Q. As a result of the conversion, A assumed all remaining assets and liabilities of H for federal income tax purposes. Also on Date 4,

Filing Positions

A, E, and H all filed as part of Taxpayer's consolidated group for the Year 2 tax year. H included the amounts of the liabilities incurred through the MSAs in its amount realized on the liquidation for federal income tax purposes and deducted these amounts under § 1.461-4(d)(5).

The consolidated net operating loss was reported as \$U,

LAW AND ANALYSIS:

Issue 1: May H (the subsidiary of A) deduct under § 1.461-4(d)(5) the amount of Product 2 liability

Section 461 provides that the amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides that under an accrual method of accounting, a liability (as defined in §1.446-1(c)(1)(ii)(B)) is incurred, and generally taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.461-4(d)(5)(i) provides that in general, if, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See §1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

The sole question under Issue 1 is whether A can assume H's MSA liabilities in satisfaction of the economic performance requirement in connection with the sale of a trade or business under § 1.461-4(d)(5)

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Therefore, when H made a "check the box election" under § 301.7701-3(c)(1) on Date 4 to become a disregarded entity, under § 301.7701-3(g)(1)(iii), H was deemed to distribute all of its assets and liabilities to A. Further, because H was insolvent at the time of the check-the-box election, Rev. Rul. 2003-125, 2003-2 C.B. 1243, clarifies that the deemed distribution of H's assets and liabilities to A cannot be in exchange for H's stock because the amount of H's liabilities is greater than the fair market value of H's assets. Because the acquisition was not in exchange for stock (per Rev. Rul. 2003-125), the shareholder must be treated as purchasing the assets and either assuming the liabilities (the case if the shareholder is directly liable to the claimants) or taking the assets subject to the liabilities (where the shareholder is not directly liable to the claimants).

¹ Exam has not challenged the taxpayer's position that the other requirements of § 1.461-4(d)(5) have been satisfied.

Therefore, H may deduct the amount of Product 2 liabilities under § 162 because economic performance is satisfied under § 1.461-4(d)(5).²

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² Exam has not challenged Taxpayer's position that these deductions qualify as

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c. Caselaw and Definitions

Deductions are a matter of legislative grace and are “strictly construed”.⁷ INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

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ii.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.