



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

OFFICE OF
CHIEF COUNSEL

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TL-N-2445-99

UILC: 1.1502.20-00

June 30, 2000

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL,

CC:

Attn:

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

SUBJECT: Loss Disallowance Rules Under Treas. Reg.
section 1.1502-20

This Field Service Advice responds to your memorandum dated March 28, 2000. 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.

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TL-N-2445-99

official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Ultimate Parent Group =

Ultimate Parent =

Ultimate Sub =

Target Parent Group =

Target Parent =

Target Sub 1 =

Target Sub 2 =

Line of Business B =

Trademark B =

Trademark C =

State X =

Asset C =

Asset D =

Individual B =

Month B =

Month C =

Date B =

Date C =

Date D =

Date E =

TL-N-2445-99

Date F =
Date G =
Date H =
Date J =
Date K =
Date L =
Date M =
Date N =
Date O =
Date P =
Date Q =
Year C =
Year D =
Year E =
Year F =
Year G =
Year H =
B =
C =
\$B =
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TL-N-2445-99

\$J	=
\$K	=
\$L	=
\$M	=
\$N	=
\$OC	=
\$P	=
\$Q	=
\$R	=
\$S	=
\$T	=
\$U	=
\$V	=
\$W	=
\$X	=
\$Y	=
\$Z	=
\$BB	=
\$CC	=
\$DD	=
\$EE	=
\$FF	=
\$GG	=
\$HH	=
\$JJ	=

TL-N-2445-99

\$KK =

\$LL =

\$MM =

\$NN =

\$PP =

\$QQ =

\$RR =

\$SS =

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\$UU =

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\$BBB =

\$CCC =

\$DDD =

\$EEE =

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TL-N-2445-99

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ISSUES

1. Whether the disallowed loss reported by Ultimate Parent on the sale of its stock in Target Parent, a wholly owned affiliated subsidiary, under Treas. Reg. section 1.1502-20 (-20) was properly computed.

CONCLUSIONS

1. The taxpayer incorrectly calculated the losses disallowed under Treas. Reg. section 1.1502-20(c). When Target Parent distributed the Target Sub 2 stock to Ultimate Sub, certain extraordinary gain dispositions under Treas. Reg. section 1.1502-20(c)(1)(i) were not included to determine the loss disallowed upon the subsequent disposition of Target Parent stock. We are also otherwise assuming that the positive investment adjustments and duplicated loss amounts disclosed are accurate and that the appropriate investment adjustments under Treas. Reg. section 1.1502-32 and the intercompany transaction rules under Treas. Reg. section 1.1502-14 were

TL-N-2445-99

followed and properly reported by Ultimate Parent on the sale of its stock in Target Parent.

FACTS

During the taxable year ended Date C, Ultimate Sub, a wholly-owned affiliate and member of the Ultimate Parent Group, acquired the stock of the Target Parent Group for about \$C. Target Parent Group consisted of Target Parent, Target Sub 1, a first tier subsidiary, and Target Sub 2, a second tier subsidiary owned by Target Sub 1. The Target Parent Group was principally involved in the Line of Business B. Goodwill, which included the value of the trademarks,¹ was valued in the financial statements at \$F, (hereinafter \$G) but the goodwill and the trademarks had a \$EEE tax basis.

According to our informal conversations with the revenue agent, it is our understanding that at the time of the purchase the Target Parent Group had a net asset basis in Asset D of \$V (\$Q aggregate basis less liabilities). In Year D and Year E, all of Asset D of the Target Parent Group were either sold off to third parties or moved to other Ultimate Sub facilities. By the end of fiscal Year F, the only asset remaining in the Target Parent Group was a \$FF note receivable from a third party and certain trademarks both owned by Target Sub 1.² The trademarks were valued in Month B of Year G at \$Z-\$X (hereinafter \$W). According to our informal discussions with the revenue agent, it is our understanding that Ultimate Parent stated that it attributed the decrease in the value of the trademarks to a decline in sales of Trademark B and Trademark C products.

On Date L, Target Sub 1 contributed the trademarks to Target Sub 2 in a section 351 transaction and then the Target Sub 2 stock was distributed from Target Sub 1

¹According to informal discussions we have had with the revenue agent, as well information disclosed in Document # 10, Document # 11 and Document # 12, when Ultimate Sub purchased the Target Parent Group in Year C, the trademarks represented all of the intangible assets associated with Ultimate Sub's purchase of Target Parent. According to our informal conversations with the revenue agent, it is our understanding that the Trademark B and Trademark C trademarks represented the vast majority of trademarks at issue in this case.

²The note was obtained in Month C Year D from a State X general partnership, which was unrelated to Ultimate Parent or any of the Target Parent Group, in connection with the exchange for Asset C which Target Sub 1 owned in State X.

TL-N-2445-99

to Target Parent and from Target Parent to Ultimate Sub.³ Target Sub 1 then merged into Target Parent. On Date M, the stock of Target Parent was sold by Ultimate Sub to Individual B, an unrelated third party, for \$DD. The only remaining asset in Target Parent when it was sold to Individual B was the \$FF note. Ultimate Parent claimed a \$P loss with respect to the sale of the Target Parent stock on its return for the year ended Date M. Ultimate Parent has since submitted a new loss computation as follows:

Amount realized	\$EE
Basis of stock	<u>(\$H)</u>
	(\$M)
Less loss disallowed under Treas. Reg. section 1.1502-20(c)	<u>\$HH</u>
Loss Claimed	<u>(\$OC)</u>

Ultimate Parent submitted documentation demonstrating how Ultimate Sub calculated both its basis in the Target Parent stock and the loss disallowed under Treas. Reg. section 1.1502-20(c). These computations are provided in the tables below:

³It is our understanding of the facts that this transaction was not made pursuant to IRC section 355. According to informal discussions with the revenue agent, Ultimate Sub subsequently had Target Sub 2 sell off or transfer all of the other Target Sub 2 assets except for the trademarks. According to the Ultimate Parent 10-K dated Date O, which was filed on Date P, Ultimate Parent retained the Trademark B and Trademark C trademark product lines as of the 10-K filing.

TL-N-2445-99

Table 1

Ultimate Sub Capital Loss With Respect to sale of Target Parent Shares Per Ultimate Parent for the year ending (FYE) Year G:

Initial Investment Month C/ Year C		\$B
Adjustment Investment		<u>(\$GG)</u>
		\$D
E&P - FYE Date B	(\$DDD)	
E&P - FYE Date D	(\$CC)	
E&P - FYE Date E	(\$TT)	
E&P - FYE Date F	\$RR	
E&P - FYE Date G	(\$XX)	
E&P - FYE Date H	\$YY	
E&P - FYE Date J	\$WW	
E&P - FYE Date K	\$SS	
Distributions- FY Year G	<u>(\$KK)</u>	
	(\$BB)	<u>(\$BB)</u>
Subtotal		\$E
Distribution Target Sub 2 Stock		<u>(\$Y)</u>
Basis After Distribution		\$H
Adj.- Reg. Sec. 1.1502-20		<u>(\$HH)</u>
Basis for Loss		\$K
Proceeds	\$DD	
Fees	<u>(\$CCC)</u>	<u>\$EE</u>

TL-N-2445-99

Capital Loss	<u>(\$OC)</u>
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Table 2

Limits to the Loss Disallowed under Treas. Reg. section 1.1502-20(c) Per Ultimate Parent:

Extraordinary Gain Dispositions	\$LL
Positive Investment Adjustments	\$NN ⁴
Duplicated Losses	<u>\$ZZ</u>
Total	<u>\$HH</u>

Table 3

Extraordinary Gain Dispositions under Treas. Reg. section 1.1502-20(c)(1)(i) Per Ultimate Parent:

Target Sub 1	
Related to Exchange of Installment note for assets	\$QQ
Related to sale of 1231(b) Property	<u>\$UU</u>
	\$MM
Target Sub 2	
Related to sale of 1231(b) Property	<u>\$BBB</u>
Total	<u>\$LL</u>

⁴Based on minor adjustments, positive investment adjustments are either \$NN or \$PP.

TL-N-2445-99

Table 4

Positive Investment Adjustments under Treas. Reg. section 1.1502-20(c)(1)(ii) Per Ultimate Parent:

E&P - FYE Date H	\$YY
E&P - FYE Date J	\$WW
E&P - FYE Date K	<u>\$SS</u>
	\$PP ⁵

Table 5

Duplicated Losses under Treas. Reg. section 1.1502-20(c)(1)(iii) Per Ultimate Parent:

Adj. Tax Basis of assets (note and interest)	(\$FFF)
FMV of shares	<u>\$DD</u>
	(\$ZZ)

The revenue agent and District Counsel question whether this loss disallowance calculation is correct.

LAW AND ANALYSIS1. The Loss Disallowance Rules

The loss disallowance rules (LDR) generally provide that no deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary. "Disposition" means any event in which gain or

⁵See, supra note 4.

TL-N-2445-99

loss is recognized, in whole or in part. Treas. Reg. section 1.1502-20(a)(2). Treas. Reg. section 1.1502-20(c) specifies that the amount of loss disallowed under paragraph (a)(1) with respect to the disposition of a share of stock will not exceed the sum of the following three items: (1) extraordinary gain dispositions; (2) positive investment adjustments; and (3) duplicated loss.

Extraordinary gains: Extraordinary gain dispositions include: actual or deemed dispositions of (1) capital assets, as defined under IRC section 1221; (2) section 1231(b) property (e.g., depreciable property or land used in a trade or business); (3) bulk sales or other dispositions of nondepreciable business assets, such as inventory, copyrights, or receivables used in the same trade or business; (4) dispositions of business assets described in section 1060(c). Extraordinary gain dispositions also include any positive section 481 adjustments resulting from a change of accounting method; income from discharge of indebtedness; and any other event (or item) identified in revenue rulings and revenue procedures. See Treas. Reg. section 1.1502-20(c)(2)(i). These extraordinary gain dispositions apply only to the extent that immediately before the disposition of the share, they are directly or indirectly reflected in the basis of the share after applying the basis adjustment rules of section 1503(e), Treas. Reg. section 1.1502-32(g), and other applicable provisions. Treas. Reg. section 1.1502-20(c)(2)(iii). An extraordinary gain disposition is taken into account under paragraph Treas. Reg. section 1.1502-20(c)(1)(i) only if it occurs on or after November 19, 1990.

Positive investment adjustments: Positive investment adjustments are the annual earnings and profits, before distributions, that result in positive basis adjustments under Treas. Reg. section 1.1502-32(b)(1)(i) and (c)(1). These earnings and profits adjustments apply only to the extent that immediately before the disposition of the share, they are directly or indirectly reflected in the basis of the share after applying the basis adjustment rules of I.R.C. section 1503(e), Treas. Reg. section 1.1502-32(g), and other applicable provisions. To a limited extent, deficits of one year can be offset against earnings and profits of another year for tax years ending on or before September 13, 1991. However, they cannot be netted for years thereafter. To the extent annual earnings and profits are extraordinary gain dispositions, they are not deemed to be positive investment adjustments.

Duplicated loss: The duplicated loss amount is determined immediately after a disposition under Treas. Reg. section 1.1502-20(c)(2)(vi) by first adding: (1) the aggregate adjusted basis of the subsidiary's assets, but not the adjusted basis of its stock or securities in a group member; (2) any losses attributable to the subsidiary and carried to its first taxable year after the disposition; and (3) any deferred deductions (such as passive losses under I.R.C. section 469) of the subsidiary. The total amount is then reduced by the sum of: (1) value of the subsidiary's stock;

TL-N-2445-99

(2) liabilities of the subsidiary; and (3) any other relevant items. The amounts determined under this paragraph with respect to a subsidiary must include the subsidiary's allocable portion of corresponding amounts with respect to each of its lower-tiered subsidiaries.

Analysis

1. The Loss Disallowance Rules

Based on the facts we currently know, we see no reason to disagree with the taxpayer's loss disallowance calculation with respect to its purported positive investment adjustments of \$NN and duplicated losses of \$ZZ (See Tables 2, 4 and 5). We do not believe that Ultimate Parent correctly calculated the purported amounts claimed as extraordinary gain dispositions of \$LL.

According to Ultimate Parent, the positive investment adjustments of \$NN computed under Treas. Reg. section 1.1502-20(c)(1)(ii) and Treas. Reg. section 1.1502-20(c)(2)(ii) appear correct. We note that Ultimate Parent properly computed the positive investment adjustments with respect to that it did not net deficits in E&P for years after September, 13, 1991 with positive E&P. According to Ultimate Parent, the \$ZZ of duplicated losses was determined when Ultimate Parent disposed of the Target Parent stock with a fmv in the Target Parent stock lower than the asset basis (See Table 5).

Extraordinary Gain Dispositions- According to Ultimate Parent, the \$LL of extraordinary gain dispositions under Treas. Reg. section 1.1502-20(c)(1)(i) and Treas. Reg. section 1.1502-20(c)(2)(i) pertained to gains on the exchange of a note and the sale of IRC section 1231(b) property.

Ultimate Parent failed to include as extraordinary gain dispositions the \$W gain Target Parent had with respect to Target Parent's disposition of its Target Sub 2 stock. See Treas. Reg. section 1.1502-20(c)(2)(i)(A)(1) and IRC section 1221. Extraordinary gain dispositions therefore increased the amount of disallowed loss as recalculated in "Revised Table 2" and "Revised Table 3" below:

Revised Table 2

Limits to the Loss Disallowed under Treas. Reg. section 1.1502-20(c)

TL-N-2445-99

	<u>Per Ultimate Parent</u>	<u>Revised</u>
Extraordinary Gain Dispositions	\$LL	\$T
Positive Investment Adjustments	\$NN	\$NN
Duplicated Losses	<u>\$ZZ</u>	<u>\$ZZ</u>
Total	<u>\$HH</u>	<u>\$S</u>

Revised Table 3

Extraordinary Gain Dispositions under Treas. Reg. section 1.1502-20(c)(1)(i):

	<u>Per Ultimate Parent</u>	<u>Revised</u>
Target Sub 1		
Disposition of 1221 Asset (Target Sub 2 Stock)	\$EEE	\$W
Related to Exchange of Installment note for assets	\$QQ	\$QQ
Related to sale of 1231(b) Property	<u>\$UU</u>	<u>\$UU</u>
	\$MM	\$U
Target Sub 2		
Related to sale of 1231(b) Property	<u>\$BBB</u>	<u>\$BBB</u>
Total	<u>\$LL</u>	<u>\$T</u>

Our response is conditioned upon the assumption the Treas. Reg. section 1.1502-14 and Treas. Reg. section 1.1502-32 rules were followed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS**1. Anti-Avoidance Rules**

TL-N-2445-99

The second issue presented by District Counsel was whether the loss on the sale of the Target Parent stock is subject to the anti-avoidance rules of Treas. Reg. section 1.1502-20(e). We have not yet resolved this issue to determine whether the anti-avoidance rules do, or do not, apply to this transaction. We will contact you within the next three weeks with regard to this matter.

2. Valuation of Trademarks

[REDACTED]

[REDACTED]

3. Target Parent's Distribution of the Target Sub 2 stock to Ultimate Sub

Target Parent had a \$W of built in gain with respect to the Target Sub 2 stock when it contributed the \$EEE basis trademarks to Target Sub 2. When the Target Sub 2

[REDACTED]

TL-N-2445-99

stock was distributed by Target Sub 1 to Target Parent and from Target Parent to Ultimate Sub, it is our understanding of the facts that this distribution was not reflected under the loss disallowance rules.

[REDACTED]

5. Anti-Avoidance Rules with Respect to Treas. Reg. section 1.1502-13 as promulgated in T.D. 8597, 1995-2 C.B. 147

The transaction in the facts before us occurred prior to July 12, 1995 and therefore the Intercompany Transaction rules promulgated in TD 8597 under Treas Reg. section 1.1502-13 generally do not apply. Therefore, the former intercompany transaction rules under Treas. Reg. section 1.1502-14 apply with respect to the transaction.

We note that if the taxpayer has engaged in a transaction on or after April 8, 1994 with a principal purpose to avoid the Treas. Reg. section 1.1502-13 intercompany rules promulgated under T.D. 8597, appropriate adjustments may be made. See Treas. Reg. section 1.1502-13(l)(2), T.D. 8597, 1995-2 C.B. at 185. We have not

TL-N-2445-99

performed research with respect to whether the taxpayer is attempting to avoid Treas. Reg. 1.1502-13. If you have questions with regard to this point, we would encourage you to submit another request for field service advice.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Please call if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel

By: _____
ARTURO ESTRADA
Acting Branch Chief
(CC:DOM:FS:Corporate)
Associate Chief Counsel (Domestic)