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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LMSB
Attention: Mark H. Howard

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

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

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TL-N-5467-00

LEGEND

Parent =

Subsidiary 1 =

Subsidiary 2 =

State X =

Business A =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Date 1 =

Date 2 =

Date 3 =

a =

Country Y =

Individual A =

B =

C =

TL-N-5467-00

D =

E =

F =

G =

H =

I =

ISSUE

For purposes of the transitional netting rule under section 1.1502-20(c)(2)(v) (“transitional netting rule”), does the baseline for determining the net increase in the basis of a share of subsidiary stock include the subsequent purchases of additional stock and contributions to capital described below?

CONCLUSION

We agree with Examination’s conclusion that the baseline for determining the net increase in the basis of a share of subsidiary stock for purposes of the transitional netting rule should include the cost basis from the additional stock purchases but should not include the basis increases from the contributions to capital.

FACTS

Parent is a State X corporation engaged in Business A. Parent purchased all of the stock of Subsidiary 1 in Year 1 for \$B. In Years 2 and 4, Parent purchased additional stock of Subsidiary 1 for \$C and \$D, respectively. Parent also made capital contributions to Subsidiary 1 in Years 3, 5 and 6 in the amounts of \$E, \$F and \$G, respectively. On Date 1, Parent transferred a% (more than 20%) of Subsidiary 1 stock to Subsidiary 2, its wholly-owned Country Y subsidiary. This transfer caused the deconsolidation of Subsidiary 1 from the Parent group. At the time of the deconsolidation, Parent’s basis in Subsidiary 1 stock was \$H. On Date 2, Subsidiary 2 sold the stock it received to Subsidiary 1’s president, Individual A, for a nominal amount of cash and a contingent amount based on resolution of certain litigation that Subsidiary 1 was involved in.

In Year 7, Parent claimed a worthless deduction on the stock of Subsidiary 1 which the Examination Division is not challenging. Examination, however, takes the position that the worthless stock deduction is limited by the loss disallowance rules of section 1.1502-20, specifically the stock basis reduction rules of section 1.1502-20(b).

TL-N-5467-00

Examination has determined that the value of Subsidiary 1 stock at the time of deconsolidation was \$1, an amount much less than the basis in Subsidiary 1 stock at the time of deconsolidation.

LAW AND ANALYSIS

Section 1.1502-20(a) provides that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. Under section 1.1502-20(a)(2), disposition means any event in which gain or loss is recognized, in whole or in part. Section 1.1502-20(b) provides that if a member's basis in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. Section 1.1502-20(c) limits the amount of loss disallowed under section 1.1502-20(a) and the amount of basis reduction under section 1.1502-20(b)(1) to the sum of the following three items: (1) extraordinary gain dispositions; (2) positive investment adjustments; and (3) duplicated loss.

Extraordinary gains: Loss on the sale of a share of stock is disallowed to the extent of the share's allocable portion of any member's earnings and profits, net of directly related expenses (e.g. commissions, legal fees, state income taxes), attributed to actual or deemed gain dispositions occurring after November 18, 1990, of (1) capital assets; (2) I.R.C. § 1231(b) property (e.g., depreciable property or land used in a trade or business; (3) bulk sales of nondepreciable business assets, such as inventory, copyrights, or receivables used in the same trade or business; (4) sale of business assets described in I.R.C. § 1060(c); (5) any positive I.R.C. § 481 adjustments resulting from a change of accounting method, including a change attributable to pre-November 19, 1990 periods (e.g., recovery of LIFO reserve; (6) income from discharge of indebtedness (not excluded from basis under I.R.C. § 1503(e); and (7) any other event (or item) identified in revenue rulings and revenue procedures. Treas. Reg. § 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 I.R.C. § 1503(e), Treas. Reg. § 1.1502-32(g), and other applicable provisions. Treas. Reg. § 1.1502-20(c)(2)(iii).

Positive investment adjustments: Section 1.1502-20(c)(1)(ii) provides that positive investment adjustments are earnings and profits that result in adjustments with respect to the share under section 1.1502-32(b)(1)(i) and (c)(1) but only to the extent the amount of these earnings and profits for a taxable year exceeds the amount of extraordinary gain dispositions. Section 1.1502-20(c)(2)(ii) provides that for purposes of section 1.1502-20(c)(1)(ii), earnings and profits are treated as resulting in adjustments under section 1.1502-32(b)(1)(i) and (c)(1) with respect to a share if they would have resulted in such adjustments but for distributions with respect to stock. Thus, positive investment adjustments are the annual earnings and profits (before

TL-N-5467-00

distributions) (other than those covered by the extraordinary gain provisions), that result in positive basis adjustments under Treas. Reg. § 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. § 1503(e), Treas. Reg. § 1.1502-32(g), and other applicable provisions. 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.

Duplicated loss: The amount of duplicated loss apportioned to each share is the portion of the loss carryforwards and net built-in losses attributed to the share. Treas. Reg. § 1.1502-20(c)(2)(vi). This amount is determined immediately after a disposition 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 disposition; and (3) any deferred deductions (such as passive losses under I.R.C. § 469) of the subsidiary or its lower-tier subsidiaries. No provision is made for any deferred gains. The total amount is then reduced by the sum of (1) value of the subsidiary's stock; (2) liabilities of the subsidiary; and (3) any other relevant items.¹

Section 1.1502-20(c)(2)(v) provides a transitional netting rule for dispositions and deconsolidations occurring in taxable years ending on or before September 13, 1991. The transitional netting rule provides that the amount determined under section 1.1502-20(c)(1)(ii) (positive investment adjustments) may not exceed the net increase, if any, in the basis of the share from (1) the date the share was first acquired to (2) the end of the last taxable year ending on or before September 13, 1991 (or if earlier, the date of the disposition or deconsolidation).

The preamble to the loss disallowance rule regulations describes the background and purpose of the transitional netting rule as follows:

The Treasury Department and the Service continue to believe that netting of extraordinary gains and losses and of positive and negative adjustments between years should not be permitted. Allowing netting would facilitate planning to circumvent General Utilities repeal. Groups would be able to net built-in gains against post-acquisition losses without reduction in stock basis, and corporate level tax attributable to the built-in gains could be eliminated as a result of stock loss.

¹ Under Treas. Reg. § 1.1502-20(c)(2)(vi), the amounts determined under this paragraph with respect to a subsidiary include its allocable share of corresponding amounts with respect to all lower tier subsidiaries.

TL-N-5467-00

Although the final regulations do not permit netting of positive and negative adjustments for years ending after September 13, 1991, they do provide a transitional rule permitting certain netting of positive investment adjustments for years ending on or before that date as administrative relief. Netting is permitted for those years because they may include periods when subsidiaries were owned by a prior group or groups, and records of the investment adjustment histories of the subsidiaries may be difficult to obtain.

Under the transitional rule contained in section 1.1502-20(2)(v), the positive adjustment factor is limited, for all taxable years ending on or before September 13, 1991, to the net increase in the basis of a share from (i) the date the share was first acquired by the consolidated group to (ii) the end of any taxable year ending after December 31, 1986 and on or before September 13, 1991, whichever such year end produces the lowest net increase. Netting is not permitted for periods after the taxable year through which this netting rule is applied. For example, if using the net increase in the basis of a share as of the end of the group's taxable year ending December 31, 1988 produces the lowest increase, the group would, in applying section 1.1502-20(c)(1)(ii), not be permitted to offset the net positive adjustments and net negative adjustments arising in subsequent taxable years.

If the share is transferred basis property (within the meaning of section 7701(a)(43)) from a prior consolidated group, the net increase is measured from the date the share was first acquired by the prior group.

Under the transitional rule, positive and negative adjustments include dividends and capital contributions, and any other events affecting stock basis during the period the share is held by a member (or in the case of transferred basis property, a prior consolidated group). Because the purpose of the transitional netting rule is to reduce the difficulty of retroactively determining the source of basis adjustments, no distinction is made between those types of adjustments that taxpayers can identify and those they cannot. For example, deemed dividends elected under section 1.1502-32(f) are treated the same as actual dividends.

See T.D. 8364, 56 FR 47379-47402 (September 19, 1991).

In this case, the determination of subsidiary stock on deconsolidation is a three step process. First, the basis of the stock on the date of the deconsolidation, \$H, is reduced to its value on that date, \$I, under section 1.1502-20(b). Second, the amount of the basis reduction under section 1.1502-20(b) is limited to the sum of the extraordinary gain dispositions, positive investment adjustments, and duplicated losses under section 1.1502-20(c). You have informed us that the taxpayer does not have any extraordinary gain dispositions and duplicated losses but has some amount of

TL-N-5467-00

positive investment adjustments.² Third, the amount of positive investment adjustments determined under section 1.1502-20(c)(ii) is limited to the “net increase” in the basis of the share of deconsolidated subsidiary stock under the transitional netting rule.

The issue you have submitted to us concerning the transitional netting rule is whether or not the baseline for determining the “net increase” in the basis of the share of deconsolidated subsidiary stock includes the cost basis from the two subsequent purchases of additional subsidiary stock and the three contributions to capital to the subsidiary.

The taxpayer argues that the baseline for determining the “net increase” in the basis of the share of deconsolidated subsidiary stock should include the cost basis from the two additional stock purchases and the basis increases from the three capital contributions. Examination argues that the baseline for determining the “net increase” in the basis of the share of deconsolidated subsidiary stock should include the cost basis from the two additional stock purchases but not in basis increases from the three capital contributions. You argue that the baseline for determining the “net increase” in the basis of the share of deconsolidated subsidiary stock should include only the original cost basis and not the cost basis from the two additional stock purchases and the basis increases from the three contributions to capital. You argue that the two additional stock purchases should be treated the same as contributions to capital because Parent already owned 100% of the stock of Subsidiary 1 at the time of these additional stock purchases. Thus, in effect you conclude that the cost basis from the two additional stock purchases constitute a “net increase ... in the basis of the share from the date the share was first acquired by a member ... ”

As stated above, the purpose of the transitional netting rule is to provide administrative relief to taxpayers due to the difficulty of retroactively determining the source of basis adjustments. To achieve this purpose, the transitional netting rule provides no distinction between those types of adjustments that taxpayers can identify and those they cannot. The preamble specifically provides that the basis increases to preexisting subsidiary stock resulting from contributions to capital are among the positive adjustments that are netted with negative adjustments under the transitional netting rule. We, therefore, agree with your conclusion that the three contributions to capital made by Parent to Subsidiary 1 should not be included in the baseline for

² We note that neither the two additional stock purchases nor the three contributions to capital should be taken into account in the calculation of Parent’s positive investment adjustments in Subsidiary 1 stock under section 1.1502-20(c)(ii). Section 1.1502-20(c)(2)(ii) restricts the calculation of positive investment adjustments to the subsidiary’s E&P that results in adjustments with respect to the subsidiary share under section 1.1502-32(b)(1)(i) and (c)(1).

TL-N-5467-00

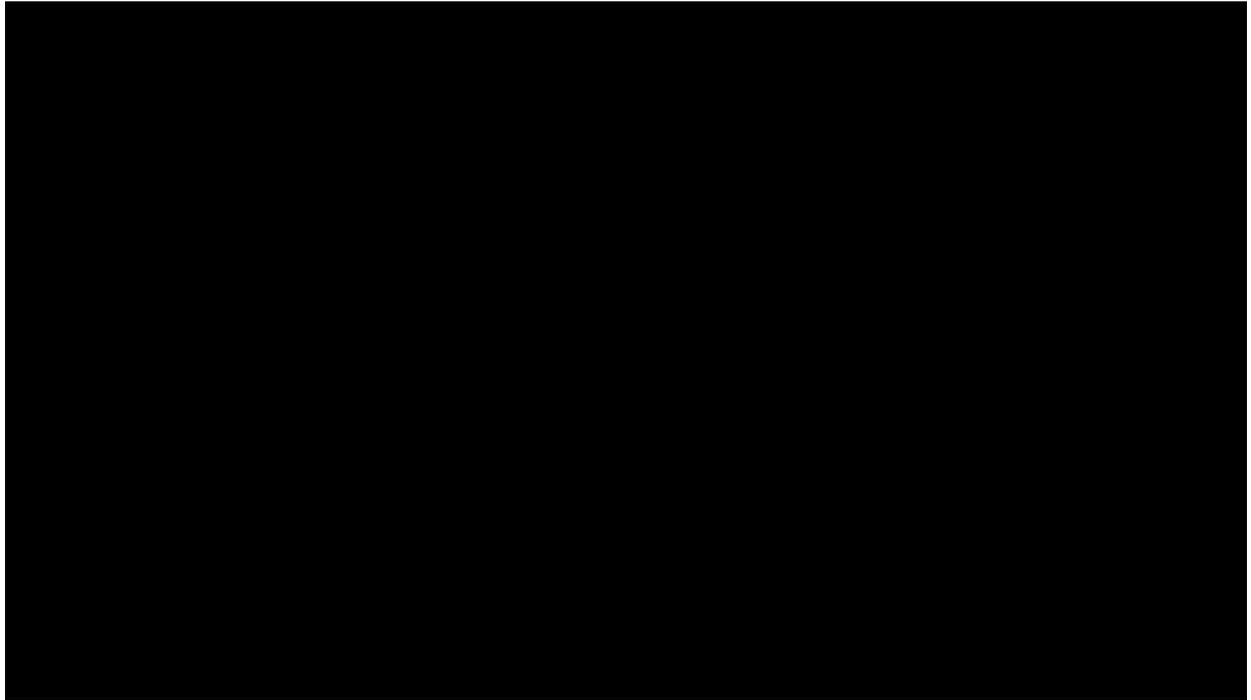
determining the “net increase” in the basis of the share of deconsolidated subsidiary stock.

However, the two additional stock purchases do not result in basis increases to the preexisting subsidiary stock, but only in a cost basis to the additional subsidiary stock acquired at that time. The transitional netting rule applies on a share by share basis to each share of subsidiary stock from when the share was first acquired to when the share is disposed of or deconsolidated. Consequently, we agree with Examination’s argument that the baseline for determining the “net increase” in the basis of the share of deconsolidated subsidiary stock should include the cost basis from the two additional stock purchases.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



TL-N-5467-00



Please call if you have any further questions.

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