



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
MEMORANDUM FOR DISTRICT COUNSEL

Attn: Attorney

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

SUBJECT: Consideration of Anti-avoidance Provisions

DISCLOSURE STATEMENT

This Chief Counsel Advice responds to your memorandum dated February 23, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

PCorp =
YCorp =
JVCorp =

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SCorp =

S2Corp =

ZProduct =

QCompany =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Date6 =

Date7 =

Date8 =

Date9 =

Date10 =

Date11 =

Date12 =

Date 13 =

Year1 =

Year2 =

Year3 =

Year4 =

#aa =

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#bb =

ISSUE

Whether any of the anti-avoidance rules of the consolidated return regulations should be applied with respect to the loss described below?

CONCLUSION

The record does not adequately support application of any of the anti-avoidance rules of the consolidated return regulations to the loss described below.

FACTS

The taxpayer is an affiliated group of corporations filing on a consolidated basis. The common parent of the consolidated group is PCorp.

PCorp became the common parent of the consolidated group through a series of acquisitions and mergers starting on Date1. The predecessor common parent was YCorp. References herein to the consolidated group prior to Date1 are to "the YCorp group."

On Date2, as a joint venture, YCorp and JVCorp incorporated SCorp. The purpose of SCorp is to develop and produce ZProduct. JVCorp is a customer of SCorp.

The Amended and Restated Certificate of Incorporation of SCorp, dated Date3, authorized SCorp to issue shares of class A and class B common stock. Voting power to elect 80% of the Board of Directors vested exclusively in the holders of the class A common stock. The voting power to elect the remaining directors vested in the class B common stock.

From Date4 through Date5, in return for capital contributions, SCorp issued a total of #aa shares of class A common stock to a member of the YCorp group, S2Corp. Also from Date4 through Date5, in return for capital contributions, SCorp issued a total of #bb shares of class B common stock to JVCorp. The voting control enabled SCorp to be a member of the YCorp group.

By amendment dated Date6, the SCorp project agreement was amended to provide that preferred stock would be issued in return for future capital contributions. The Certificate of Incorporation for SCorp was accordingly amended and restated on Date7, resulting in a recapitalization. As a result of the foregoing, the two classes of the SCorp common stock were converted into one class of common stock and one class of preferred stock (as described in section 1504(a)(4) of the Internal Revenue Code).

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As a result of the SCorp stock conversion/recapitalization in Date5, S2Corp held 80.33% of the SCorp common stock, while JVCorp held 19.67% of the SCorp common stock and all of the SCorp preferred stock. SCorp remained a member of the YCorp group after the recapitalization.

Beginning in Year1, SCorp issued preferred stock in return for capital contributions. A table prepared by the taxpayer indicates that the last block of preferred stock in question was issued on Date8, in return for contributions made from Date9 through Date10. As of Date11, PCorp owned 80.33% of the SCorp common stock and JVCorp owned the remaining 19.67%. PCorp owned 47.65% of the preferred stock and JVCorp owned 52.35%. SCorp was a first tier subsidiary of PCorp.

During the taxable years Year2 through Year3, SCorp incurred operating losses that were fully absorbed and reported on the returns of the consolidated group. Pursuant to the investment adjustment rules of Treas. Reg. section 1.1502-32, the SCorp losses resulted in a reduction of the basis of the SCorp common stock held by PCorp. By the end of Year4, PCorp had an excess loss account (ELA) (or the equivalent of negative basis) with respect to its SCorp common stock.

PCorp sold two businesses during the Year4 taxable year and recognized a long-term capital gain therefrom. In order to offset this long-term capital gain, PCorp offered to sell its SCorp preferred stock to JVCorp. For purposes of the stock sale to JVCorp, PCorp performed a financial analysis of SCorp to determine SCorp's future profitability. According to the taxpayer, QCompany analyzed spreadsheets prepared by PCorp and arrived at a fair market value for the SCorp preferred stock owned by PCorp of an amount less than the issue price.

On Date12, PCorp entered into a stock purchase agreement with JVCorp to sell all of its SCorp preferred stock to JVCorp. The stock purchase agreement between JVCorp and PCorp for the SCorp preferred stock did not alter the rights and privileges attached to the preferred stock so as to impact the 80% ownership test.

PCorp recognized a long-term capital loss on the sale of its SCorp preferred stock. At the time PCorp sold the preferred stock, no "extraordinary gains" or "duplicated losses" existed. Pursuant to Treas. Reg. section 1.1502-20(c)(1), PCorp reduced the loss to account for positive investment adjustments. PCorp filed a statement pursuant to Treas. Reg. section 1.1502-20(c)(3).

LAW AND ANALYSIS

I. Law.

The final consolidated return regulations as amended by T.D. 8560, 1994-2 C.B. 200, added anti-avoidance provisions. References herein to "the proposed

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consolidated return regulations” are to the proposed regulations to which the final regulations under T.D. 8560 relate. See Notice of Proposed Rulemaking, 1992-2 C.B. 627 [CO-30-92, 1992-48 I.R.B. 27 (November 12, 1992)]. Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the year at issue.

The principal operative consolidated return regulations in the instant case are sections 1.1502-32 (Investment adjustments), 1.1502-19 (Excess loss accounts), and 1.1502-20 (Loss disallowance).¹

The Investment Adjustments Rules

Treas. Reg. section 1.1502-32 in general provides rules for adjusting the basis of the stock of a subsidiary (S) owned by another member (P). Treas. Reg. § 1.1502-32(a)(1). The purpose of the adjustments is to treat P and S as a single entity so that consolidated taxable income reflects the group’s income. Id.

Adjustments under Treas. Reg. section 1.1502-32 are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. Treas. Reg. § 1.1502-32(b)(1).

P’s basis in S’s stock is increased by positive adjustments and decreased by negative adjustments. Treas. Reg. § 1.1502-32(b)(2). Negative adjustments may exceed P’s basis in S’s stock. Treas. Reg. § 1.1502-32(a)(3)(ii). The resulting negative amount is P’s excess loss account (ELA) in S’s stock. Id. The amount of the adjustment, determined as of the time of the adjustment, is the net amount of S’s (i) taxable income or loss, (ii) tax-exempt income, (iii) noncapital, nondeductible expenses, and (iv) distributions. Treas. Reg. § 1.1502-32(b)(2).

In general, the portion of the adjustment pertaining to negative adjustments for distributions is allocated to the shares of S’s stock to which the distribution relates. Treas. Reg. § 1.1502-32(c)(1). The remainder of the adjustment (adjustments for taxable income or loss, tax-exempt income, and noncapital, nondeductible expenses) is allocated among the shares of S’s stock. Id. If the remainder of the adjustment is positive, it is allocated first to any preferred stock to the extent provided in section 1.1502-32(c)(3), and then to the common stock as provided in

¹ As amended by T.D. 8560, 1994-2 C.B. 200, in general Treas. Reg. sections 1.1502-32 and 1.1502-19 are applicable with respect to consolidated return years beginning on or after January 1, 1995. Treas. Reg. §§ 1.1502-32(h)(1), 1.1502-19(h)(1). Treas. Reg. section 1.1502-20 is applicable with respect to dispositions and deconsolidations on or after February 1, 1991. Treas. Reg. § 1.1502-20(h)(1).

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section 1.1502-32(c)(2). Id. If the remainder of the adjustment is negative, it is allocated only to common stock as provided in section 1.1502-32(c)(2). Id.

Treas. Reg. section 1.1502-32(d)(2) defines “preferred stock” for purposes of the section as stock that is limited and preferred as to dividends and has a liquidation preference. A class of stock that is not described in section 1504(a)(4), however, is not treated as preferred stock for purposes of Treas. Reg. section 1.1502-32(c) if members own less than 80% of each class of common stock (determined without taking Treas. Reg. section 1.1502-32(d)(2) into account).² Treas. Reg. § 1.1502-32(d)(2).

The anti-avoidance rule of Treas. Reg. section 1.1502-32(e) provides that if any person acts with a principal purpose contrary to the purposes of the section, to avoid the effect of the rules of the section or apply the rules of the section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of the section. Treas. Reg. section 1.1502-32(e)(1).

The Excess Loss Account Rules

Treas. Reg. section 1.1502-19 in general provides rules for a member (P) to include in income its ELA in the stock of another member (S). Treas. Reg. § 1.1502-19(a)(1). The purpose of the ELA is to recapture in consolidated taxable income P’s negative adjustments with respect to S’s stock (e.g., under Treas. Reg. § 1.1502-32 from S’s deductions, losses, and distributions), to the extent the negative adjustments exceed P’s basis in the stock. Id. P’s ELA is treated for all Federal income tax purposes as basis that is a negative amount. Treas. Reg. § 1.1502-19(a)(2)(ii).

In general, if P is treated under Treas. Reg. section 1.1502-19 as “disposing” of a share of S’s stock, P takes into account its ELA in the share as income or gain from the disposition. Treas. Reg. § 1.1502-19(b). For purposes of Treas. Reg. section 1.1502-19 in general, P is treated as disposing of a share of S’s stock upon the occurrence of one of three events: (1) P transfers or otherwise ceases to own the share for Federal income tax purposes, or P takes into account gain or loss (in

² In general, under section 1504(a)(4) the term “stock” does not include any stock which is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption premium or liquidation premium), and is not convertible into another class of stock.

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whole or in part) with respect to the share; (2) P or S deconsolidates; or (3) S becomes worthless. Treas. Reg. § 1.1502-19(c)(1).

The anti-avoidance rule of Treas. Reg. section 1.1502-19 provides that if any person acts with a principal purpose contrary to the purposes of the section, to avoid the effect of the rules of the section or apply the rules of the section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of the section. Treas. Reg. § 1.1502-19(e).

The Loss Disallowance Rule

The loss disallowance rule (LDR) of Treas. Reg. section 1.1502-20 generally provides that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. Treas. Reg. § 1.1502-20(a)(1). The term “disposition” is defined under Treas. Reg. section 1.1502-20(a)(2) as any event in which gain or loss is recognized, in whole or in part. Treas. Reg. section 1.1502-20(c)(1) provides in general that the amount of loss disallowed under Treas. Reg. section 1.1502-20(a)(1) with respect to a share of stock shall not exceed the sum of the following amounts: (i) Extraordinary gain dispositions; (ii) positive investment adjustments; and (iii) duplicated loss.

The anti-avoidance rule of Treas. Reg. section 1.1502-20 provides that the rules of section 1.1502-20 must be applied in a manner that is consistent with and reasonably carries out their purposes, and that if a taxpayer acts with a view to avoid the effect of the rules of section 1.1502-20, adjustments must be made as necessary to carry out their purposes. Treas. Reg. §1.1502-20(e)(1).

II. Analysis.

In reviewing the propriety of the loss claimed on the sale of the preferred stock, you have asked whether any of the anti-avoidance rules may apply given the following assumptions: (1) All of the S Corp common stock is section 1504(a)(2) “stock,” and all of the S Corp preferred stock is section 1504(a)(4) preferred stock (and therefore

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is not section 1504(a)(2) “stock”;³ (2) S Corp has properly been a member of the consolidated group for all relevant years up to and including Year3; (3) P Corp accurately computed its ELA in the S Corp common stock; and (4) P Corp properly limited its loss on the sale of the S Corp preferred stock pursuant to Treas. Reg. section 1.1502-20(c)(1).

The loss on the sale of the preferred stock follows from the above assumptions and the general operation of the investment adjustment rules of Treas. Reg. section 1.1502-32 (both prior to and after amendment by T.D. 8560).⁴ Hence, we have considered the anti-avoidance provision of Treas. Reg. section 1.1502-32(e), discussed infra.

We also have considered the anti-avoidance provisions of Treas. Reg. sections 1.1502-19(e) and 1.1502-20(e). However, the record does not adequately reflect that the taxpayer “acted” (as of yet) to avoid having to take into income the ELA associated with the common stock, or otherwise avoid application of Treas. Reg. section 1.1502-19. Given the assumptions that the taxpayer properly accounted for positive investment adjustments and that there was no duplicated loss or extraordinary gain, there is no indication that the taxpayer acted to avoid application of Treas. Reg. section 1.1502-20. Therefore, the focus of our discussion is on Treas. Reg. section 1.1502-32(e).

Treas. Reg. section 1.1502-32(e)(2) provides five examples illustrating the principles of the anti-avoidance rule of paragraph (e). They are: (1) Preferred stock treated as common stock; (2) contribution of appreciated property; (3)

³ Only corporations belonging to an “affiliated group” may file a consolidated return. § 1501. Generally stated, an “affiliated group” is a chain of corporations in which a common parent owns directly stock possessing at least 80 percent of the voting power and 80 percent of the value of all classes of stock. § 1504(a)(1) and (2). However, for purposes of determining affiliation under section 1504, the term “stock” does not include any stock which is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption premium or liquidation premium), and is not convertible into another class of stock. § 1504(a)(4).

⁴ Prior to amendment by T.D. 8560, Treas. Reg. section 1.1502-32(c)(2) provided in relevant part that the “negative adjustment with respect to a share of stock which is limited and preferred as to dividends shall be the amount of the distributions made by the subsidiary during the taxable year with respect to such share out of earnings and profits of the subsidiary * * *.” See also Treas. Reg. section 1.1502-32(b) prior to amendment by T.D. 8560.

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reorganizations; (4) post-deconsolidation basis adjustments; and (5) pre-consolidation basis adjustments. The facts of the instant case are somewhat analogous to the first example, which provides as follows:

Example 1. Preferred stock treated as common stock. (a) Facts. S has 100 shares of common stock and 100 shares of preferred stock described in section 1504(a)(4). P owns 80 shares of S's common stock and all of S's preferred stock. The shareholders expect that S will have negative adjustments under paragraph (b) of this section for Years 1 and 2 (all of which will be allocable to S's common stock), the negative adjustments will have no significant effect on the value of S's stock, and S will have offsetting positive adjustments thereafter. When the preferred stock was issued, P intended to cause S to recapitalize the preferred stock into additional common stock at the end of Year 2 in a transaction described in section 368(a)(1)(E). P's temporary ownership of the preferred stock is with a principal purpose to limit P's basis reductions under paragraph (b) of this section to 80% of the anticipated negative adjustments. The recapitalization is intended to cause significantly more than 80% of the anticipated positive adjustments to increase P's basis in S's stock because of P's increased ownership of S's common stock immediately after the recapitalization.

(b) Analysis. S has established a transitory capital structure with a principal purpose to enhance P's basis in S's stock under this section. Under paragraph (e)(1) of this section, all of S's common and preferred stock is treated as a single class of common stock in Years 1 and 2 for purposes of this section. Thus, S's items are allocated under the principles of paragraph (c)(2)(ii) of this section, and P decreases its basis in both the common and preferred stock accordingly.

Like the example, the capital structure here contributed to the loss in issue. Specifically, the operating losses utilized by the group were funded by purchases of preferred stock, but negative basis adjustments (and any resulting ELA) for utilization of those losses applied exclusively to the common stock. This effectively preserved the basis in the preferred stock and "enabled" the loss in issue.

Unlike the example, however, it is difficult to characterize the capital structure here as "transitory." Further, arguably the purchases of the preferred stock (made from Year1 through Date13)--and not the sale of the preferred stock in Year4--constitute the "act" referred to in paragraph (e)(1). Consequently, the focus of the inquiry under Treas. Reg. section 1.1502-32(e) could be on acts committed a considerable number of years prior to the examination period and prior to promulgation of the final consolidated return regulations. This would make fact-gathering particularly difficult, as well as complicate the issue of the taxpayer's intent because the acts occurred while different rules were in effect.

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Moreover, note that the loss at issue remains subject to potential recapture in the form of the ELA in the common stock. Positive basis adjustments will be made to the ELA in the common stock as S Corp earns sufficient taxable income. Treas. Reg. § 1.1502-32(b)(2). Also, the ELA in the S Corp common stock may be triggered all at once by a disposition of the stock, including a deconsolidation of either P Corp or S Corp, or a determination of worthlessness of S Corp. Treas. Reg. § 1.1502-19(b) and (c).

In view of the foregoing, we do not recommend consideration be given to Treas. Reg. section 1.1502-32(e). However, should the taxpayer attempt to avoid the ELA in the common stock, at that time consideration should be given to the anti-avoidance rule under Treas. Reg. section 1.1502-19(e).

Finally, as an aside to this discussion (and for future reference), note that in appropriate cases consideration may be given to arguments such as whether the preferred stock qualifies as, or is to be respected as, preferred stock for purposes of the consolidated return regulations in general, or whether S Corp properly has been a member of the affiliated group within the meaning of section 1504(a). See Alumax Inc. v. Commissioner, 165 F.3d 822 (11th Cir. 1999), aff'g 109 T.C. 133 (1997).

CASE DEVELOPMENT



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Please call if you have any further questions.

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