INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Chief, Appeals Office

Taxpayer's Name:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer	=
Parent	=
Sub 1	=
Sub 2	=
Sub 3	=
Sub 4A	=
Sub 4B	=
Sub 4C	=
Country A	=
State B	=
Date 1	=
Date 2	=
Date 3	=

Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Fiscal Year 1	=
Fiscal Year 2	=
c	=
d	=
e	=
f	=
g	=
h	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=

ISSUE:

In the application of §1.337(d)-2(c) of the Income Tax Regulations, is any of Taxpayer's claimed loss "attributable" to the recognition of built-in gain on asset dispositions?

CONCLUSION:

No. Therefore, Taxpayer's deduction for a loss on the sale of the Sub 3 stock in the amount of $g on its consolidated return for Fiscal Year 2 is not disallowed by §1.337(d)-2(c)(2).

FACTS:

For Fiscal Year 2, Taxpayer was the common parent of an affiliated group of corporations filing consolidated Federal income tax returns. Taxpayer was formed on Date 6 as a wholly owned subsidiary of Parent, a Country A corporation. Through a series of transactions,[1] Sub 3 came to be a wholly owned subsidiary of Taxpayer on Date 7.

At the time, Sub 3 owned both assets and stock of subsidiaries. Sub 3 held, in part, the stock of three wholly owned subsidiaries: Sub 4A (c percent of the stock of which was acquired on Date 1 and d percent on Date 3, adding to 100 percent); Sub 4B (which was acquired in a taxable stock purchase on Date 5), and Sub 4C (which was formed in Fiscal Year 1). During the time that Sub 3 owned these subsidiaries, Sub 4A sold built-in gain assets for a gain of $k, Sub 4B sold built-in gain assets for a gain of $l, and two subsidiaries of Sub 4C sold built-in gain assets for a gain of $m.

Sub 3 sold the stock of Sub 4A for a gain of $n on Date 8 and the stock of Sub 4B for a gain of $o and Sub 4C for a gain of $p on Date 9.

On Date 10, which is in Fiscal Year 2, Taxpayer sold all of the stock of Sub 3 for $e to unrelated purchasers. Taxpayer's basis for the Sub 3 stock was claimed to be $f, and Taxpayer deducted a loss of $g on its consolidated return for Fiscal Year 2. The

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[1] Originally, Parent also had a wholly owned subsidiary, Sub 1, a Country A corporation. Sub 1, in turn, owned all of the stock of Sub 2, a Country A corporation. On Date 1, Sub 2 formed Sub 3, a wholly owned State B corporation. On Date 2, Sub 1 transferred the stock of Sub 2 to Parent. On Date 4, Sub 2 sold all of the stock of Sub 3 to Sub 1 in a transaction submitted by the taxpayer as being described in §304 of the Internal Revenue Code. On Date 7, Sub 1 transferred all of the stock of Sub 3 to Taxpayer solely in exchange for voting stock of the Taxpayer in a transfer submitted as being described as a reorganization under §368(a)(1)(B).

tax basis of the Sub 3 stock, $f, included a total of $h of built-in gains on asset sales by Sub 3's subsidiaries ($k + $l + $m)and Sub 3's sales of the subsidiaries' stock ($n + $o + $p). Taxpayer did not reduce the loss by the amount of the built-in gain recognition. The Appeals Officer suggests that only $q (i.e., $g - ($k + $l + $m)) of such loss is allowable under §1.337(d)-2.

LAW AND ANALYSIS:

In 1991, final regulations under §§1502 and 337(d) were adopted to limit the loss recognized by a consolidated group that disposes of the stock of a subsidiary corporation. T.D. 8364, 1991-2 C.B. 43, 56 F.R. 47379 (September 19, 1991). The parties to this Technical Advice Memorandum state that the rules of §1.337(d)-2 apply to this transaction since the disposition of stock at issue, Taxpayer's sale of the stock of Sub 3, occurred on Date 10, which is within the window period. We agree.

Section 1.337(d)-2(a) provides the general rule 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.[2] However, §1.337(d)-2(c) provides that, if the group's entire equity interest in the subsidiary is disposed of before February 1, 1991 (the effective date of §1.1502-20) to an unrelated party and a separate statement is filed in accordance with §1.337(d)-2(c)(3), then, generally, the loss is not disallowed "to the extent the taxpayer establishes that the loss ... is not attributable to the recognition of built-in gain on the disposition of an asset (including stock and securities)."[3]

Examples are provided in the regulations,[4] but none of these examples address situations like Taxpayer's in this case in which there is an intervening sale of a second-tier subsidiary at a gain between the recognition of gain on built-in gain assets by that

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[2] Section 1.337(d)-2(a)(2)(ii) defines a "disposition" as any event in which gain or loss is recognized, in whole or part (e.g., a sale).

[3] Built-in gain is defined by reference to the appreciation of an asset that is reflected, before the disposition of an asset, in the basis of the corporation's stock, directly or indirectly, after applying §1503(e) and other applicable provisions of the Code and regulations. Accordingly, appreciation arising in separate return years is not treated as built-in gain unless it is reflected in stock basis before the disposition of the asset.

[4] Section 1.337(d)-2(c)(4) provides an example of the operation of the allowable loss rule of §1.337(d)-2(c)(2). In addition, the principles of paragraphs (a), (b), and (c) of §1.337(d)-2 are illustrated by the examples in §1.337(d)-1(a), §1.1502-20(a) (except examples 3, 4, and 5, which illustrate concepts only operative under the loss disallowance rules of §1.1502-20(a)), and §1.1502-20(b).

second-tier subsidiary and the sale of the stock of the first-tier subsidiary at a loss. Thus, we must rely on the underlying concepts and policies of the transitional loss disallowance rules to fashion an answer to Taxpayer's situation.

The loss disallowance rules were designed, in part, to disallow the noneconomic loss on the sale of stock that results when the basis of that stock has been increased by positive basis adjustments without a corresponding economic foundation. Non-economic losses typically arise when a purchaser (P) acquires a subsidiary (S) in a taxable transaction and, at the time of the acquisition, S holds assets with unrealized built-in gains. On acquisition, P's basis in S will be its cost, reflecting the full fair market value of S's assets. When S disposes of the built-in gain assets, under the investment adjustment rules of §1.1502-32, P's basis in S stock will be increased by the amount of gain recognized. If it were property that appreciated while in the group, the basis adjustment to reflect the recognized gain would be necessary to prevent the group from being taxed twice on the same gain (i.e., once by the member as gain on the asset and again by the group as gain on the member stock). But, in the case of built-in gain, the basis adjustment for the recognized gain is not necessary (because P's basis in S stock already reflects the full fair market value of S's assets) nor appropriate (the basis adjustment would inflate the stock basis above its value). If the adjustment were made and P then were to sell the S stock, P would recognize a loss because its basis in the S stock would be inflated above its value, offsetting the gain recognized on the asset and resulting in the elimination of the corporate level of tax on the built-in appreciation of the asset.

Examples 1 and 2 of §1.1502-20(a)(5) (which are illustrative of the rules in §1.337(d)-2 as well) elucidate the basic concepts. In Example 1, P buys all of the stock of T for $100, and T becomes a member of the P group. T has an asset with a basis of $0 and a value of $100. T sells the asset for $100. Under the investment adjustment rules of §1.1502-32, P's basis in the T stock increases to $200, even though T is still economically worth only $100 (a $100 asset has been converted into $100 of cash through the sale of that asset).[5] Five years later, P sells all of the T stock for $100 and recognizes a loss of $100. Under §1.1502-20(a)(1), no deduction is allowed to P for the $100 loss because T's economic worth is still $100, and P should not recognize gain or loss on the sale of T for $100. The same result follows under §1.337(d)-2.

In Example 2, P buys all of the stock of T for $100, and T becomes a member of P's group. T has a built-in gain asset worth $100 but with a basis of $0. T sells this asset for $100. Under the investment adjustment rules of §1.1502-32, P's basis in the T stock increases to $200. T invests the $100 of cash proceeds from the sale of the asset in another asset, which appreciates in value to $180. Five years after the sale of

[5] All tax effects of recognized gains are being ignored in these examples to simplify the calculations.

the asset, P sells the stock of T for $180 and recognizes a loss of $20. Under §1.1502-20(a)(1), no deduction is allowed to P for the $20 loss. The same result follows under §1.337(d)-2.

In fact, had T not sold the built-in gain asset, the asset had appreciated to $180, and P had sold T for $180, P would have recognized $80 of gain on the sale of the T stock. Assume, instead, that T sold the asset for $100 (so that P's basis increased to $200) and invested the proceeds in another asset that appreciated to $220. If P sold T for $220, P would have a gain of $20, and the loss disallowance rules would not be applicable. Thus, even though it could be argued that P should have recognized $120 of gain in the above example, there are no rules to restore otherwise-reduced gains; there are only rules to disallow non-economic losses.

This illustrates a fundamental principle of the regulations, i.e., unrecognized post-acquisition appreciation can substitute for built-in gains.[6] As a result of such substitution, the corresponding basis adjustments in the corporation's stock do not produce the "phantom" losses on the sale of that subsidiary corporation that the transitional loss disallowance rule is intended to address because such stock basis adjustments do not create, or contribute to, an overall loss on the sale. See Example 5 and discussion in the preamble to T.D. 8294, 1990-1 C.B. 67, 70, 55 F.R. 9426 (March 14, 1990). As a result, the loss experienced on the sale of subsidiary stock is not treated as attributable to built-in gain because it reflects a change in the real value of the subsidiary.[7]

Thus, in this case, Sub 4A had built-in gain assets, which it sold for a gain of $k. Sub 3 then sold Sub 4A on Date 8. However, Sub 3 did not sell Sub 4A at a loss, which would have triggered the loss disallowance rules and treated $k of Sub 3's loss as disallowed loss because it was attributable to recognized built-in gain. Instead, Sub 3 sold Sub 4A at a gain of $n. Although Sub 3's gain might have been larger had Sub 4A not sold the built-in gain assets, the loss disallowance rules do not address reduced gains, only losses. Thus, when Taxpayer sells Sub 3, the tiered-up basis originally attributable to Sub 4A's built-in gain items now reflects reduced gain when coupled with the positive basis adjustment ($n) made when Sub 3 sold Sub 4A. The fact that

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[6] This principle represents an important compromise that was made in the loss disallowance rules in adopting a formula-based approach and allowing substitution in light of the decision to prohibit tracing. The limited tracing available under §1.337(d)-1 and -2 were transitional rules adopted to mitigate the effects of the introduction of the loss disallowance rules.

[7] As the preamble discussion indicates, "this aspect of the rule will in many cases permit the parent to shelter post-acquisition appreciation in stock of an acquired subsidiary." Preamble to T.D. 8294, 1990-1 C.B. 67, 70.

Taxpayer sold Sub 3 at a loss is no longer attributable to the built-in gain in the assets sold by Sub 4A but to unrealized losses in other Sub 3 assets.

In an effort to more clearly explain the operation of the transition rules to a situation like the present one, we have designed the following example to illustrate facts similar to those of Taxpayer in this case:

P forms S with $75 in cash and, thus, owns all of the stock of S with an original basis of $75. S purchases all of the stock of three corporations, X, T, and Y, each at a price of $25. T owns three assets, Asset 1, Asset 2, and Asset 3. Asset 1 has a basis of 0 and a fair market value of $5; Asset 2 has a basis of 0 and a fair market value of $15; and Asset 3 has a basis of $5 and a fair market value of $5. Thus, Asset 1 and Asset 2 are built-in gain assets.

In Scenario A, T decides to sell its two built-in gain assets at their fair market values. T, thus, recognizes $5 of gain on the sale of Asset 1 and $15 of gain on Asset 2. As a result of this recognition, S increases its basis in the T stock by $20 under §1.1502-32, for a total basis at this point of $45. In turn, P increases its basis in the S stock by $20 for a total basis of $95. At this point, T has $20 in cash (from the sales of Asset 1 and Asset 2) and Asset 3.

Asset 3 appreciates in value to $50. T is now worth $70 (the $20 in cash and Asset 3's fair market value of $50). S decides to sell the stock of T for $70 and recognizes a $25 gain ($70 less its adjusted basis of $45). P positively adjusts its basis in S stock by the $25 gain, for a total basis of $120.

S is worth $120 (X’s value of $25, Y’s value of $25 and $70 in cash from the sale of T). Then, the fair market value of X depreciates to $15. Thus, S is now worth $110. P sells S for $110. Since P had a basis of $120 in its S stock, P has a loss of $10 on the sale of S.

In Scenario B, T does not sell its two built-in gain assets. Asset 3 appreciates in value to $50. T, thus, is worth $70 (Asset 1's value is $5, Asset 2's value is $15, and Asset 3's value is $50). S sells the stock of T for $70 and recognizes a gain of $45 ($70 less its basis in the T stock of $25). As a result, P positively adjusts its basis in the S stock by $45, for a total basis of $120 (its original basis of $75 plus $45).

S is worth $120 (X’s value of $25, Y’s value of $25 and $70 in cash from the sale of T). Then, the fair market value of X depreciates to $15. Thus, S is now worth $110. P sells S for $110. Since P had a basis of $120 in its S stock, P has a loss of $10 on the sale of S.

The issue is what portion, if any, of P’s $10 loss on the sale of S stock is disallowed under the transitional rule of §1.337(d)-2. There are two aspects of the transitional rule that affect the answer: substitution and tracing (in the limited form allowed under §1.337(d)-2).

The first, substitution, relates to the built-in gain assets themselves. In the example, T has two built-in gain assets and one asset that appreciates after acquisition. Even though S's gain upon the sale of the T stock in Scenario A is less than in Scenario B due to the sale of the built-in gain assets, which caused the positive adjustments in S's basis in T, the transitional *loss* disallowance rules do not capture reduced gain. In fact, the transitional rules go further to allow for substitution of the nature of the gain in the sense that S's ability to sell T at a gain due to an appreciated asset removes the "taint" of the nature of the positive basis adjustments attributable to T's sale of the built-in gain assets that tiered up to S and P. That is to say, P's basis in its S stock would have been $120, whether or not T had sold the built-in gain assets (i.e., either $75 original basis plus $20 for the sale of the built-in gain assets plus $25 on S's sale of T, or $75 plus $45 on S's sale of T stock) due to the after-acquisition appreciation of another one of T's assets. Thus, as taxpayer has established, the loss experienced on P's sale of S is not attributable to the recognition of built-in gain on T's disposition of assets due to the cleansing result of the substitution of after-acquisition appreciation in assets.

The second aspect, the limited tracing allowed under the transitional rules, also operates herein to allow taxpayer to avoid disallowance of loss on the sale of S stock. In the scenarios above, P is able to establish that it would have a $10 loss on the sale of S stock, whether or not T sold its built-in gain assets, due to the depreciation of X. Thus, through tracing, P is able to demonstrate that the loss is not attributable to the recognition of built-in gain on the disposition of assets. Thus, coupled together, post-acquisition appreciation can be substituted for built-in gain items, and the regulations allow for the tracing of these items to determine if real losses have been experienced on the sale of a subsidiary.

In this case, by tracing the basis adjustments that tiered up to Taxpayer, the substitution principle demonstrates that the adjustments that were made did not inflate Taxpayer's basis in the stock of Sub 3 above its true value, or in other words, did not reflect amounts that were already reflected in the basis. Therefore, Taxpayer's deduction for a loss on the sale of the Sub 3 stock, in the amount of $g, on its consolidated return for Fiscal Year 2 is not disallowed.

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.