



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

OFFICE OF  
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR  
SPECIAL LITIGATION ASSISTANT

FROM: Edward S. Cohen  
Branch Chief CC:CORP:B02

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated August 16, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent	=
Sub	=
Year 1	=
Date 1	=

ISSUES

Whether, for purposes of Treas. Reg. § 1.1502-32, a parent corporation increases its basis in a subsidiary's stock by the amount of the subsidiary's "Fresh Start" adjustment?

CONCLUSIONS

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A parent corporation does increase its basis in a subsidiary's stock, under Treas. Reg. § 1.1502-32, by the amount of the subsidiary's "Fresh Start" adjustment.

## FACTS

Parent was formed in Year 1 and became the common parent of a consolidated group that included Sub. On Date 1, Parent sold all of Sub's stock. At the time, Sub owned a number of corporations that were property and casualty insurance companies that were subject to the "Fresh Start" provisions of the Tax Reform Act of 1986. In determining its gain or loss on the sale of the Sub stock, Parent increased its stock basis in Sub by an amount equal to the subsidiaries' 1986 "Fresh Start" adjustment.

## LAW AND ANALYSIS

Property and casualty insurance companies are allowed a deduction for "losses incurred" during the taxable year. I.R.C. § 832(c)(4). Prior to 1986, "losses incurred" was defined so as to allow a property and casualty company to deduct the full amount of the estimated loss in the year the loss occurred, even though the claim might not be paid for several years. Former I.R.C. § 832(b)(5).

Congress determined that the effect of this provision was to give an unwarranted benefit to property and casualty companies for it failed to take into account the time value of money in determining the permissible deduction. See S. Rep. No. 313, 99<sup>th</sup> Cong., 2d Sess. 499-500 (1986). To remedy the situation, Congress enacted I.R.C. § 846 as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, section 1023(c), 1986-3 (Vol. 1) C.B. 321-22. Section 846 requires unpaid losses to be discounted to present value when claimed as a deduction. As part of the same legislation, Congress amended § 832(b)(5)(A) to provide that the deduction for "losses incurred" is computed by adding to losses paid "all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year" and deduct therefrom "all discounted unpaid losses outstanding at the end of the preceding taxable year."

To implement the new accounting provisions, Congress provided transitional rules. The first rule provided that in computing the 1987 deduction for losses incurred, the 1986 year-end reserve would be discounted just as the 1987 year-end is discounted under new I.R.C. § 846. The second rule provided that in lieu of requiring the corporation to make a positive § 481 adjustment as a result of discounting the 1986 year-end reserve under the first rule, Congress forgave that income (the difference between the discounted and un-discounted 1986 year-end

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reserve). Specifically, Congress provided that the forgiven amount “shall not be taken into account for purposes of the Internal Revenue Code of 1986.” However, Congress provided that the corporation shall increase its earnings and profits by the forgiveness amount.

The issue in this case is whether the forgiveness of the “Fresh Start” amount resulted in a basis increase under the applicable consolidated return regulations. Treas. Reg. § 1.1502-32(h) provides that this section applies with respect to determinations of the basis of the stock of a subsidiary in consolidated return years beginning on or after January 1, 1995. If this section applies, basis must be determined or redetermined as if this section were in effect for all years. Therefore, since Parent sold the Sub stock after January 1, 1995, Parent determines its basis in the Sub stock, including whether the basis is increased because of the “Fresh Start” adjustment, under the regulations effective after January 1, 1995 even though the “Fresh Start” was effective in 1986.

Treas. Reg. § 1.1502-32(b)(2)(ii) provides, in part, that a parent corporation’s basis in a subsidiary’s stock is increased by the amount of the subsidiary’s tax-exempt income. Tax-exempt income is defined in § 1.1502-32(b)(3)(ii)(A) as income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets. Section 1.1502-32(b)(3)(ii)(B) goes on to provide that to the extent the subsidiary’s taxable income or gain is permanently offset by a deduction or loss that does not reduce, directly or indirectly, the basis of the subsidiary’s assets, the income or gain is treated as tax-exempt income and is taken into account in determining the parent corporation’s basis.

The term forgiveness of income, that constitutes the “Fresh Start” adjustment, qualifies as tax-exempt income under Treas. Reg. § 1.1502-32(b)(3)(ii). In fact, in Example 10(c) of § 1.1502-32(b)(5)(ii), the regulations treat the “Fresh Start” provision of Sec. 11305(c) of the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 as tax-exempt income that increases basis.

The basis increase also seems to comport with Congressional intent. As stated above, Congress provided that the “Fresh Start” forgiveness of income is included in the corporation’s earnings and profits. Under the consolidated return regulations effective at that time, the basis in a subsidiary’s stock is increased by the undistributed earnings and profits of the subsidiary for the taxable year. Former Treas. Reg. § 1.1502-32(b)(1)(i). Therefore, Congress must have expected the basis increase because of the earnings and profits inclusion.

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Therefore, pursuant to Treas. Reg. § 1.1502-32(b)(2)(ii), the members of the consolidated group that own stock in a property and casualty company that was subject to the 1986 "Fresh Start" adjustment, increase their basis in the subsidiary stock by the amount of the "Fresh Start" forgiveness of income. Furthermore, pursuant to Treas. Reg. § 1.1502-32(a)(3)(iii), adjustments to a subsidiary's stock are taken into account in determining adjustments to higher-tier stock. Thus the property and casualty subsidiaries' "Fresh Start" adjustment is reflected in Sub's basis in its subsidiaries and Parent's basis in Sub stock.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The conclusion herein in no way affects the Service's position that Parent's loss on the sale of the Sub stock is disallowed under Treas. Reg. § 1.1502-20.

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.

Please call if you have any further questions. \_\_\_\_\_

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