# Federal Consolidated Return Regulations for Corporate Taxpayers: Mastering Complex Rules and Guidance

**THURSDAY, APRIL 3, 2014, 1:00-2:50pm Eastern**

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April 3, 2014

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CONSOLIDATED SECT. 382 ISSUES
Sect. 382 – Generally

Sect. 382 generally limits the amount of a loss corporation’s taxable income that may be offset by pre-change losses in taxable years following an ownership change.

- An ownership change is a greater than 50-percentage-point increase in ownership by 5% shareholders during a testing period, which is generally three years.

- A loss corporation is any corporation that has certain tax attributes, including NOL or capital loss carryforwards and net built-in losses.
The Sect. 382 Limitation

The Sect. 382 limitation generally equals:

- Value of the loss corporation
  \times
  long-term tax-exempt rate

- Increased by
  - Recognized built-in gains and
  - Unused limitation from prior year
Consolidated Sect. 382, In General

Ownership change: Parent change method
- Test ownership of parent stock
- Ignore minority ownership in subs
- Ownership change *generally* applies to the entire group.

Sect. 382 limitation:
- Value of all the stock of the common parent

*Plus*
- Value of the stock of any consolidated subsidiary not held by a group member
Parent Change Method Ownership Change

A 45% → B 25% → FMV 180

B 25% → C 30% → C 20% → FMV 180

A 45% → C 20% → P 80% → S1 80% → FMV 100

B 25% → P 80% → S2 100% → FMV 100
Parent Change Method Ownership Change (continued)

A 45%  

B 25%  

C 30%  

Sale to F

P FMV 180

C 20%  

S1 80% FMV 100

S2 100% FMV 100
**Parent Change Method No Ownership Change**

Step 2a

- **A** (45%)
- **B** (25%)
- **C** (30%)

- **C** (20%)
  - **P** (FMV 180)
  - **S1** (FMV 100)
  - **S2** (FMV 100)

**FMV 100**
Aggregation / Segregation / Final Small Shareholder Regulations
The Aggregation Rules

- To the extent stock is held directly or indirectly by less than 5 percent owners, the stock is aggregated into public groups which are treated as 5 percent shareholders.
- Starting with the shareholders of the highest tier entity within a chain of ownership, combine less than 5% owners through the chain of ownership until there is a 5% public group.
- Presumption of no cross ownership rebuttable with actual knowledge.
- Treas. Reg. § 1.382-2T(1)
Treas. Reg. § 1.382-2T(j)

The Segregation Rules

- After certain identifiable transactions (e.g., redemptions, section 1032 stock issuances) shareholders acquiring less than 5% will be segregated into separate public groups from other less than 5% shareholder public groups.
- Segregation rules apply to first tier and higher tier entities and sales of stock by individuals owning more than 5%.
- Treas. Reg. § 1.382-2T(j)(2)
Issues with Aggregation and Segregation Rules

• Contribute greatly to the complexity of identifying owner shifts and determining when an ownership change has occurred.

• These rules may be particularly burdensome when loss corporations are owned in part by investment advisors or institutional investors that frequently buy and sell.
Treas. Reg. § 1.382-2T(j)

Notice 2010-49

- IRS requested comments on two possible approaches to identifying and limiting the application of the aggregation and segregation rules to small shareholders.

- **Ownership Tracking Approach**
  - Taxpayers would track all changes in ownership without regard to the circumstances of the transaction. For example, if a 5% shareholder sold stock to small shareholders, those small shareholders would be tracked in a new public group segregated from the existing public groups. The IRS explained that this approach, which is consistent with the current regulations, would be intended to ensure that all of these transactions are addressed.
Notice 2010-49

• Purposive Approach
  - This approach would seek to identify the circumstances in which abusive transactions are likely to arise and tailor the application of the aggregation and segregation rules accordingly.
  - Thus, instead of tracking all changes in ownership the purposive approach would not require the loss corporation to track acquisitions of stock by small shareholders.
  - This approach would be based on the presumption that small shareholders generally are not in a position to engage in certain abusive transactions such as contributing income producing assets or diverting income-producing opportunities to the loss corporation to accelerate its use of NOL carryforwards.
Final Small Shareholder Regulations

T.D. 9638

On October 21, 2013, Treasury and the Service issued final regulations.

- Regulations finalize proposed regulations (REG-149625-10) published on November 23, 2011
- Final regulations provide several taxpayer favorable exceptions to the current segregation rules for “Small Shareholders”
  - Small Shareholders = Shareholders who are not 5-percent shareholders
Final Small Shareholder Regulations

T.D. 9638 (continued)

• Effective Date – Effective for testing dates on or after October 22, 2013
  - With an option for taxpayers to apply the new rules to earlier testing dates in a testing period which ends on or after October 22, 2013
    ◦ However, taxpayers may not apply the rules retroactively to:
      › Any date on or before the date of an ownership change that occurred prior to October 22, 2013 and
      › To any testing date if such application would result in an ownership change occurring on a date before October 22, 2013
Three Exceptions for Small Shareholders

- “Secondary Transfer” Exception
- Small Redemption Exception
- General Exception to Segregation Rules for 5-percent Entities

Final regulations excluded any guidance on what constitutes a “coordinated acquisition” under Treas. Reg. § 1.382-3(a).

- Note – Treasury and the Service may issue guidance in the future
Secondary Transfer Exception

Regulations adopt a “Secondary Transfer Exception” for Small Shareholders

- Secondary Transfer Exception
  - Renders the segregation rules inoperable to transfers of loss corporation stock to Small Shareholders by 5-percent entities or individuals who are 5-percent shareholders
  - Final regulations clarify this exception applies to a transfer of higher tier entity stock only if the seller indirectly owns 5% or more of the loss corporation

Treas. Reg. § 1.382-3(j)(13)
Small Redemption Exception

Small Redemption Exception

• Turns off current segregation rules for redemptions of 10% of loss company’s stock annually

• Based upon mechanics of small issuance exception

• Retained the ceiling of 10% of the value of the stock of the entity (or to classes of stock of the entity, as the case may be) that is engaging in the redemption

Treas. Reg. § 1.382-3(j)(14)
Small Redemption Exception (continued)

- Small Redemption Limitation
  - Loss company has the option to exempt annually redemptions of either:
    - Less than 10% of the total value of the loss corporation’s stock at the beginning of the taxable year, or
    - Less than 10% of the number of shares of the redeemed class outstanding at the beginning of the taxable year
General Exception

General Exception

• Turns off all the segregation rules for transactions involving stock of certain 5-per cent entities

• The General Exception applies if, on the date of the transaction –
  - The 5-percent entity owns 10% or less (by value) of all the outstanding stock of the loss corporation (ownership limitation)
  - Subject to anti-avoidance rule (instead of asset threshold test)

Treas. Reg. § 1.382-3(j)(15)
ONGOING COMPLIANCE AND AUDIT SITUATIONS
Electing To File Consolidated Returns

• Attach the election to the common parent’s return (by the extended due date of that return) for the first taxable year a consolidated return is to be filed

• A subsidiary member “consents” to the election via filing Form 1122
  – Timely file a signed Form 1122 with the consolidated return, or
  – Submit an unsigned copy with the return and retain a signed original

• All members of the group during any part of the first taxable year a consolidated return is filed must consent to the election, including:
  – Inactive corporations
  – Bankrupt corporations
  – Sold corporations that are not owned at year-end

• Deemed consent exists for a subsidiary joining the group in later years
Failure to Consent

• As Forms 1122 are required for each subsidiary joining in a consolidated return, taxpayers often inadvertently fail to comply with this requirement
  – This omission is a common due diligence issue

• The result of non-compliance is to require all members of the group, including those members that did in fact satisfy their Form 1122 filing obligation, to be treated as if they had filed separate returns for each tax year since the initial election.

• Non-compliance can have significant tax consequences, such as the inability to offset the income of one member with the losses of another.
Relief for Failure to Consent

• The IRS recently released Rev. Proc. 2014-24 providing automatic relief for failure to timely file Form 1122

• Under the Rev. Proc., automatic relief is available to all affiliated groups provided the following requirements are satisfied:
  1) The affiliated group timely filed what purported to be a consolidated return for the tax year, with clear evidence of intent to file as a consolidated group;
  2) The non-filing subsidiary was not prevent from joining in the filing of the return by any rule of law;
  3) A separate return was not filed by the non-filing subsidiary for any period included in the return or any subsequent tax year (unless it was not an includible entity); and
  4) One of three enumerated conditions for the failure file is satisfied.

• Taxpayers are not required to take any specific action to obtain relief (such as filing a statement or affidavit with the IRS).
“Reverse” Acquisitions

• Commonly described as the “minnow swallowing the whale”

• A reverse acquisition occurs when:
  – One corporation (Acquiring) acquires, in exchange in whole or in part for stock of Acquiring, either the stock or assets of a second corporation (Target); and
  – After the acquisition, former shareholders of Target own more than 50% of the FMV of Acquiring’s outstanding stock as a result of owning Target’s stock (Treas. Reg. 1.1502-75(d)(3)).

• Result
  – Any consolidated group of which Acquiring was the common parent ceases to exist, and
  – Any consolidated group of which Target was the common parent continues to exist (with Acquiring becoming the new common parent).
Reverse Acquisitions: Additional Concepts

• Based on the “substance over form” doctrine

• Stock must be used or deemed used as consideration, at least in part, to have a reverse acquisition.
  – Use of only cash will not cause a reverse acquisition.
  – Hence, in an all-cash purchase of Target by Acquiring, Target’s consolidated group would not continue.

• Neither the target nor the acquiring corporation has to be a member of an affiliated/consolidated group prior to the acquisition, for reverse acquisition rules to apply.
  – See Rev. Rul. 72-322, 1972-1 C.B. 287
Reverse Acquisitions: Things To Consider

• Election to file consolidated return if separate return had previously been filed

• Limitations on carryovers and carrybacks

• Due dates for tax returns of the acquiring and target corporations

• Impact on earnings and profits / other attributes

• Basis of stock in former common parent
Joining Or Leaving A Consolidated Group

- If a corporation becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all federal income tax purposes at the end of that day.

- Requires allocation of subsidiary’s income and deductions
  - Two methods under Reg. 1.1502-76(b)
    - Default method: Closing of the books
    - Pro-rata election: Available in certain situations with respect to non-extraordinary items
  - Pro-rata election is available only if the subsidiary does not change its tax year or its accounting method.
    - Election is irrevocable
    - Extraordinary items cannot be allocated ratably
Joining Or Leaving A Consolidated Group

- An acquisition or disposition of a subsidiary generally is deemed to occur at the end of the day.

- However, if a transaction occurs on the date of the acquisition or disposition but is properly allocable to the portion of that day after the acquisition or disposition, then the regulations require an allocation to the next day.

- An agreement of the parties generally is respected if it is:
  - Reasonable
  - Consistently applied by all affected persons

- Consider treatment of compensation-related payments
Example

- Parent files a consolidated return with Sub.
- Sub buys all of the stock of Target for $10 million; Target has $20 million worth of NOL carryforwards that will expire in the next 10 years.
- Assuming Target is acquired from an unrelated seller, the transaction caused an ownership change. Assuming a 5% interest rate, the annual Section 382 limitation is $500,000/year.
- Assuming the annual Section 382 limitation is not increased by RBIG, Parent group can expect to absorb no more than $5 million worth of Target’s losses (10 yrs @ $500K/year).
- Under the investment adjustment rules, an expiring NOL is a “noncapital, nondeductible” item that reduces stock basis.
Solution

• Parent can waive some or all of Target’s pre-affiliation losses.

• Losses are deemed to expire immediately before Target joins the group.

• Waiver election is made by attaching a statement to Parent’s consolidated return for the year of acquisition.
Apportionment Of CNOL To Member With Separate Return Year

General rule
- If part of a CNOL is attributable to a member that files a separate return in a carryback or carryforward year, then the CNOL must be apportioned to that member and carried to its separate return year (Treas. Reg. 1.1502-21(b)(2))

How to apportion CNOL
- The amount of the CNOL that is attributable to a member is the CNOL multiplied by a fraction, whose numerator is the separate NOL of the member for the year and whose denominator is the aggregate of the separate NOLs of all members that have losses (Treas. Reg. 1.1502-21(b)(2)(iv))
- For this purpose, the separate NOL of a loss member is determined by computing the loss member’s income, gain, deductions and losses actually taken into account and absorbed by the group in the determination of the CNOL (Treas. Reg. 1.1502-21(b)(2)(iv))
Apportionment Of CNOL To Member With Separate Return Year

P (100)
S1 (200)
S2 225
CNOL (75)

P’s portion: $100/300 \times 75 = 25$

S1’s portion: $200/300 \times 75 = 50$
Intercompany Debt Considerations

• Relevant in various scenarios
  – Worthless stock losses
  – Sale of stock in consolidated subsidiary
  – Spin-offs

• Documentation

• Debt vs. equity analysis
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Overview

- Allocation of Income Between Consolidated and Separate Return Years: Next Day Rule and GLAM 2012-010
- Developments in Basis Elimination Gain Acceleration Rule in Intercompany Transaction Regulations – New Potential Exceptions
Allocation of Income Between Consolidated and Separate Return Years – Review of General Rules
Taxable Year of Consolidated Group  1.1502-76
Overview

- Group must adopt the Common Parent’s* taxable year ( 1.1502-76(a))**

- Taxable year of the Common Parent continues to be the taxable year of the Subsidiary members if:
  - A Subsidiary member leaves the Group (unless such member joins another consolidated group), or
  - The Group terminates

*Certain Capitalized terms are defined in  1.1502-1

**Citations are to Internal Revenue Code and Treasury regulations
Taxable Year of Consolidated Group  1.1502-76

Overview

• Consolidated return must include the Common Parent’s items of income, gain, deduction, loss, and credit for the entire Consolidated Return Year, and each Subsidiary’s items for the portion of the year that it is a member of the group ( 1.1502-76(b)(1))
Taxable Year of Consolidated Group  1.1502-76

*Items to Be Included in Consolidated Tax Returns*

- Items of the Common Parent for the entire year unless (i) in another consolidated tax return or (ii) the Group terminates
- Items of each Subsidiary for portion of year Subsidiary is a member of Group
- Subsidiary will need to file short-year separate tax return to report items that are NOT included in consolidated tax return unless it joins another consolidated return group
• Allocation of items between separate return and consolidated return periods
  - Transaction deemed to occur at the end of the day and income for the day of the transaction generally is included in the first short period (i.e., in the short-year return of the Subsidiary member if joining the Group and in the Group’s return if the Subsidiary member is leaving the Group)
  - Close the books (1.1502-76(b)(2)(i)) – default method
  - Pro rata allocation (1.1502-76(b)(2)(ii))
    • Group is permitted to “ratably allocate” (as opposed to “closing the books”) the income of a departing Subsidiary or one that is joining the Group, provided the Subsidiary is not required to change its year end or its accounting method and makes an election to ratably allocate its income for the year. The election is irrevocable. Extraordinary items are excepted.
  - Mid-month allocation under any reasonable method
Certain extraordinary items may not be ratably allocated:
- Section 1231 gains & losses
- Capital gains & losses
- Items from discharge of indebtedness (e.g., unamortized loan origination fees and repurchase premium)
- Subpart F income
- PFIC income
- NOL carryovers
- Section 481(a) adjustments
- Credits from activity or items that are not ratably allocated (e.g., the purchase of property)
- Tort settlements
- Compensation related deductions (including option cancellation payments)
- Dividends from Section 304 controlled (by Subsidiary) but unaffiliated corporations
- Any item the Commissioner determines would cause a substantial distortion of income if ratably allocated
Taxable Year of Consolidated Group  1.1502-76
One-Month Allocation Rule

- If the ratable allocation election is not made (or is not available), a Subsidiary may prorate its income for the month of its change in status, instead of closing the books on the change in status date ( 1.1502-76(b)(2)(iii))
- Extraordinary items for the one-month may not be prorated
- There is no formal election; however, the allocation of income must be consistently applied
- Neither annual ratable allocation election nor one-month ratable allocation is available for S corporation acquisitions
Special Rules for S Corporations (1.1502-76(b)(1)(ii)(A)(2))

- S corporation generally becomes a member at the beginning of the day of its acquisition by the consolidated return group.
- If a Section 338(h)(10) election is made for S corporation acquisition by consolidated return group, S corporation joins the beginning of the day after its acquisition (1.338(h)(10)-1(d)(3)).
- Both of above rules avoid the need for a one-day return but if a “plain vanilla” Section 338(g) election is made for an S corporation acquisition, a one transaction return must be filed.
- If a consolidated subsidiary used LIFO and its stock is purchased by individuals who elect S status, Section 1363(d)(4)(D) does not allow LIFO recapture to be included on consolidated return. A one-transaction recapture return must be filed.
Next Day Rule and GLAM 2012-010
Taxable Year of Consolidated Group  1.1502-76 Timing

• End of the day rule: departing/joining member is treated as leaving or joining the group at the close of the day of the event resulting in the member’s change in status ( 1.1502-76(b)(1)(ii)(A)(1))

• Next day rule: certain items incurred on the day of change in status, but after the event causing the change in status, might be treated as occurring at the beginning of the following day ( 1.1502-76(b)(1)(ii)(B))
“If, on the day of S’s change in status as a member, a transaction occurs that is properly allocable to the portion of S’s day after the event resulting in the change, S and all persons related to S under Section 267(b) immediately after the event must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S’s day after the event will be respected if it is reasonable and consistently applied by all affected persons.”
For this purpose, the following factors are among those to be considered:

- Whether income, gain, deduction, loss, and credit are allocated inconsistently;

- If the item is from a transaction with respect to S stock, whether it reflects ownership of the stock before or after the event;

- Whether the allocation is inconsistent with other requirements under the Code and Treasury regulations; and

- Whether other facts exist, such as a prearranged transaction or multiple changes in S’s status.
• T incurred the following costs:
  - Amounts paid to employees for and in cancellation of nonqualified stock options and stock appreciation rights (SARs) in the event of a change in control
  - Fees paid to financial advisory and investment banking firms to provide consulting services for T in connection with the acquisition and contingent upon the successful closing of the acquisition
  - Retirement of tendered T bonds at a premium after the acquisition has closed
The IRS concluded that:

- **Next Day Rule does not permit the expenses associated with the stock options, the SARs, and the success-based consulting fees to be allocated to the period after the acquisition.**
  - Conclusion was based on the view that deductions for these items are not attributable to any “transaction” on the acquisition date other than the acquisition itself.

- **Application of Next Day Rule may be appropriate to the retirement of T’s bonds at a premium.**
  - Conclusion was based on the view that the liability to retire the bonds at a premium did not become fixed and determinable until after the closing. Facts provide that in contemplation of the acquisition, A and T agree that T will give the bondholders the opportunity to tender their bonds at a premium by a date before the acquisition date. However, T is not obligated to purchase any of the tendered bonds and does so only after the acquisition.
Timing of Deductions Between Returns

The Accrual Method Generally (461):

- Under the accrual method, a liability is taken into account in the taxable year in which the “all events” test is satisfied and economic performance has occurred (1.461-1(a)(2)(l))

- In the case of compensation deductions for services, economic performance generally occurs as the services are provided (461(h)(2)(A); 1.461-4(d)(2))

  - However, in the case of deferred comp, economic performance occurs only when the compensation is deductible under 404 (1.461-1(a)(2)(iii)(D), 1.461-4(d)(2)(iii))
Deferred Comp (404):

- Compensation is generally deferred comp if it is paid more than 2 \( \frac{1}{2} \) months after the end of the employer’s taxable year in which the compensated services were performed and is not deferred comp if it is paid before then \((1.404(b)-1T, Q&A (2)(a))\)

- Deferred comp is deductible in the employer’s taxable year that includes the last day of the employee’s taxable year of inclusion
  - Since employees generally have a calendar taxable year, deferred comp is deductible by the employer in its taxable year that includes December 31 of the employee’s year of inclusion
Compensatory Transfers of Property (83):

- Transfers of “property” for services are deductible:
  - If the property is “substantially vested upon transfer”, in the employer’s taxable year determined under the employer’s method of accounting (1.83-6(a)(1), (3))
  - If the property is not “substantially vested upon transfer”, in the employer’s taxable year that includes the last day of the employee’s taxable year of inclusion (83(h)) - December 31 in most cases

- 83 does not apply to grant or vesting of most options or SARs, ultimate deduction is generally governed by Section 461 or Section 404 (83(e)(3); PLR 7946072 (Aug. 20, 1979))
Developments in Basis Elimination Gain Acceleration Rule in Intercompany Transaction Regulations – New Potential Exceptions
Overview: Single Entity Model

• Reg. 1.1502-13(c)(1)(i) generally provides that the separate entity attributes of the selling member’s (S) intercompany item and the buying member’s (B) corresponding item are redetermined, to the extent necessary to produce the same effect on CTI (or CTL) as if S and B were divisions of a single corporation.

• Reg. 1.1502-13(c)(4)(i) generally provides that, to the extent B’s corresponding item offsets S’ intercompany item, the attributes of B’s corresponding item (determined based on both S’ and B’s activities) control the attributes of S’ offsetting intercompany item.
Overview: General Attribute Redetermination Rule

- Reg. 1.1502-13(c)(6)(i)
- General rule: Under the attribute redetermination rule of -13(c)(1)(i), S’s intercompany item may be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount
- Example: S’ intercompany loss from the sale of property to B is treated as a noncapital, nondeductible amount if B distributes the property to a non-member shareholder at no further gain/loss (if S and B were divisions of a single corporation, the loss would have been disallowed under 311(a))
Limitation on Redetermination of Attributes of Gain -- 1.1502-13(c)(6)(ii)

- Notwithstanding the general rule, S’ intercompany income/gain is redetermined to be excluded from gross income only to the extent an exception applies
  - B’s corresponding item is a deduction/loss, and in the taxable year the item is taken into account under 13 the item is permanently and explicitly disallowed (e.g. 265)
  - B’s corresponding item is a loss that is realized, but not recognized under 311(a) on a distribution to a non-member
  - 1.1502-13(c)(6)(ii)(C) and (D) Exceptions – to be discussed
Example 1: Intercompany Sale Of Member Stock Followed By §332 Liquidation -- Loss

- **Step 1:** S sells the T stock to B for $100 resulting in a loss of ($30). (§304 N/A)
- **Step 2:** In an unrelated transaction, T liquidates into B in a §332 transaction

- Under -13(c)(6)(i), S’ intercompany loss of ($30) is recharacterized as noncapital and nondeductible.
- Consistent with the purpose of -13, in “preventing intercompany transactions from creating, accelerating, avoiding, or deferring” CTI – Loss Churning
Example 2: Intercompany Sale of Member Stock Followed by a Section 332 Liquidation -- Gain

• Step 1: S sells the stock of T to B for $100. S’s adjusted basis in its T stock is $70 (§304 N/A)

• Step 2: In a later unrelated transaction, T liquidates into B in a section 332 transaction

• See Reg. § 1.1502-13(f)(7), Example (6)(b)

• Under Reg. § 1.1502-13(c)(6)(ii), S’s $30 intercompany gain is not recharacterized as unrecognized gain under section 332, but is included in S’s income as a result of T’s liquidation

• Facially, a “heads-we-win tails-you-lose” rule
Example 3: Distribution Of Member Stock Followed By §332 Liquidation – Transferor, Transferee Become Single Entity

- **Step 1**: S distributes the T stock to P. The distribution causes S to recognize, but not take into account, $100 of §311(b) gain.
- **Step 2**: In an unrelated transaction, S liquidates into P under §332.
- **Step 3**: T liquidates into P in a §332 transaction (or P spins-off T under Section 355) eliminating IT – determined stock basis.

- Upon liquidation of S, P inherits the $100 §311(b) gain.
- Prior to March 7, 2008:
  - Upon Section 332 liquidation (or Section 355 distribution) of T, P recognizes S’ $100 §311(b) gain.
Exception for Certain Intercompany Gains on Stock §1.1502-13(c)(6)(ii)(C)

- Temporary regulations were published on March 7, 2008 (Treasury Decision 9383)
- Provided relief for intercompany gain generated within Group with respect to member stock following certain basis elimination transactions (e.g. §332, §355)
- Temporary regulations were limited to situations in which the Common Parent was the member that held the stock with respect to which the intercompany gain was realized, and the gain was the Common Parent’s intercompany item
- Final regulations issued March 4, 2011 (Treasury Decision 9515) are more flexible
Analytical Tools for DIG Recognition

• The “Selling Member” (SM) and its Successor Person(s)

• The asset subject to the DIG (usually member stock) and its Successor Assets

• Note that the potential for multiple Successor Persons and Successor Assets w/r/t what was originally a single DIG transaction could lead to multiple events in which DIG is taken into account (but not duplication of aggregate DIG)
Intercompany Gains On Stock: §1.1502-13(a)(6)(ii)(C) Temporary Vs. Final Regulations

2008
Temporary Regulations

• Gain is the Common Parent’s (“P’s”) intercompany item as SM or Successor Person. *Changed in final regulations*

• Immediately before the intercompany gain is taken into account, P holds the member stock with respect to which the gain was realized. *Changed in final regulations*

• P’s basis in the member stock that reflects the intercompany gain is eliminated without the recognition of gain or loss (and this basis is not reflected in the basis of a successor asset). *Same as final regulations*
• The group has not and will not derive any federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of the intercompany gain. *Same as final regulations*

• The effects of the intercompany transaction have not previously been reflected on the group’s return. *Same as final regulations*
2011
Final Regulations - Differences

- B or S becomes the Successor Person to the other party (or a third member is a Successor Person to both B and S)

- Immediately before the intercompany gain is taken into account, the Successor Person holds the member stock with respect to which the gain was realized

- Amounts excluded from gross income under this regulatory exception are not taken into account as E &P of any member and are not treated as tax-exempt income for purposes of stock basis adjustment regulations
Step 1: S distributes the T stock to P in a §301 distribution, recognizing a $60 §311(d) gain.

Step 2: In an unrelated transaction, S liquidates into P under §332 and P succeeds to S’s $60 §311(b) intercompany gain.

Step 3: T distributes the T1 stock to P under §355, and P’s basis in its T stock is allocated between T and T1 based on FMV (i.e., $75 and $25, respectively).

Step 4: liquidates into P in a §332 transaction.

Upon liquidation of T:
- T and T1 stock are Successor Assets reflecting P’s intercompany gain as Successor Person to S of $45 and $15, respectively.
- P’s intercompany gain with respect to T stock of $45 is taken into account under the matching rule because of T’s liquidation.
- P’s intercompany gain of $15 with respect to T1 stock as Successor Asset is not taken into account.

Reg. § 1.1502-13(c)(6)(iii)(C) allows the intercompany gain of $45 to be excluded.
The Commissioner may determine (via the PLR process) that treating S’ intercompany items as excluded from gross income is consistent with the purpose of -13 and other applicable authority, if the following conditions are met, depending on whether the intercompany item is an item of income or an item of gain:

- In the case of an item of income, the corresponding item is permanently disallowed

- In the case of an item of gain, the following conditions as satisfied: (i) the effects of the intercompany transaction have not previously been reflected on the Group’s return, and (ii) the Group has not derived, and no taxpayer will derive, any federal income tax benefit from the intercompany transaction that gave rise to the gain or the redetermination of gain
Background Facts:

- D3 is the Common Parent of a consolidated group
- As a result of prior intercompany transactions, gains were recognized by SMs with respect to sales and distributions of C2 stock that were deferred pursuant to -13
- D1 is SM for DIG 5; and D2 is SM for DIG 1, DIG 3 and DIG 4
- Successor Assets A and B are not “the member’s stock with respect to which DIG was realized” (Reg. 1.1502-13(f)(6)(ii)(C)(ii))
PLR 201352007 (DIG 1 Facts)

- A portion of Dl’s D2 stock is treated as a Successor Asset to the DIG 1 (Successor Asset A) under 1.1502-13(j)(2) as a consequence of a Section 351 transaction.

- All of Dl’s C1 stock is treated as a Successor Asset subject to DIG 1 (Successor Asset B) under -13(j)(2) as a consequence of a Section 355 split-off transaction.
• D1 distributes its C1 stock to D3 in partial redemption of D3’s D1 stock, and D1 merges downstream with and into D2 with the D1 shareholder (D3) receiving D2 stock.

• The downstream merger is a 381 transaction and D2 will becomes a Successor Person to D1 as SM under 1.1502-13(j)(2) w/r/t DIG 1 (but only w/r/t Successor Asset B – what happens to DIG 1 w/r/t Successor Asset A)
• D2 takes into account the portion of DIG 1 reflected in Successor Asset A (D2’s eliminated stock basis in the hands of merged D1)

• Notwithstanding the elimination of D1’s basis for D2 stock (Successor Asset A) in the downstream merger, the portion of DIG 1 reflected in Successor Asset A is excluded under the Commissioner’s Discretionary Rule, Reg.1.1502-13(c)(6)(ii)(D)

• The remainder of DIG 1 continues to be reflected in Successor Asset B (the C1 stock basis held by D3)
See also PLR 201210018 (Dec. 7, 2011)

- Similar Commissioner’s Discretionary Rule ruling in which Successor Asset to two intercompany transactions was eliminated by downstream merger of buyer member into one of two SMs

- One of SMs is issuer of Successor Asset and therefore is not the holder of the Successor Asset as required for automatic relief under Reg. 1.1502-13(c)(6)(ii)

- No ruling issued on consequences to SM that does not hold Successor Asset and is not a party to the merger
S3 liquidates under Section 332, distributing cash to D3 and its C2 stock to D2

D2 does not have to take into account DIG 5 because of C2 stock basis carryover to D2

D2 distributes all of its C2 stock to D3 in a Section 355 internal spin-off

Part of C2 stock basis in hands of D3 is eliminated by substitution of D2 stock basis
Ruling:

- D 2 takes into account all of DIG 3 and all of DIG 5 by reason of the elimination of C stock basis, but all of DIG 3 and DIG 5 will be redetermined to be excluded from income under Reg. 1.1502-13(c)(6)(ii)(C)

- NOTE: D 2 remains SM w/r/t DIG 4 because the C stock basis resulting from DIG 4 was not eliminated in the Section 355 transaction
PLR 201352007 (LLC Conversions)

- See also PLR 201312027 (Dec. 20, 2012)
  - Commissioner’s Discretionary Rule ruling in which Successor Assets to five intercompany transactions are eliminated by conversion of corporate issuer to LLC status (Section 332 liquidations)
  - Conversions apparently not eligible for automatic relief under Reg. 1.1502-13(c)(6)(ii)(C) because five SM Successor Persons do not own Successor Assets (as in PLR 201352007) and also convert to LLCs as part of the same transaction
Step 1
Step 2

DMEAST 18606134
Background Facts of Steps 1 and 2 (Condensed):

- Sub 2 distributes stock of CFC to Sub 1 at a gain
- CFC transfers all of its assets in a Section 368(a)(1)(F) reorganization to F Sub 1 in which all of F Sub 1 stock is issued to Sub 1
- F Sub 1 contributes all of the former CFC assets to F Sub 2 in exchange for stock of F Sub 2
Step 3
Step 3 - Proposed Transaction:

- F Sub 2 sells assets of CFC to third party and loans proceeds to P
- Sub 2 liquidates into Sub 1 in a Section 332 liquidation
- F Sub 1 and F Sub 2 each made a check-the-box to become disregarded entities
Significant Representations

- F Sub 1 stock constitutes a Successor Asset to CFC stock distributed in the intercompany transaction.
- Sub 1 is a Successor Person to Sub 2 w/r/t the intercompany transaction.
- Loan of proceeds of sale of CFC assets by F Sub 2 to Parent will be treated as debt for federal income tax purposes (indicating F Sub 2 is seller of CFC assets).
Rulings

- Sub 1 is required to take into account DIG as a consequence of F Sub 1’s CTB election
- DIG is redetermined to be excluded from income under Reg. 1.1502-13(c)(6)(ii)(D), Commissioner’s Discretionary Rule
- Redetermined DIG is not taken into account as earnings and profits of any member and is not treated as tax-exempt income for purposes of stock basis adjustment rules
Circular 230 Disclosure

Any tax advice included in this written communication was not intended or written to be used, and it cannot be used, by any taxpayer, for the purpose of avoiding any penalties that may be imposed by any governmental taxing authority or agency.
Greg Featherman, KPMG

CONSOLIDATED RETURN ISSUES WITH TROUBLED SUBSIDIARIES
Granite Trust Transactions and §267
Granite Trust Transactions
Basic Transaction Structure

Facts
Pre-transaction: P owns 100% of the S1 stock. P’s basis in the S1 stock exceeds the fair market value; thus, P has a built-in loss in the S1 stock.
Step 1: P sells 25% of its S1 stock to FSub.
Step 2: After the sale and at a time when S1 is insolvent, S1 liquidates.

S1 Assets FMV $50
S1 Liabilities $400

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Granite Trust Transactions  
§332

- §332(a) provides that in certain circumstances, no gain or loss will be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

- For this exception to apply, the corporate shareholder must be the owner of, on the date of the adoption of the plan of liquidation and at all times through the final liquidating distribution, at least 80% of the total voting power and total value of the stock of the liquidating corporation (the “control requirement”). §332(b)(1) and §1504(a)(2).

- Treas. Reg. 1.1502-34 provides that for purposes of determining whether the control requirement is satisfied, the stock ownership of all members of the consolidated group is aggregated.
Granite Trust Transactions

§331

- Amounts received by a shareholder in a distribution in complete liquidation are treated as in full payment in exchange for the stock. 331(a)

- The gain or loss to a shareholder from a complete liquidation is determined under 1001 by comparing the amount of the distribution with the shareholder’s basis in the stock of the liquidating corporation. Treas. Reg. 1.331-1(b); 1001(c)
Granite Trust Transactions
Electivity Of §332 – Generally

Courts and the IRS have generally allowed taxpayers, in certain circumstances, to intentionally avoid the application of § 332. See e.g., Granite Trust v. United States, 238 F.2d 670 (1st Cir. 1956); Commissioner v. Day and Zimmerman, 151 F.2d 517 (3rd Cir. 1945); Avco Manufacturing Corporation v. Commissioner, 25 T.C. 975 (1956). But see Associated Wholesale Grocers Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991).

See also PLR 8428006 (Mar. 26, 1984); FSA 200148004 (Nov. 30, 2001)
Granite Trust Transactions
§267

- 267(a)(1) disallows losses on sales between related persons. See 267(b) for the definition of related persons.

- 267 does not, however, apply to any loss of a distributor or distributee in a complete liquidation.

- 267(f) defers losses from sales between members of the same controlled group to which 267(a)(1) would otherwise apply, until the property is transferred outside the controlled group and there would be recognition of the loss under consolidated return principles, or until another time proscribed by the regulations.

  For purposes of this provision, “controlled group” is defined in 1563, with certain modifications.
Granite Trust Transactions
Treas. Reg. §1.267(f)-1

Treas. Reg. 1.267(f)-1

- Treas. Reg. 1.267(f)-1 provides rules under 267(f) for the deferral of losses and deductions from certain transactions between members of a controlled group.

- These regulations cross reference Treas. Reg. 1.1502-13, which addresses the treatment of intercompany transactions between members of a consolidated group.
Granite Trust Transactions
Treas. Reg. §1.267(f)-1(c)(1)(iv)

- Treas. Reg. 1.267(f)-1(c)(iv) states that “to the extent [the Selling Member]’s loss would be redetermined to be a noncapital, nondeductible amount under the principles of Treas. Reg. 1.1502-13(c) but is not redetermined because of [Treas. Reg. 1.1502-13(c)(2)], then [the Selling Member]’s loss continues to be deferred and is not taken into account until [the Selling member and the Buying Member] are no longer in a controlled group relationship.”

  In other words, this rule requires an analysis of the hypothetical treatment of the transactions at issue under the principles of Treas. Reg. 1.1502-13.

- As an example, the regulations state that if the selling member sells all of its stock of a wholly owned subsidiary to another member for a loss, then the target subsidiary liquidates in a 332 transaction, and the selling member’s loss is deferred until the selling and buying members are no longer in a controlled group relationship.
Granite Trust Transactions
Transfer Within A Controlled Group: Example 1

Consolidated return rules

- In Example 1, if P, S1 and S2 were members of the same consolidated group, S1’s $90 loss on its sale of the S2 stock would be redetermined to be noncapital and nondeductible. Treas. Reg. 1.1502-13(f)(7)(i), Example 6(c)

Treas. Reg. 1.267(f)-1(c)(1)(iv)

- If we assume, however, that P, S1 and S2 are not members of the same consolidated group (e.g., P is a foreign parent), if the loss were redetermined to be noncapital and nondeductible under the principles of Treas. Reg. 1.1502-13, the loss would be deferred until P and S1 were no longer in a controlled group relationship together.

  - See e.g., PLR 201323005 (loss recognized upon transfer outside of controlled group)
Facts

- Parent, a publicly traded corporation, conducts Business A in the U.S. and abroad through direct and indirect affiliates and is the common parent of a group of domestic subsidiaries that file a consolidated return.
- Parent had a built-in loss in the stock of Sub 1.
Relevant steps

1. On Date C, Parent purchased certain assets from Sub 1 for $b.

2. On Date C, Parent sold e shares of common stock in Sub 1 (representing f percent of Sub 1’s outstanding stock) to Foreign Sub 2 in exchange for g shares of h percent cumulative redeemable preference stock.
Granite Trust Transactions
ILM 201025046 (Cont.)

Steps (Cont.)

3. On Date D, Sub 1’s board of directors adopted a plan of complete liquidation, which was approved by the Sub 1 shareholders (Parent and Foreign Sub 2) on that date.

   – Between Date E and Date F, Sub 1 distributed all of its assets to Parent and FSub 2 in redemption and cancellation of their equity interests.

Issue

• Whether, upon the liquidation of Sub 1, Parent may include a loss of $n from its sale of f percent of Sub 1 stock to Foreign Sub 2, which had been deferred under 267(f)(2)?

Conclusion

• Upon the liquidation of Sub 1, Parent may not include the loss of $n from its sale of f percent of Sub 1 stock to FSub 2. This loss continues to be deferred pursuant to Treas. Reg. 1.267(f)-1(c)(1)(iv).
Step one: US sells X% of its common and preferred stock in F1 to FP for fair market value.
Step two: F1 converts to a ULC, resulting in a deemed liquidation of F1.
Rulings

• If the F1 common and preferred shares are all worthless, any worthless stock loss otherwise allowable to F1’s shareholders will not be disallowed under 267(a)(1) or disallowed under 267(f)(2).

• If the F1 preferred shares have value but the common shares are worthless:
  • Any worthless stock loss otherwise allowable to F1’s shareholders on the common stock will not be disallowed under 267(a)(1) or deferred under 267(f)(2).
  • The sale of the preferred stock is a 1001 exchange (and 304 does not apply).
  • US will account for any loss on the sale of the preferred stock under 267(f); the loss will remain deferred after the conversion (until FP and US are no longer in a controlled group relationship).

• If the F1 common and preferred shares all have value:
  • The sale of the F1 stock is a 1001 exchange (and 304 does not apply).
  • US will account for any loss on the sale under 267(f); the loss will remain deferred after the conversion (until FP and US are no longer in a controlled group relationship).

• Neither 332 nor 368(a)(1)(C) will apply to the deemed liquidation of F1 (citing Granite Trust and Day & Zimmerman).
  • A shareholder of F1 that receives a liquidating distribution will recognize gain or loss; a loss will not be disallowed or deferred under 267(a)(1) or 267(f)(2).
Example

- The new regulations provide that if the seller sells all of the stock of target corporation to the buyer at a loss (in a transaction that is treated as a sale or exchange for federal income tax purposes), and the target corporation subsequently liquidates in an unrelated transaction that qualifies under § 332, then the seller’s loss is deferred until the seller and the buyer are no longer in a controlled group relationship.

- Similarly, the regulations provide if the seller owns all of the target corporation stock, sells 30% of the target corporation’s stock to the buyer at a loss (in a transaction that is treated as a sale or exchange for federal income tax purposes), and the target corporation subsequently liquidates into the seller and the buyer, then the seller’s loss on the sale is deferred until the seller and the buyer (including their successors) are no longer in a controlled group relationship.

Requirement to aggregate certain stock

- For purposes of this paragraph, stock held by the seller, stock held by buyer, stock held by all members of the seller’s consolidated group, stock held by any member of a controlled group of which the seller is a member that was acquired from a member of the seller’s consolidated group, and stock issued by target to a member of the controlled group must be taken into account in determining whether a loss would be determined to be a noncapital, nondeductible amount under the principles of Treas. Reg. §1.1502-13.
On Date 1, S sells 25% of L's stock to P1 for cash. On Date 2, L liquidates.

Under 1.267-1(a)(2), S's loss on the sale of L stock to P1 is deferred.

Under 1.267-1(c)(1)(iv), upon the liquidation of L, to the extent S's loss would be redetermined to be a NCND amount under 1.1502-13 principles, S's loss continues to be deferred.

S's loss is not redetermined to be a NCND amount to the extent of P1's $10 of gain recognized, therefore S takes into account $10 of loss as a result of the liquidation.

The liquidation of L would be treated as qualifying under 332, and the remained of S's loss would be redetermined to be NCND, therefore S's remaining $20 loss continues to be deferred until S and P1 are no longer in a controlled group relationship.
Under 1.267-1(a)(2), P’s loss on the sale of T stock to FP is deferred.

Under 1.267-1(c)(1)(iv), upon the conversion of T, to the extent P’s loss would be redetermined to be a NCND amount under 1.1502-13 principles, P’s loss continues to be deferred.

In determining whether the loss would be redetermined to be NCND, stock held by FS (which was acquired from T) and stock held by FP (the buyer of the T stock from P and a member of P’s controlled group) is taken into account.

The deemed liquidation of T resulting from the conversion of T would be treated as a 332 liquidation and P’s loss would be redetermined to be NCND, therefore P’s loss continues to be deferred until P and FP are no longer in a controlled group relationship.
Worthless Stock Losses Under §165
Worthless Stock Losses Under §165

Generally

Facts
Year 1: P capitalized S2 with $100 of equity, and S1 loaned S2 $400.
Year 2: S2 incurred an unabsorbed net operating loss of $450. Thus, at the end of Year 2, S2 is insolvent.
End of Year 2: P checks the box on S2.
165 Generally
- 165 provides a deduction for “any loss sustained during the taxable year and not compensated for by insurance or otherwise.” 165(a)
- To be allowable as a deduction, the loss must be a bona fide loss that is evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained during the taxable year. Treas. Reg. 1.165-1(b)
Worthless Stock Losses Under §165
Worthless Stock Loss – Timing of the Loss

**Timing**

- 165(g) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange of a capital asset on the last day of the taxable year. 165(g)

  - To establish worthlessness, one must prove that the stock had value (either liquidating value or potential value) at some point during the tax year, but that by year-end, it had neither.

  - “No liquidating value” generally means that the liabilities exceed the fair market value of the assets. See also *Spaulding Bakeries, Inc. v. Commissioner*, 252 F.2d 693 (2nd Cir. 1958) (where parent owned all the common and nonvoting preferred stock of a subsidiary and received assets in liquidation with a value less than the liquidation preference on the preferred); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986); PLR 201103026 (P could claim a worthless stock loss on the liquidation of its subsidiary regardless of whether the intercompany account between S and P constituted debt or equity in S for U.S. federal income tax purposes).

  - “No potential value” is generally indicated by an identifiable event, such as a liquidation. See, e.g., Rev. Rul. 2003-125

- For the timing of a worthless stock loss in consolidation, see next slide.
Timing of Worthless Stock Losses In Consolidation

- Under Treas. Reg. 1.1502-80(c), stock of a subsidiary generally is not treated as worthless under 165 until immediately before the earlier of the time (i) the stock is worthless within the meaning of Treas. Reg. 1.1502-19(c)(1)(iii), or (ii) the subsidiary for any reason ceases to be a member of the consolidated group. There is no successor principle under Treas. Reg. 1.1502-80(c).

- Stock of a subsidiary is treated as disposed of by worthlessness under Treas. Reg. 1.1502-19(c)(1)(iii) at the time that:
  - All of the subsidiary’s assets (other than its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence) are treated as disposed of, abandoned, or destroyed for U.S. federal income tax purposes.
    - An asset of the subsidiary is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of the subsidiary under 332 or is in exchange for consideration (other than relief from indebtedness).
  - An indebtedness of the subsidiary is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Treas. Reg. 1.1502-32(b)(3)(ii)(C), or
  - A member takes into account a deduction or loss for the uncollectibility of an indebtedness of the subsidiary, and the deduction or loss is not matched in the same tax year by the subsidiary's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.
    - Under Treas. Reg. 1.1502-13(g)(4)(i), COD income from an intercompany obligation is not treated as excluded from income under 108(a).
Worthless Stock Losses Under §165
Worthless Stock Loss – Character of the Loss

**Character**

- If stock or securities that are not held as capital assets become wholly worthless during the taxable year, the loss resulting therefrom may be deducted under §165(a) as an ordinary loss. Treas. Reg. 1.165-5(b)

- In the case of a taxpayer that is a domestic corporation, stock or securities in a subsidiary corporation that is affiliated with the taxpayer (the “affiliation test”) and meets a gross receipts test (the “gross receipts test”) are not treated as capital assets for purposes of §165(g)(1). The result is that the taxpayer is entitled to an ordinary (rather than a capital) loss upon worthlessness of the subsidiary’s stock. §165(g)(3); Treas. Reg. 1.165-5(b)
In order to satisfy the gross receipts test, more than 90% of the subsidiary’s aggregate gross receipts for all taxable years must be from sources other than passive sources, i.e., royalties, rents (except rents derived from rental of properties to employees in the ordinary course of the subsidiary’s operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from dispositions of stocks and securities. 165(g)(3)(B); Treas. Reg. 1.165-5(d)(2)(iii)

- See also PLR 200710004 (March 9, 2007) (consolidated group approach to intercompany dividends); TAM 200727016 (July 6, 2007) (separate return approach to dividends); TAM 8939001 (Sept. 29, 1989) (holding company with no gross receipts violates 90% test); TAM 200914021 (April 3, 2009) (operating company with no gross receipts satisfies 90% test).
Worthless Stock Losses Under §165
§ 165(g)(3)(B) – Gross Receipts Test PLR 200710004

- Relevant IRS rulings
  - §165(g)(3) gross receipts are a 381 attribute.
  - Thus, in the example above, US Opco 1’s gross receipts became gross receipts of US Holding as a result of the liquidation.
  - In a consolidated group, intercompany dividends count as gross receipts and can be non-passive receipts, if attributable to distributing corporation’s non-passive E&P.
  - Thus, dividends from US Opcos 2 to US Holdings counted as gross receipts from passive sources, to the extent they are attributable to US Opcos 2’s gross receipts from passive sources.
Worthless Stock Losses Under §165
§ 165(g)(3)(B) – Gross Receipts Test TAM 200727016

Relevant IRS ruling
Outside a consolidated group, dividends are always passive receipts, even if attributable to distributing corporation’s active business.
Worthless Stock Loss Under §165
PLR 201011003

Pre-Transaction: C Book disbursed funds to members of SubG for operations and collects all funds (i.e., gross receipts) from SubG. These collections occur on a daily basis with cash moved back and forth (the “cash sweep”). No interest was charged or paid.

Step 1: P contributes to capital a note owed to it by LCo (the “LCo Note”)
Step 2(a): P sells LCo to Purchaser for cash and Purchaser stock. As a result of this acquisition, a §338(h)(10) election (the “election”) is made for SubG (the ruling does not state whether such an election is made for C Book).
Step 2(b): As a result of the election, LCo and certain members of SubG are deemed to liquidate under §332 (the “deemed liquidations”).
Step 3: LCo and its subsidiaries filed for bankruptcy.
Worthless Stock Losses Under §165
PLR 201011003 (Cont.)

● **Relevant representations**
- LCo was insolvent at the time of the deemed liquidation of LossCo, and its stock was worthless at that time.
- The tax attributes of SubG carried over to LCo pursuant to the deemed liquidation. 332, 381

● **Rulings**
- P was entitled to claim a worthless stock loss with respect to its shares of LCo, as a result of the deemed liquidation of LCo.
  
  • For purposes of determining the character of the loss, LCo’s gross receipts include all amounts from intercompany transactions (as defined in Treas. Reg. 1.1502-13), and such amounts are treated as gross receipts from passive sources to the extent they are attributable to the counterparty’s gross receipts from passive sources.
    
    The Service also ruled that for purposes of computing the gross receipts, the cash sweeps would be characterized as if interest and dividends were actually paid.
  
  • In other words, look-through is required until a source of income from outside the group is reached (i.e., the counterparty member applies the same methodology for its gross receipts from other members until the ultimate counterparty that transactions with outside parties is reached).
  
  • SubG’s gross receipts carry over to LCo as a result of the deemed liquidation. However, LCo will eliminate gross receipts from intercompany transactions with SubG, where appropriate, to prevent duplication.
Worthless Stock Losses Under §165
Examples of Application of PLR 201011003

- All of S2’s gross receipts are active.
- S1 lends $100 to S2, and S2 pays $10 of interest to S1. S1’s interest income from S2 is nominally passive gross receipts.
- Under PLR 201011003, the interest income are characterized as active gross receipts in S1’s hands.
Example 2

- All of S2’s gross receipts are passive.
- S1 sells property to S2 in the course of S1’s business for $100.
- S1’s proceeds for the sale are nominally active gross receipts.
- Under PLR 201011003, the sales proceeds are characterized as passive gross receipts in S1’s hands.
Worthless Stock Losses Under §165
PLR 201149015

Prior to its liquidation while worthless, H2 engaged in four types of intercompany transactions with other members of the various consolidated groups of which it was a member:

- H2 received dividends from subsidiaries including a distribution of property and workforce;
- H2 received distributions in excess of a subsidiary’s E&P;
- H2 provided management services to subsidiaries for a fee; and
- H2 purchased furniture and fixtures from a subsidiary.

- H2 served primarily as a holding company for subsidiaries engaged in business.
- H2 and its subsidiaries became members of P’s consolidated group through a reverse subsidiary cash merger treated as a taxable stock purchase.

Rulings

- Applying look-through approach, H2’s gross receipts include those received in intercompany transactions and are passive to the extent they are attributable to the counterparty’s passive gross receipts.

- In applying this approach for H2 as to a counterparty, H2’s counterparty also will apply the same approach to its receipts from intercompany transactions.

- In applying the look-through approach for gross receipts from intercompany dividends, the amounts will be attributed pro rata to the gross receipts that generated the E&P from which the dividend was distributed, and H2’s gross receipts also take into account the historic gross receipts of any transferor corporation in a 381(a) transaction with adjustments made to prevent duplication.
Worthless Stock Losses Under §165
PLR 201314005

Relevant Facts

- Sub owns an interest in a foreign partnership, FP.
- FP has substantial active business operations conducted through disregarded entities.
- Sub determined to be insolvent.

Relevant Ruling

- For purpose of computing the gross receipts test, Sub should include its distributive shares of FP’s gross receipts.