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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Treatment of Excess Loss Account

This Field Service Advice responds to your memorandum dated September 9, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =

Sub1 =

Sub2 =

Sub3 =

Sub4 =

Sub5 =

CorpX =

Xsub1 =

Xsub2 =

Xsub3 =

Buyer	=
Bsub	=
Newco	=
Partnership	=
Pcorp1	=
Pcorp2	=
Country Z	=
Year1	=
Year2	=
FYend	=
Date1	=
Date2	=
Date3	=
Date4	=
Date5	=
Date6	=
Date7	=
Date8	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=

$ii	=
%r	=
%s	=
%t	=
%u	=

ISSUE:

Whether Taxpayer has gain from restoration of an excess loss account ("ELA") or whether such gain is avoided through use of an intervening section 355 reorganization.

CONCLUSIONS:

The facts suggest that the a principal purpose of the distribution of the subsidiary's stock to Taxpayer was to avoid the recognition of the distributing member's ELA with respect to the subsidiary's stock. Under the anti-avoidance rule of Treas. Reg. § 1.1502-19(e), it is appropriate to make an adjustment that results in recognition of gain from the ELA to carry out the purpose of the ELA rules under Treas. Reg. § 1.1502-19.

FACTS:

Taxpayer is the common parent of an affiliated group that files consolidated returns using a fiscal year ending FYend. Prior to Date6, Taxpayer owned all of the stock of Sub1, which owned all of the stock of Sub2. In turn, Sub2 owned %r of Partnership. The other partner in Partnership was Xsub1, a subsidiary of CorpX, which is not related to Taxpayer. Partnership owned Pcorp1, a domestic corporation, and several foreign corporations. Partnership also owned %s of the stock of Pcorp2, a Country Z corporation. The remaining %t of the Pcorp2 stock was owned equally by Sub2 and Xsub3, a Country Z subsidiary of CorpX.

On Date1, Taxpayer caused Sub2 to establish a line of credit up to $aa, which Taxpayer agreed to guarantee. The stated purpose of this arrangement was to monetize a portion of the value of Partnership and also reduce state taxes. On Date7, Sub2 borrowed $aa against the line of credit and distributed the funds to Sub1. Sub1 contributed the entire amount to its subsidiary Sub3, which contributed that amount to its subsidiary, Sub4. Sub4 loaned $hh to Taxpayer and $ii to Sub5, a subsidiary of Taxpayer, which used the funds to repay its intercompany debt to Taxpayer. As a result, Taxpayer effectively received the entire distribution of $aa,

which it used to retire debt, fund future acquisitions and meet other general cash needs.

According to Taxpayer's consolidated return for the tax year ending Date8, after the $aa distribution by Sub2, there was an excess loss account of approximately $bb with respect to the stock of Sub2. On or about Date6, Sub1 distributed all of its Sub2 stock to Taxpayer. As a result of this distribution, Sub2 became a first-tier subsidiary of Taxpayer.

On Date2, Taxpayer authorized Partnership to borrow up to $ff million and invest the proceeds in one or more notes rated AA or better. On Date3, Partnership borrowed $gg (with Taxpayer and Sub2 as guarantors) and used the proceeds to purchase a non-marketable note.

On Date4, Taxpayer approved divestiture of its interest in Partnership to Buyer. The following steps were taken to accomplish the divestiture:

1. Xsub1 transferred a %u interest in Partnership to Xsub2, a related corporation, resulting in three partners in the joint venture.

2. Pcorp2 elected to change its classification to that of a partnership pursuant to the check-the-box provisions of Treas. Reg. § 301.7701-3(c). Sub2 reported $cc in deemed dividends from this change.

3. Pursuant to an agreement dated Date5, Partnership sold Pcorp1, its foreign corporations and its %s interest in Pcorp2 to Bsub, a subsidiary of Buyer. Sub2 reported capital gains of $dd from these transactions.

4. Sub2 and Xsub3 sold their stock in Pcorp2 to Bsub. The gain on these sales had already been taxed as a result of Pcorp2's check-the-box election.

5. Taxpayer transferred its Sub2 stock to Newco, a subsidiary of Buyer, in exchange for nonvoting preferred stock of Newco valued at $ee. Simultaneously, Buyer transferred its stock in Bsub to Newco in exchange for Newco voting common stock. In connection with these transactions, Taxpayer was relieved of its guarantee obligations with respect to the debts of Sub2 and Partnership.

LAW AND ANALYSIS

Treas. Reg. § 1.1502-32 provides rules for adjusting the basis in the stock of a subsidiary owned by another member of a consolidated group. Under Treas. Reg. § 1.1502-32(b)(1)(i), adjustments are made as of the close of each consolidated return year, and interim adjustments are made any other time that it is necessary to

determine a tax liability of any person. Particularly relevant to the instant case, Treas. Reg. § 1.1502-32(b)(2)(iv) provides an adjustment for the net amount of a subsidiary's distributions with respect to its stock. The distributions taken into account under this adjustment are the distributions to which I.R.C. § 301 applies and all other distributions treated as dividends (e.g., gain in reorganization treated as dividend under I.R.C. § 356(a)(2)). A distribution out of current or accumulated earnings and profits results in a negative adjustment to the parent corporation's basis in the distributing member. *See* Treas. Reg. § 1.1502-32(b)(5), Example 5. For purposes of this rule, a distribution under I.R.C. § 301 is treated as taken into account when the shareholding member becomes entitled to it. Treas. Reg. §§ 1.1502-32(b)(3)(v), 1.1502-13(f)(2)(iv).

If a negative adjustment exceeds the basis in the subsidiary's stock, the resulting negative amount is the shareholder's ELA in the subsidiary's stock. *See* Treas. Reg. §§ 1.1502-32(a)(3)(ii) and 1.1502-19(a)(2)(i). In general, Treas. Reg. § 1.1502-19(b) requires a member that disposes of a subsidiary's stock in which an ELA exists to take into account the ELA in the stock as income or gain from the disposition. Under Treas. Reg. § 1.1502-19(c)(1)(i)(A), a member is treated as disposing of such stock of a subsidiary when it transfers or otherwise ceases to own the stock for federal income tax purposes, even if no gain or loss is taken into account. However, any nonrecognition or deferral rules applicable to the disposition are applicable to the income or gain from the ELA.

Treas. Reg. § 1.1502-19(e) provides a broad anti-avoidance rule that applies wherever "any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations . . . ." This anti-avoidance rule allows adjustments as necessary to carry out the purposes of the section.

In general, a corporation is required to recognize gain under I.R.C. § 311(b) on a nonliquidating distribution to its shareholders of appreciated property, including stock of a subsidiary. If certain requirements are satisfied, however, I.R.C. § 355 permits a corporation ("distributing corporation") to distribute to its shareholders stock or securities of a subsidiary corporation ("controlled corporation") without recognition of any gain by either the distributing corporation or the receiving shareholders. After a section 355 transaction, the amount of a shareholder's basis in the stock of the distributing corporation is allocated between that shareholder's stock in the distributing and controlled corporations in proportion to their relative fair market values. *See* I.R.C. § 358(c); Treas. Reg. § 1.358-2(a).

Example 3 of Treas. Reg. § 1.1502-19(g) describes a section 355 distribution within an affiliated group in which there is an ELA with respect to the stock of both the distributing and controlled corporations. Specifically, in Example 3, P has a $30

ELA in S's stock, and S has a $90 ELA in T's stock. S distributes the T stock to P in a section 355 transaction, and neither P nor S recognizes any gain or loss on the transaction. At the time of the distribution, the T stock represents 33 percent of the value of the S stock. In analyzing these facts, Example 3 determines that S's distribution of the T stock is a disposition under section 1.1502-19(c) but that S recognizes no gain from the distribution pursuant to section 355. Applying the rules of section 358(c), Example 3 determines that S's ELA in the T stock is eliminated, with P's $30 ELA in the S stock treated as basis allocated between its S stock and T stock based on their relative fair market values. As a result, P has a $20 ELA in the S stock and a $10 ELA in the T stock. Example 3 notes parenthetically that if P had a basis of $30 (in lieu of a $30 ELA) in the S stock, P would have a basis of $20 in the S stock and $10 in the T stock. Finally, the example considers a subsequent distribution of the T stock to P's shareholders in another section 355 transaction, determining that the distribution would be a disposition requiring P to take into account its $10 ELA in the T stock notwithstanding the nonrecognition rules of section 355.

In the instant case, Sub2's distribution of $aa to Sub1 in Year1 resulted in an ELA of approximately $bb with respect to the stock of Sub2. Taxpayer contends that Sub1's distribution of the Sub2 stock on Date6 was a section 355 transaction and thus the analysis of Example 3 should apply. Under Taxpayer's position, Sub1's ELA of approximately $bb would be eliminated, and its basis in Sub1 would be allocated between the Sub1 and Sub2 based on their relative fair market values. Consequently, Taxpayer would not take into account any ELA in the Sub2 stock when it transferred the Sub2 stock to Newco (a nonmember) a few months later in Year2.

For purposes of this discussion, we accept Taxpayer's position that Sub1's distribution of the Sub2 stock on Date6 qualified for nonrecognition under I.R.C. § 355(c). Because we lack all the relevant facts concerning that distribution, we offer no opinion on whether it was a section 355 transaction.

Assuming that Sub1's distribution of the Sub2 stock to Taxpayer was a nonrecognition transaction under I.R.C. § 355, the analysis under Example 3 does not control the instant case. In Example 3, the section 355 distribution was merely an internal restructuring or a step toward the ultimate distribution of the T stock to P's shareholders. In contrast, the facts of the instant case suggest that a principal purpose Sub1's distribution of the Sub2 stock to Taxpayer was to avoid Sub1's recognition of its ELA in Sub2 as gain on the subsequent disposition of the Sub2 stock in the transfer to Newco.

If Sub1 had transferred the stock of Sub2 directly to Newco in exchange for the nonvoting preferred stock of Newco, the transfer would have been a disposition of the Sub2 stock under Treas. Reg. § 1.1502-19(c)(1)(i)(A) since Sub1 would no

longer own the Sub2 stock after the transfer. Thus, Sub1 would have had to take into account the amount of its ELA in the Sub2 stock as a result of the disposition. By distributing the Sub2 stock to Taxpayer in a section 355 transaction and applying the rules of I.R.C. § 358(c) to eliminate Sub2's ELA, Sub1 avoided having to recognize the amount of the ELA as gain. The anti-avoidance rule of Treas. Reg. § 1.1502-19(e) should apply to ensure that the purposes of the ELA provisions are carried out.

In this case, an adjustment should be made under the anti-avoidance rule to preserve Sub1's gain from the ELA. For example, the transfer of the Sub2 stock to Newco could be treated as a transfer by Sub2, as if the section 355 distribution had not occurred, followed by a distribution of the Newco preferred stock to Taxpayer. This would result in a recognition by Sub1 of the amount of the ELA and give Taxpayer ownership of the Newco stock, albeit with a different basis than it would have under the section 355 distribution.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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If you have any further questions, please call (202) 622-7930.

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