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RESTRUCTURINGS 2011

**Intercompany Transaction Problems**

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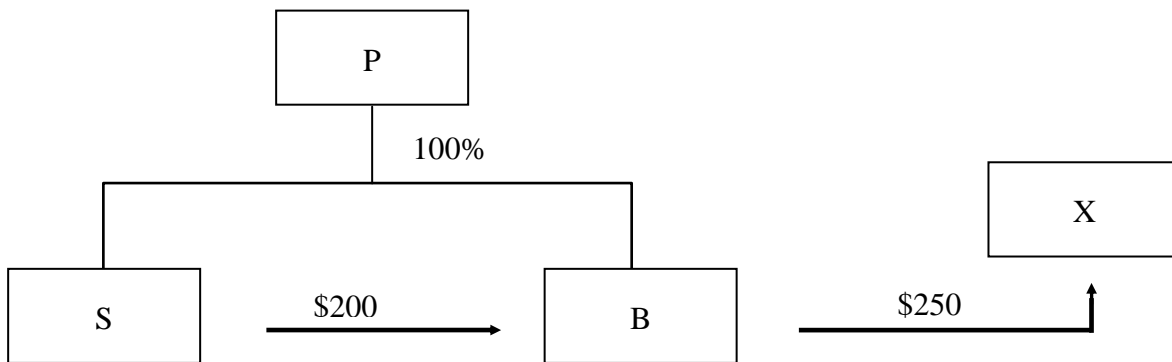
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## Nomenclature

S	=	transferor or service provider
B	=	transferee or service recipient
II	=	S's intercompany item
CI	=	B's corresponding item
RCI	=	the group's recomputed CI
X, Y	=	nonmembers

## **Matching Rule**

1. **Timing--Sales of Property**



(1) In year 1, S sells land to B for \$200; S had a \$100 basis

(2) B holds the land for investment and sells it to X in year 2 for \$250; B had a \$200 basis

In year 1, S takes none of its \$100 intercompany gain into account under Reg. § 1.1502-13(c)(2):

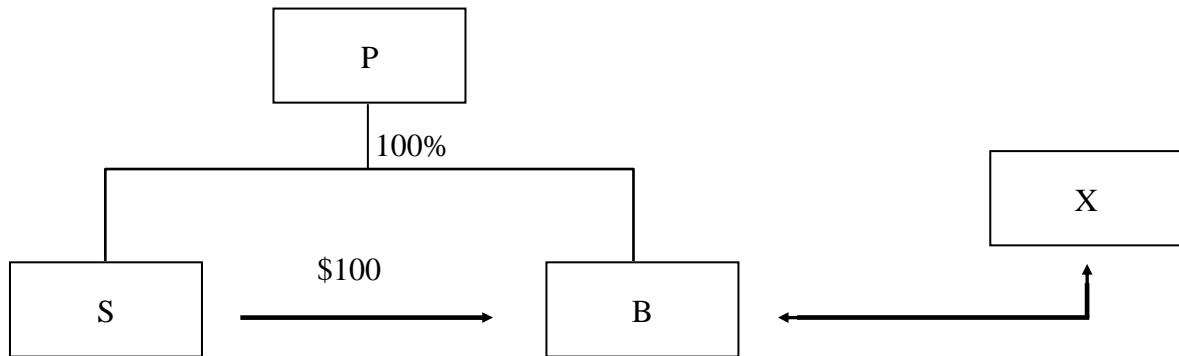
RCI	=	\$0
CI	=	<u>\$0</u>
Difference	=	<u>\$0</u>

In year 2, S takes its entire \$100 intercompany gain into account under Reg. § 1.1502-13(c)(2):

RCI	=	\$150 (\$250 proceeds - S's \$100 basis)
CI	=	<u>\$ 50</u> (\$250 proceeds - B's \$200 basis)
Difference	=	<u>\$100</u>

Comment: If S is a securities dealer under § 475, S treats its gain or loss on the sale to B as an II. Reg. § 1.1502-13(c)(7)(ii) ex. 11. This is inconsistent with Prop. Reg. § 1.475(a)-2, which treats the gain or loss as arising before the intercompany transaction. Future § 475 regulations are anticipated to address the inconsistency.

2. **Timing-- Section 1031 Exchange Outside The Group**



(1) In year 1, S sells Property Z (a § 1231 asset) to B for \$100; S had a \$10 basis

(2) In year 4, B transfers Property Z to X in exchange for Property Z1 (worth \$100); § 1031 applies

A. Current Law

Under the matching rule, there is no difference between B's CI and RCI as a result of B's exchange with X of Property Z for Z1.

RCI = \$0 (\$90 gain realized, but not recognized under § 1031)

CI = \$0 (\$0 realized and recognized)

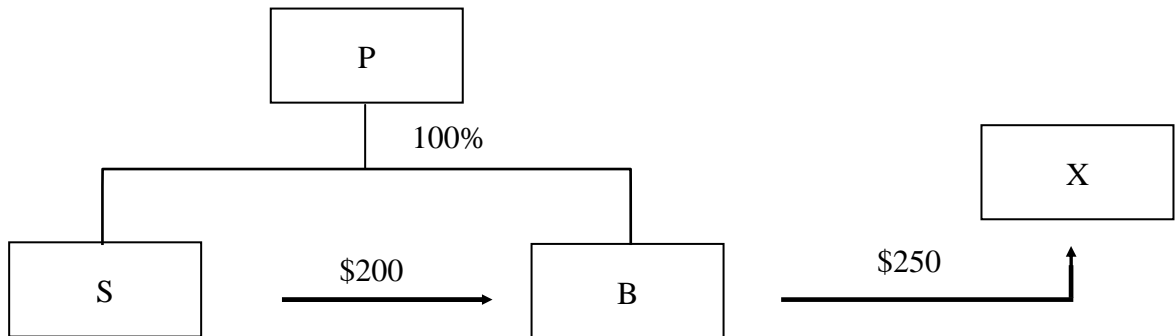
Difference = \$0

Acceleration is not required because X does not reflect any aspect of the intercompany transaction, and matching of S's entire \$90 gain remains possible with respect to Property Z1. Reg. § 1.1502-13(d)(1), (j)(1). Thus, S continues to defer its gain and to match with respect to Property Z1 (the successor to Property Z). Reg. § 1.1502-13(c)(7)(ii) ex. 1(h).

B. Old Law

Former Reg. § 1.1502-13(f)(1)(i) and -13(m) restored S's gain on a disposition outside the group, and no exceptions were made for transfers outside the group in nonrecognition transactions. Thus, S's entire \$90 gain was taken into account. See also T.A.M. 9201002 (Sept. 30, 1991); P.L.R. 7838045 (June 21, 1978).

### 3. Attributes--Sale Of Dealer Property



(1) In year 1, S sells to B for \$200 undeveloped lots that S held for sale to customers; S had a \$100 basis

(2) B holds the lots for investment and sells them to X in year 2 for \$250; B had a \$200 basis

#### A. Timing

In year 1, S takes none of its \$100 intercompany gain into account under Reg. § 1.1502-13(c)(2)(ii). In year 2, S takes its entire \$100 intercompany gain into account under Reg. § 1.1502-13(c)(2)(ii).

#### B. Character

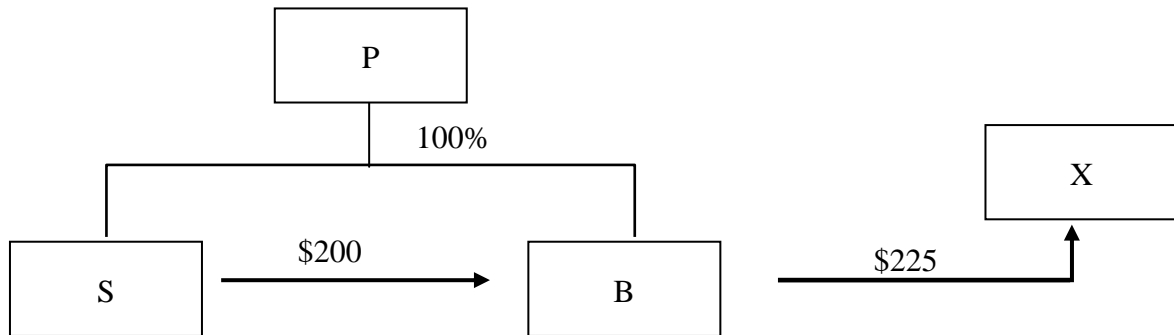
The attributes of both S's \$100 intercompany gain and B's \$50 corresponding gain are redetermined to the extent necessary to treat S and B as divisions of a single corporation. Reg. § 1.1502-13(c)(1)(i). Thus, both gains will be either ordinary or capital (depending on the facts and circumstances). Reg. § 1.1502-13(c)(7)(ii) ex. 2. The former regulations bifurcated IIs and CIs, treating S's gain as ordinary income and B's gain as capital gain. Former Reg. § 1.1502-13(c)(4).

Comment: Unlike the "all or nothing" approach with respect to most other cases, § 475(d)(3) provides that a single dealer corporation may recognize both ordinary gain or loss and capital gain or loss with respect to a single security.

Comment: The attributes of an II or CI are all of its characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income (and tax liability). Attributes even include exclusion from gross income or treatment as a noncapital, nondeductible amount. Reg. § 1.1502-13(b)(6). But see Reg. § 1.1502-13(c)(6)(ii).

Comment: Intercompany § 351 transfers are treated like any other intercompany transactions for purposes of attribute determination (i.e., B must take S's activities into account).

4. **Attributes--Source Of Income (No Independent Factory Price)**



(1) In year 1, S manufactures inventory in the U.S. and sells it to B for \$200 with title passing in Country Y; S has a \$125 basis; there is no independent factory price (§ 863)

(2) B sells the inventory to X for \$225 in year 1 with title passing in Country Y; B had a \$200 basis

Current Law

A. Timing

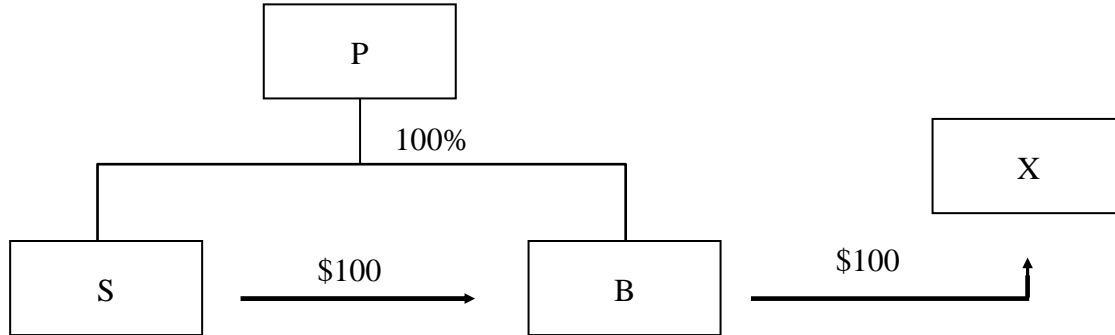
In year 1, S takes all of its \$75 intercompany gain into account, and B takes its \$25 corresponding income into account, under Reg. § 1.1502-13(c)(2).

B. Source

The § 863 allocation is determined by treating S and B as divisions of a single corporation, with \$100 of income recognition from producing property in the U.S. and selling it in Country Y. Assume that, on a single-entity basis, \$50 is treated as foreign source income and \$50 is treated as U.S. source income. Assume that on a separate-company basis, S would have \$37.50 foreign source and \$37.50 U.S. source income, and that all of B's \$25 income is foreign source. Consequently, \$12.50 of separate-entity foreign source income must be recharacterized as U.S. source income. Reg. § 1.1502-13(c)(1)(i).

This redetermined attribute may be allocated between S and B using any reasonable method. Reg. § 1.1502-13(c)(4)(ii). It may be reasonable to recharacterize \$12.50 of S's foreign source income as U.S. source, because only S would have U.S. source income. It may also be reasonable to allocate the recharacterized \$12.50 between S and B in proportion to their separate-entity amounts of foreign source income (i.e., a 3:2 ratio -- \$7.50 to S and \$5 to B), provided the same method is consistently applied. Reg. § 1.1502-13(c)(7)(ii) ex. 14.

## 5. Attributes--Recapture Of Depreciation



(1) In year 1, S sells a machine to B for \$100, recognizing \$60 of ordinary income and \$40 of § 1231 gain; S had a \$0 basis

(2) After claiming \$60 of depreciation, B sells the machine to X in year 4 for \$100; B had a \$40 basis

### A. Timing

During the first 4 years, S takes into account \$60 of its intercompany gain as a result of B's \$60 of depreciation. Reg. § 1.1502-13(c)(2).

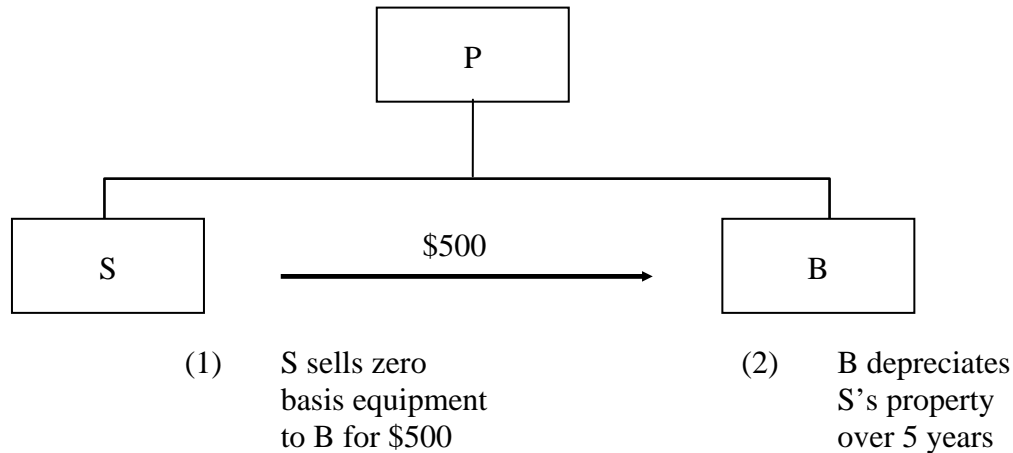
In year 4, S takes into account its remaining \$40 of intercompany gain as a result of B's sale to X:

RCI	=	\$100
CI	=	<u>\$ 60</u>
Difference	=	<u>\$ 40</u>

### B. Character

The character of S's \$60 of gain taken into account in years 1 to 4 as a result of B's depreciation is ordinary income to offset B's depreciation. Reg. § 1.1502-13(c)(4)(i)(A) (offsetting amounts). When the property is sold, the combined § 1231 gain of S and B would have been \$40 if they were divisions of a single corporation. Reg. § 1.1502-13(c)(1)(i). On a separate-entity basis, both S and B would have § 1231 gain. Thus, the proper allocation of the redetermined § 1231 gain between S and B is unclear. Compare Reg. § 1.1502-13(c)(7)(ii) ex. 4(e) with Reg. § 1.1502-13(c)(7)(ii) ex. 14(a). Whatever convention is adopted, it is unreasonable unless thereafter consistently applied by all members. Reg. § 1.1502-13(c)(4)(ii).

6. **Attributes--Section 382 Recognized Built-In Gain**



S, a loss corporation with a large NOL carryover, joins the P group with an ownership change and a net unrealized built-in gain of \$500.

A. **Current Law**

Gain that is deferred under Reg. § 1.1502-13 may be treated as recognized built-in gain only to the extent it is taken into account by the group during the recognition period. Reg. § 1.1502-91(h)(3); see also Reg. § 1.1502-13(c)(7)(ii) ex. 10. Thus, it would appear that S's \$500 II constitutes recognized built-in gain as it is taken into account.

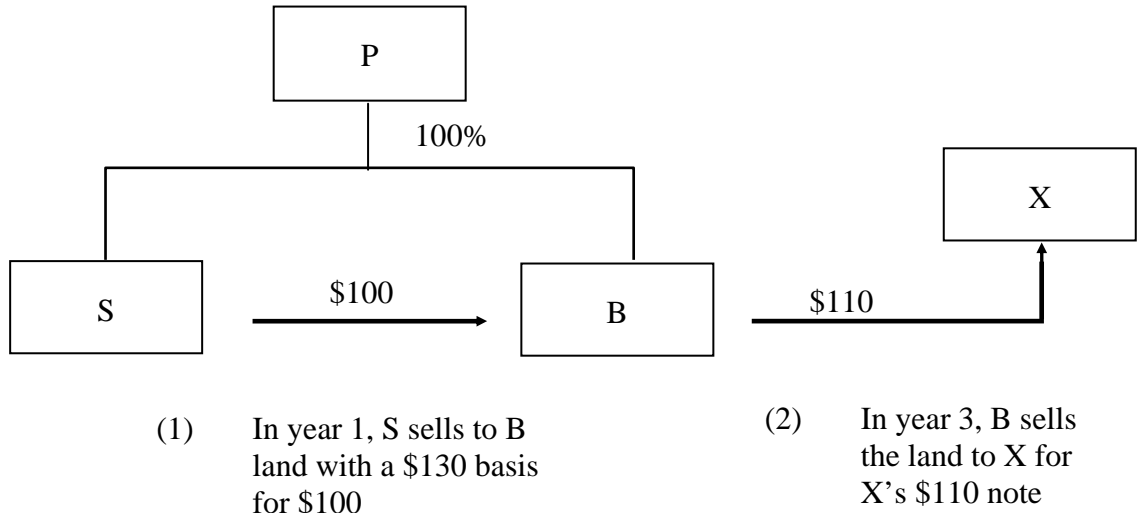
However, the attributes that are redetermined under Reg. § 1.1502-13 include whether an II or CI is "built-in" under § 382(h). Reg. § 1.1502-13(b)(6). Treating S and B as divisions of a single corporation, S's \$500 II is § 382(h) recognized built-in gain if the single corporation's consumption of the appreciated asset constitutes recognized built-in gain. Reg. § 1.1502-13(c)(1)(i), (4)(i)(B). The current law on a single entity's consumption is unclear. See § 382(h)(6); Reg. § 1.1374-4(b); F.S.A. 199307081 (July 8, 1993). Thus, S's \$500 II might be recognized built-in gain. (If B sells the equipment at the beginning of year 3 for \$500, when B's basis is \$300, B's \$200 gain causes S's remaining \$300 II to be taken into account under the matching rule; if none of S's gain previously taken into account is treated as built-in, both S's remaining \$300 II and all of B's \$200 CI should be built-in.)

Comment: The portion of S's II taken into account by reason of B's depreciation would not have been treated as built-in gain by the proposed regulations, but the proposed example demonstrating this result was deleted from the final regulations. Compare Prop. Reg. § 1.1502-13(c)(4)(ii) ex. 11(d) with Reg. § 1.1502-13(c)(7)(ii) ex. 10.

B. Old Law

S would restore its \$500 II as B claimed additional depreciation. Former Reg. § 1.1502-13(d), (l). S's \$500 II appeared to be recognized built-in gain under § 382(h) as it was restored. See Former Reg. § 1.1502-13(c)(4); Prop. Reg. § 1.1502-91(h)(3). Thus, S's \$500 II restored as a result of B's additional depreciation would increase S's § 382 limitation.

7. **Attributes--Treatment Of Eligibility For Installment Reporting As An Attribute**



In year 1, S takes none of its \$30 intercompany loss into account under Reg. § 1.1502-13(c)(2):

RCI	=	\$0
CI	=	<u>\$0</u>
Difference	=	<u>\$0</u>

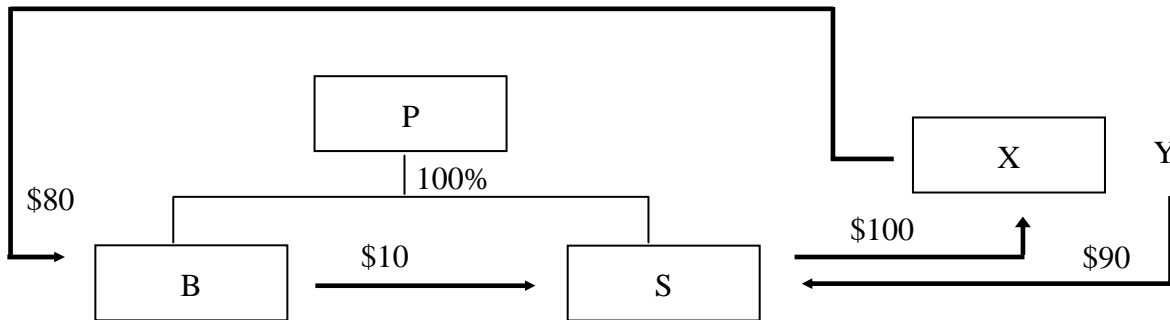
In year 3, S takes its entire \$30 intercompany loss into account under Reg. § 1.1502-13(c)(2):

RCI	=	\$(20)	(\$110 proceeds - S's \$130 basis)
CI	=	<u>\$10</u>	(\$110 proceeds - B's \$100 basis)
Difference	=	<u>\$30</u>	

Amount is not an attribute. Reg. § 1.1502-13(b)(6). However, the fact that there is an overall loss is treated as an attribute that B must take into account in determining the timing of CIs under its own method of accounting. Thus, B would not be eligible for installment reporting under § 453. Reg. § 1.1502-13(c)(7)(ii) ex. 5(e).

Comment: Is overall loss also an attribute that B would have to take into account under the acceleration rule if B left the group before the sale to X? See Reg. § 1.1502-13(a)(3), (d)(2)(i)(B).

## 8. Amount--S's Items Not Yet Taken Into Account



- (1) In year 1, B sells a product, which B manufactured, to X, an independent dealer, for \$80
- (2) In year 2, B initiates a \$10 incentive program for customers of its independent dealers
- (3) In year 3, pursuant to B's incentive program, S buys the product from X for \$100, paying \$90 cash and assigning S's right to the \$10 payment from B. S then leases the product to Y, a nonmember.
- (4) In year 3, B pays S \$10 under its incentive program (which S then pays to X).

S has a \$10 II "not yet taken into account" under its separate-entity method of accounting. Reg. § 1.1502-13(b)(2)(iii). Under the matching rule, S must take all of its II's into account to reflect the difference between B's \$10 CI taken into account and the RCI. In year 3, there is a \$10 difference between B's \$10 deduction and the \$0 recomputed deduction. Thus, S must take the \$10 incentive payment into account in year 3 as ordinary income to match B's \$10 deduction. S's basis in the product is \$100, rather than the \$90 it would be under S's separate-entity method of accounting, and the additional basis is recovered based on subsequent events (e.g., S's depreciation or sale of the product). See Former Reg. § 1.1502-13(c)(7)(ii) ex. 13 (an example which assumed that if S and B were divisions of a single corporation, B's \$10 payment would not have been deductible and S's basis in the property would have been \$100 rather than \$90).

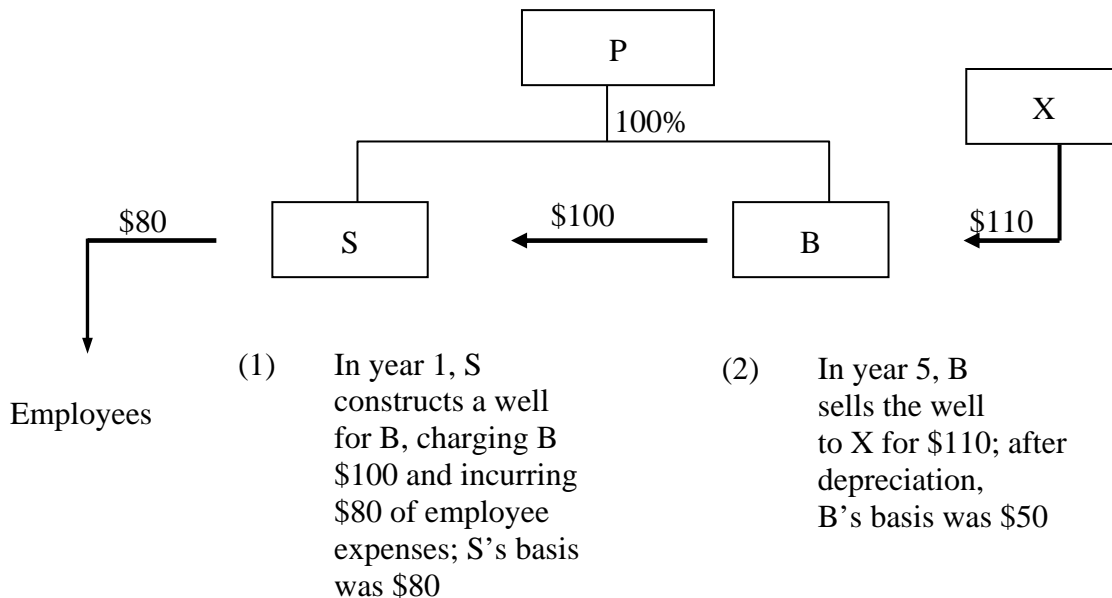
Comment: Proposed regulations supplemented the fact pattern of Former Reg. § 1.1502-13(c)(7)(ii) ex. 13 with two additional fact patterns involving manufacturer incentive payments in order to address the developing variety of transactions involving such payments. See Former Prop. Reg. § 1.1502-13(c)(7)(ii) ex. 13.

Comment: Because a premise underlying Example 13 is under reconsideration by the Service, final regulations published by the Treasury Department and the Service removed both Example 13 and the proposed changes to Example 13 pending further guidance. See T.D. 9261 (May 5, 2006). Example 13 relied upon Rev. Rul. 76-96, 1976-1 C.B. 23, which discusses the tax treatment of rebates paid by an automobile manufacturer to retail customers, to support the position

that manufacturer incentive payments are ordinary and necessary business expenses deductible under § 162. However, in Rev. Rul. 2005-28, I.R.B. 2005-19, the Service and Treasury Department suspended Rev. Rul. 76-96. (Rev. Rul. 2005-28 has been superseded by 2008-26, 2008-21 IRB 985.)

Comment: The old proposed regulations included rules for “deemed intercompany items,” “deemed corresponding items,” and “amount deemed not to be items.” Although the final regulations eliminated these rules, the old proposed results are generally achieved (e.g., by treating amounts “not yet taken into account” as items). The results under the old former regulations were similarly unclear because they also took into account amounts not yet recognized by S. See Old Former Reg. § 1.1502-13(c)(1).

## 9. Amount--S's Related Costs And Expenses



### A. Timing

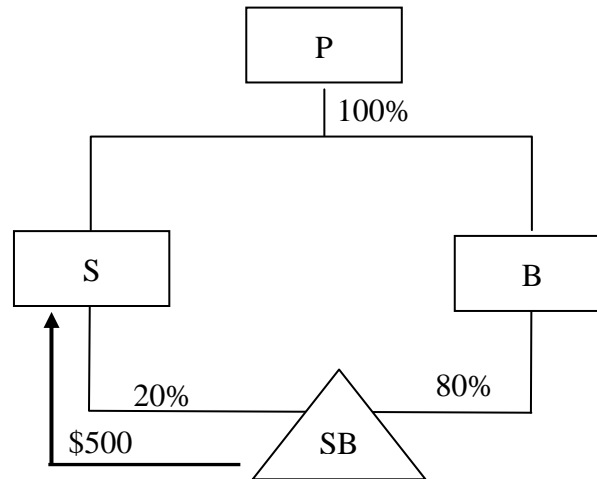
S's deductions for employee wages and other related costs, whether or not capitalized under S's separate-entity method of accounting, are "included" in determining its IIs. Reg. § 1.1502-13(b)(2)(ii). S's net \$20 II is taken into account each year to reflect the annual \$2 difference between B's \$10 of depreciation and the \$8 of recomputed depreciation (based on the well having an \$80 basis if S and B had been divisions). In addition, S takes into account \$80 of its income and all \$80 of expenses in year 1. (If S's offsetting \$80 of income and expense would not be taken into account in the same year under its separate accounting method, they nevertheless must be taken into account to clearly reflect the group's income. See Reg. § 1.1502-13(a)(3).) Any of S's IIs not taken into account to match B's depreciation are taken into account by S at the time B sells the well to X. Reg. § 1.1502-13(c)(7)(ii) ex 7; see also Reg. § 1.263A-9(g)(5).

Comment: How does S identify its items that are "related?" See Reg. § 1.1502-13(a)(3); see also Prop. Reg. § 1.1502-13(c)(4)(ii) ex. 12 (deleted from the final regulations).

### B. Character

The \$80 of S's income and expenses taken into account in year 1 are ordinary. To the extent S's net \$20 II is taken into account as a result of B's depreciation, the II is ordinary. Reg. § 1.1502-13(c)(4). To the extent IIs are taken into account as a result of B's sale, the IIs are treated as recapture income or § 1231 gain (even though attributable to S's performance of services) as necessary to conform to single-entity treatment. Reg. § 1.1502-13(c)(7)(ii) ex 7.

10. **Restructuring--Sale To A Controlled Partnership**



P acquires all of the S stock, and S has a § 382 ownership change. S has a § 382(h) net unrealized built-in gain. The SB partnership (a previously existing partnership) purchases equipment from S for \$500 to enable S to take into account its built-in gain before expiration of the § 382(h) five-year recognition period.

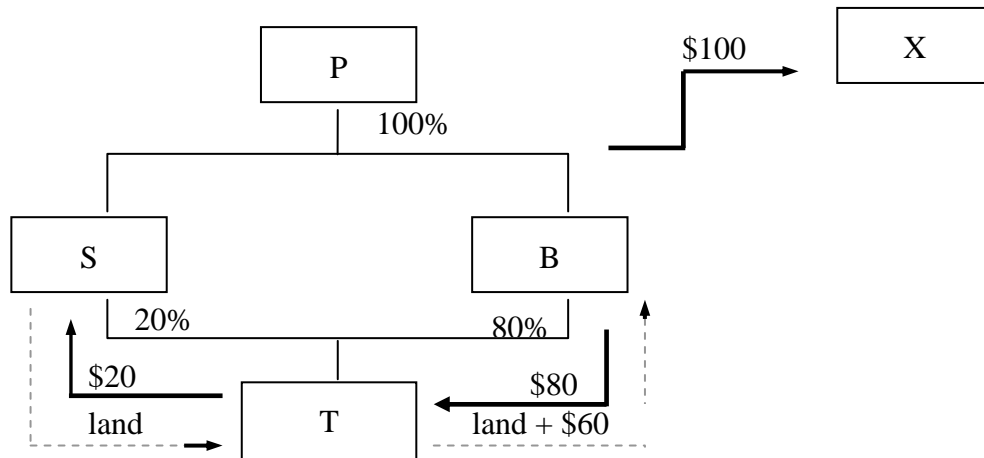
A. Current Law

Any transaction engaged in or structured with a principal purpose to avoid “clear reflection” must be adjusted. Reg. § 1.1502-13(h)(1). This example was in the proposed regulations, and concluded that S’s sale was treated as an intercompany transaction. Prop. Reg. § 1.1502-13(h)(2) ex. 2. The proposed treatment raised many questions. For example, if X, rather than S, were the partner with B, would the correct result be to treat SB as a member to the extent of only 80% of S’s gain? Similarly, could Reg. § 1.1502-13 apply to a transaction between S and a 79% subsidiary? The proposed example was deleted in the final regulations, and the preamble states that the examples from the proposed regulations have been revised to “better illustrate the effect” of the anti-avoidance rule. 60 Fed. Reg. 36,671, 36,678 (Jul. 18, 1995). Although the example has been eliminated, the transaction, as with any other transaction, is subject to challenge under other authorities. See, e.g., Reg. § 1.701-2. Moreover, Reg. § 1.1502-13(h) may apply if the property is later transferred by SB back to a member. See Reg. § 1.1502-13(h)(2) ex. 4.

B. Old Law

S should have recognized \$500 of built-in gain, which was not deferred, because SB was not a member of the P group. See P.L.R. 9645015 (Aug. 9, 1996).

## 11. Restructuring--Corporate Mixing Bowl



B operates a business on land leased from S. P intends to sell B to X, together with the land owned by S. To avoid gain on the land, B and S form T, with S contributing the land (value of \$20 and basis of 0) and B contributing \$80. T liquidates three years later, distributing \$20 to S and its remaining assets to B. P sells all of the B stock to X one year later.

### A. Current Law

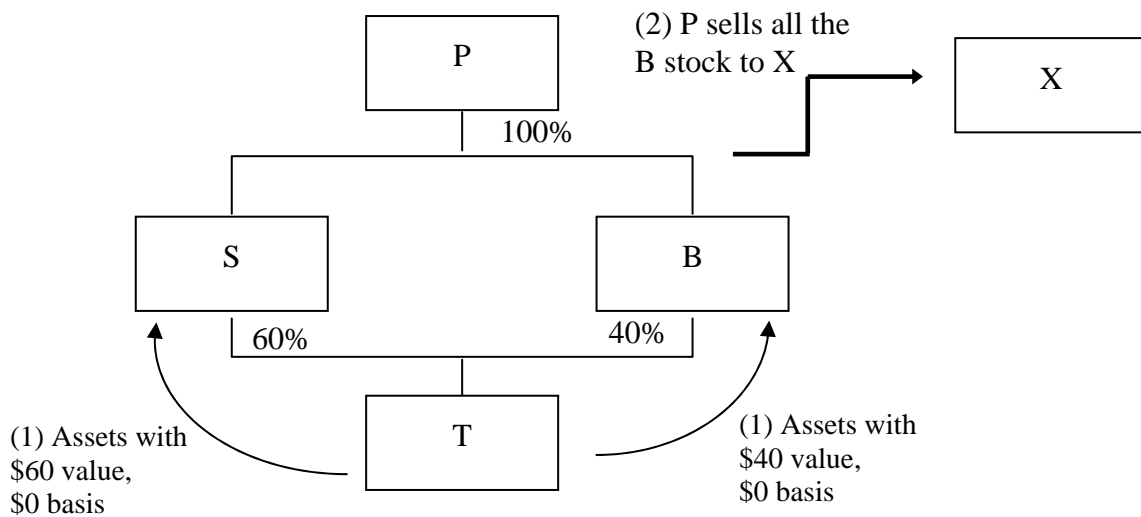
Because a principal purpose for forming and liquidating T was to avoid gain from the sale of S's land, the anti-avoidance rule requires S to take \$20 of gain into account when the B stock is sold to X, and B takes a \$20 basis in the land. Reg. § 1.1502-13(h)(2) ex. 3. The scope of the example is unclear, because there is no indication that the formation and liquidation of T is not otherwise respected. For example, what about other nonrecognition transactions that reduce the P group's income, such as a § 351 transfer to a member with SRLY NOLS? See also Reg. § 1.1502-13(h)(2) ex 1.

Comment: A second mixing bowl example is included in the final regulations, which involves similar asset movements through a partnership formed by S and B. Reg. § 1.1502-13(h)(2) ex. 4. What if the land remained in the partnership, but special § 704(b) allocations are adopted? See also Reg. §§ 1.701-2, 1.704-4(f), 1.737-4.

### B. Old Law

Provided the formation and later liquidation of T were respected for Federal income tax purposes, no intercompany gain was recognized. See §§ 336, 337(c), 351. Thus, no gain was accelerated on P's sale of the stock of B.

12. **Restructuring--Successor Rule In Section 332 Liquidations**



S owns 60%, and B owns 40%, of the stock of T. In year 1, T completely liquidates, distributing assets with a \$60 value and \$0 basis to S, and assets with a \$40 value and \$0 basis to B. In year 3, P sells all of the B stock to X.

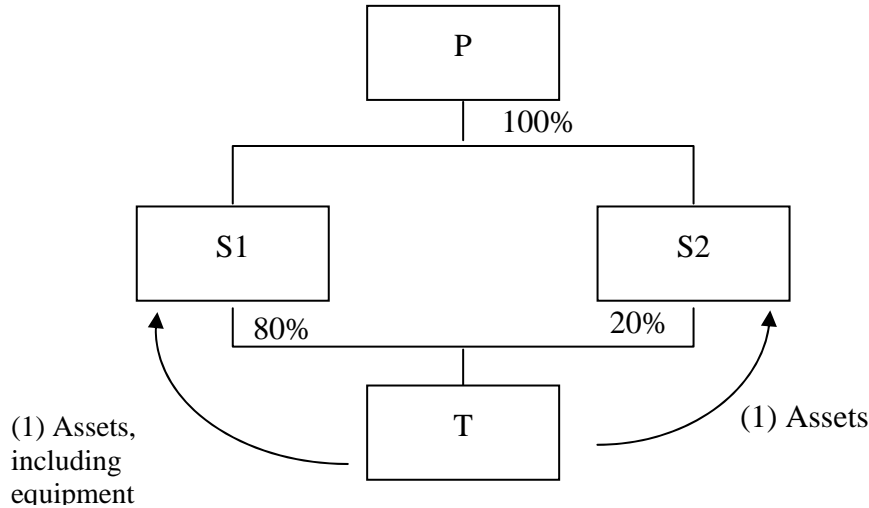
A. **Current Law**

S and B are both successors to T, with S inheriting the \$40 gain on the assets distributed to B, and B inheriting the \$60 gain on the assets distributed to S. Reg. § 1.1502-13(j)(2), (j)(9) ex. 7. The example states that this result is required to be consistent with the purposes of intercompany transaction rules. Cf. Reg. § 1.1502-13(h)(2) ex. 3. Thus, all \$100 of gain will be accelerated on P's sale of the B stock to X. (The entire amount of gain is accelerated, because it will no longer be possible to match either S's or B's gain once B leaves the group.) Compare the results if T had redeemed its stock held by B in a transaction separate from its liquidation into S.

B. Old Law

Under §§ 336 and 337(c), T would have a \$100 gain from its liquidating distributions to S and B. Because S received the majority in value of T's assets, S inherited T's entire \$100 deferred gain. Former Reg. § 1.1502-13T(c). Thus, B's deconsolidation in year 2 restored the \$40 portion of the gain on the assets owned by B (because the assets leave the group), but did not restore the \$60 gain on the assets owned by S.

13. **Restructuring-- Successor Rule In Section 332 Liquidations (Non-Intercompany Items)**



Prop. Reg. § 1.1502-13(j)(2)(ii) and (9)(i), exs. 6, 7, were withdrawn on January 15, 2008 by T.D. 9376, and, in their place, final regulations were issued under Reg. § 1.1502-80(g). Reg. § 1.1502-80(g) provides that, if multiple members (distributee members) acquire assets of a corporation in a liquidation to which § 332 applies, such members succeed to and take into account the items of the liquidating corporation (including items described in § 381(c), but excluding items under Reg. § 1.1502-13).

On January 1 of year 1, T acquired equipment with a 10-year recovery period and elected to depreciate the equipment using the straight-line method of depreciation. On January 1 of year 7, S1 and S2 own 80% and 20%, respectively, of T's stock. T is a domestic corporation but is not a member of the group that includes S1 and S2. On that date, T distributes all of its assets to S1 and S2 in complete liquidation. The equipment is distributed to S1. Under section 334(b), S1's basis in the equipment is the same as it would be in T's hands. After computing its tax liability for the taxable year that includes liquidation, T has net operating losses of \$100, business credits of \$40, and earnings and profits of \$80.

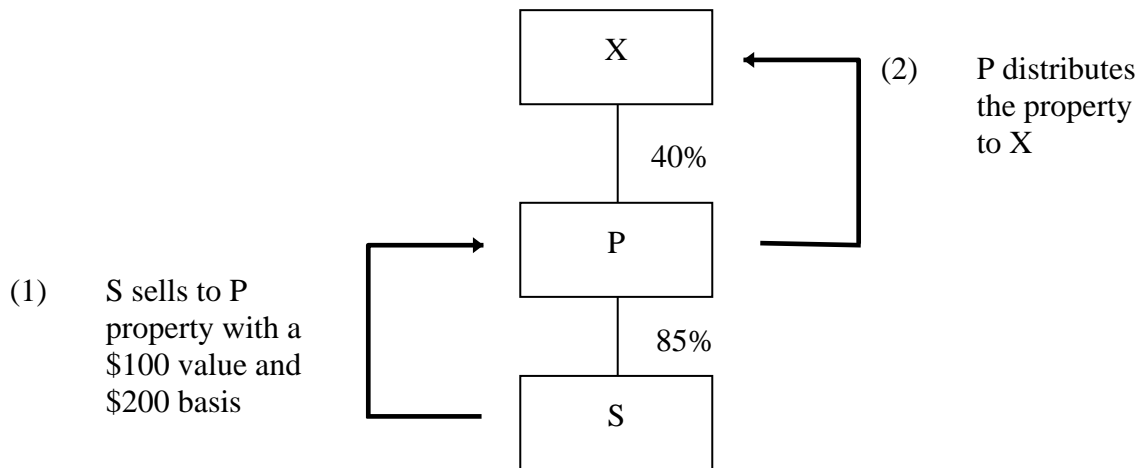
S1 and S2 succeed to \$80 and \$20, respectively, of X's net operating loss. Under Reg. § 1.1502-80(g)(1), each member succeeds to T's items that could be used to offset the income of the group or any member to the extent that such items would have been reflected in investment adjustments to the stock of T it owned under Reg. § 1.1502-32(c) if, immediately prior to the liquidation, such items had been taken into account.

S1 and S2 succeed to \$32 and \$8, respectively, of T's \$40 business credits because, immediately prior to the liquidation, S1 and S2 hold 80% and 20%, respectively, of the value of the stock of T.

In addition, T's earnings and profits are allocated to S1 and S2 under the principles of Reg. § 1.1502-32(c). Therefore, S1 and S2 succeed to \$64 and \$16, respectively of T's earnings and profits.

S1 is required to continue to depreciate the equipment using the straight-line method of depreciation over the remaining recovery period of 4.5 years (assuming T used a half-year convention) because under Reg. § 1.1502-80(g)(4), S1 owns stock in T meeting the requirements of § 1504(a)(2) without regard to the application of Reg. § 1.1502-34. See Reg. § 1.1502-80(g)(6), ex. 1 (effective for transactions occurring after April 14, 2008).

14. Section 267(f)



Although P owns 85% of the S stock, P and S do not file a consolidated return. Nevertheless, they are members of a controlled group of corporations within the meaning of § 267(f).

A. Current Law

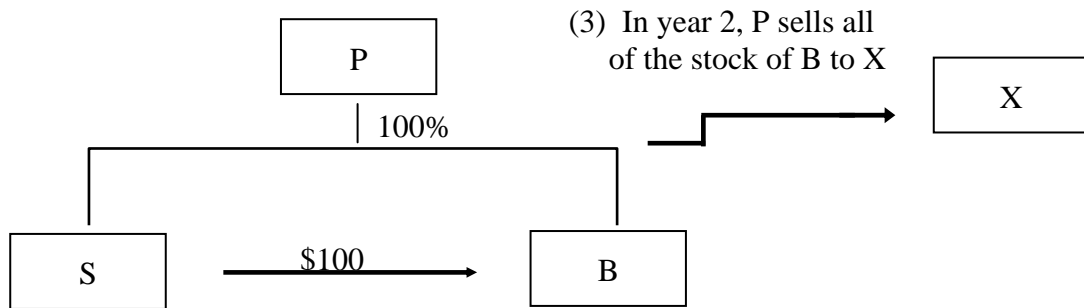
Although § 267(f) generally incorporates the timing principles of Reg. § 1.1502-13, it does not incorporate the principles relating to attributes, unless the transaction is also within a consolidated group. Under the timing principles of Reg. § 1.1502-13, S's loss would ordinarily be accelerated on P's distribution. However, a special rule continues S's loss deferral to the extent S's loss would be recharacterized as a noncapital, nondeductible amount under Reg. § 1.1502-13. Reg. § 1.267(f)-1(c)(1)(iv). If P and S had filed consolidated returns, Reg. § 1.1502-13 would recharacterize S's loss as a noncapital, nondeductible amount because of the nonrecognition of loss under § 311(a). Reg. § 1.1502-13(c)(6)(i). Thus, S's loss continues to be deferred under § 267(f) until S and P are no longer in a controlled group relationship with each other (e.g., if P sells 36% of the S stock to unrelated persons). But see Reg. § 1.267(f)-1(h).

B. Old Law

§ 267(f) generally incorporated the timing principles of Reg. § 1.1502-13 for sales of loss property among members of a controlled group. Former Reg. § 1.267(f)-1T(c)(1). Thus, S's \$100 loss was restored on P's distribution to X (a nonmember).

## **Acceleration Rule**

### 15. Sale Of Member Outside Group



(1) In year 1, S sells equipment to B and has \$40 of § 1231 gain and \$10 of § 1245 recapture income

(2) B claims \$10 of depreciation (\$5 more than if S and B had been divisions)

#### A. Timing

B's \$10 of depreciation causes S to take into account \$5 of its gain. Reg. § 1.1502-13(c)(2). P's sale of the B stock makes further matching in the P group impossible. Therefore, the entire \$45 of S's remaining gain is accelerated as a result of P's sale of the B stock to X. Reg. § 1.1502-13(d)(1)(i).

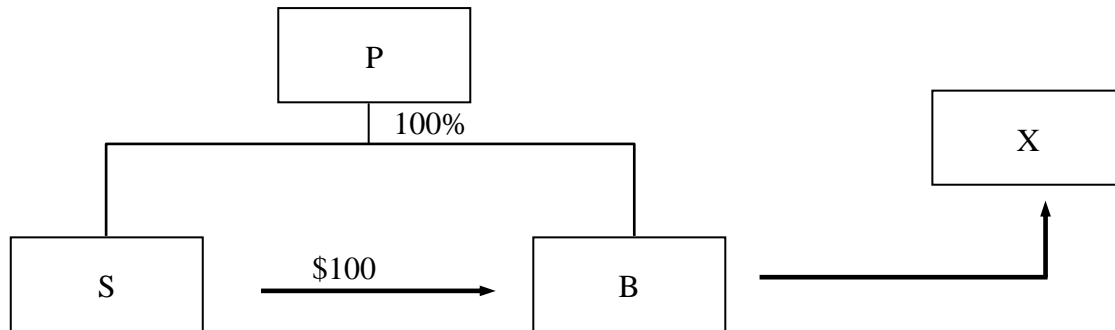
Comment: If X had purchased the stock of P (rather than B) and filed a consolidated return for the year of purchase, S's remaining \$45 gain would not have been accelerated. Reg. § 1.1502-13(j)(5), (j)(9) ex. 5.

#### B. Character

The character of S's accelerated gain is determined as if B sold the equipment to B in its capacity as a nonmember, for an amount equal to its \$90 adjusted basis immediately before P's sale. Reg. § 1.1502-13(d)(1)(ii)(A). Because B is unrelated to P, S, and B immediately after S's gain is taken into account, none of S's gain is ordinary under § 1239. The attributes of B's remaining CIs are determined as if the S division (but not the B division) were transferred by the single corporation to an unrelated person. Reg. § 1.1502-13(d)(2)(i)(B). Thus, S's activities before the intercompany transaction continue to affect the attributes of the CIs.

Comment: If P had sold S's stock to X, or had sold the B stock to a party related to P, S's accelerated gain might be ordinary. Reg. § 1.1502-13(d)(1)(ii)(A)(2), (d)(3) ex. 2(c).

16. **Section 351/721 Exchange Outside Group**



(1) S sells property with a basis of \$200 to B for \$100, recognizing a \$100 § 1231 loss

(2) B exchanges the property with X for \$100 of X equity in § 351 (or § 721) transaction

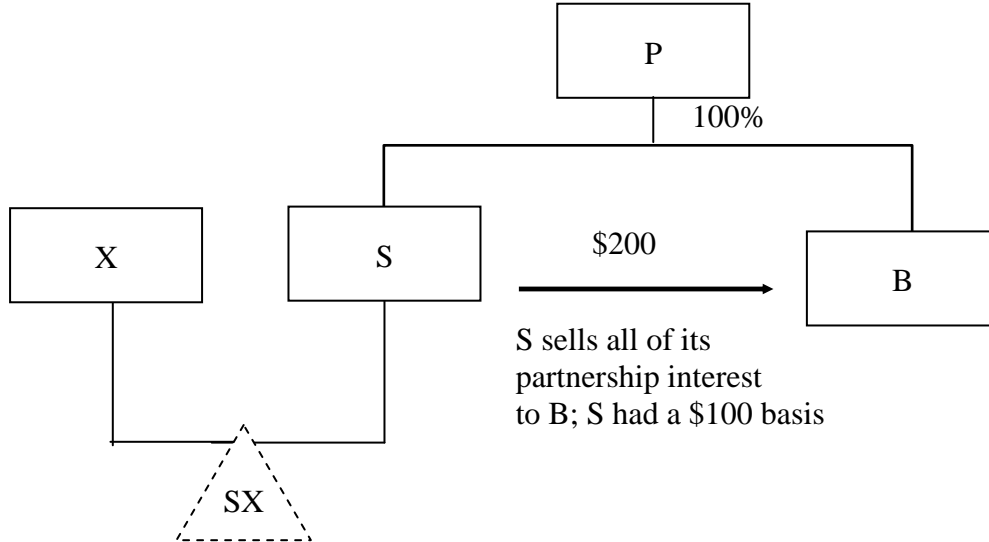
A. X is corporation

If X is a nonmember corporation, acceleration of S's remaining IIs ordinarily is required by Reg. § 1.1502-13(d)(1)(i)(B). See Reg. § 1.1502-13(c)(7)(ii) ex. 1(j), -13(d)(1). However, acceleration of loss does not occur if X is a member of the same controlled group as B (e.g., P also owns 50% or more in vote and value of the stock of X). Reg. § 1.267(f)-1(j) ex. 4(c). Moreover, the loss would be disallowed if X were related to any member under § 267(b). Reg. § 1.267(f)-1(c)(1)(iii); see also Reg. §§ 1.1502-13(h), 1.267(f)-1(h) (anti-avoidance rules).

B. X is partnership

If X is a partnership that is less than 50% owned by B, the result appears to be the same (i.e., the loss is allowed to S), even though the loss would have been proportionately disallowed if S had sold the property directly to the partnership. If the partnership is related to any member of the P group under § 267(b) or § 707(b), however, the entire loss is disallowed. Reg. § 1.267(f)-1(c)(iii), -1(j) ex. 6(b). For example, if P owns a more than 50% capital or profits interest in X, X will be related. See also Reg. §§ 1.1502-13(h), 1.267(f)-1(h). The results would be similar if S had directly sold the property to X for \$100. See §§ 267(b)(10), 707(b); Reg. § 1.267(b)-1(b)(1).

## 17. Transfer Of Partnership Interest



### A. S Owns 20% Interest

Because S owns only a 20% capital and profits interest in SX, SX does not terminate under § 708(b)(1)(B). Consequently, S's \$100 gain is deferred even if SX has a § 754 election in effect (giving B a \$100 § 743(b) step-up in the basis of the SX assets). This step-up is personal to B (i.e., no nonmember reflects any aspect of the intercompany sale), and, therefore, the acceleration rule does not apply. Reg. § 1.1502-13(c)(7)(ii) ex. 9(b). Thus, S's gain may continue to match with the SX assets as well as with B's partnership interest in SX. Reg. § 1.1502-13(j)(3). If SX later distributes property to B in complete liquidation of its interest in SX, B's \$200 cost basis from the intercompany purchase becomes the basis of the property, and the property is successor property for subsequent matching. § 732(b); Reg. § 1.1502-13(j)(1), (j)(9) ex. 2.

### B. S Owns 50% Interest

#### 1. Current Law

If S owns a 50% capital and profits interest, S's sale will terminate SX under § 708(b)(1)(B). As a result, SX is deemed to contribute all of its assets and liabilities to a new partnership and distribute the interests in the new partnership to S and X. See Reg. § 1.708-1(b)(4). Thus, the basis of the assets in new SX does not reflect B's \$200 cost basis from the intercompany purchase (whether or not a § 754 election is in effect). Therefore, S's \$100 gain is not accelerated. See §§ 721, 723; Reg. § 1.1502-13(c)(7)(ii) ex. 9, (d)(1)(i)(B). This treatment applies to partnership terminations occurring on or after May 9, 1997. However, this treatment may be applied to terminations occurring on or after May 9, 1996,

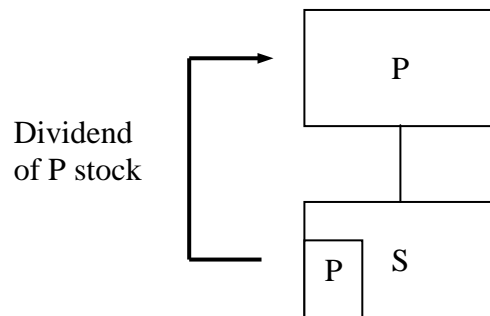
provided that the partnership and its partners apply the regulations to the termination in a consistent manner. See Reg. § 1.708-1(b)(4).

2. Old Law

S's sale still caused a termination of SX under § 708(b)(1)(B). However, the termination resulted in a deemed distribution of assets by SX to S and X, followed by a recontribution of such assets to a new partnership. Former Reg. § 1.708-1(b)(1)(iv). Thus, the basis of the assets in a nonmember, new SX, reflected B's \$200 cost basis from the intercompany purchase (whether or not a § 754 election is in effect). Therefore, S's \$100 gain was accelerated. See §§ 723, 732; Reg. § 1.1502-13(d)(1)(i)(B); Notice 94-49, 1994-1 C.B. 358.

## **Member Stock**

## 18. Distribution Of Member Stock To Issuer



S becomes a member of the P consolidated group at a time when S owns 100 shares of P stock. The shares were acquired by S several years earlier from the public, and they have a \$70 basis and \$100 value when S becomes a member. S distributes the shares to P after becoming a member.

### A. Current Law

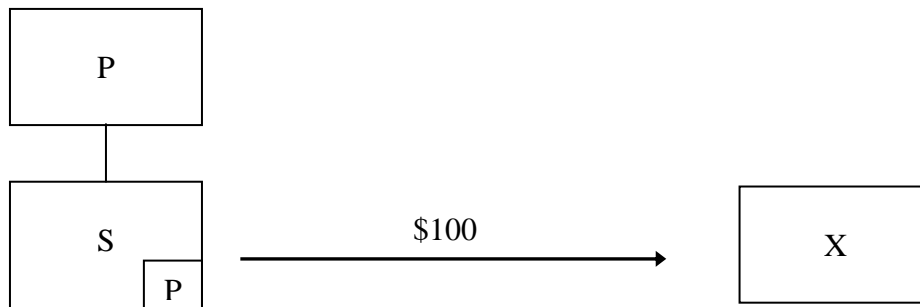
On P's acquisition of its own stock, P's basis in the stock is treated as eliminated for all purposes, and S's \$30 intercompany gain is taken into account under the acceleration rule. Reg. § 1.1502-13(f)(4). In effect, matching is no longer possible and acceleration is required. The attributes of S's gain are determined by applying the matching rule as if P had sold the stock to an affiliated corporation that is not a member of the group at no gain or loss. Reg. § 1.1502-13(d)(1)(ii)(A)(2). Although any CI of P from a later sale of the stock would be subject to § 1032, S's gain must be included as capital gain (provided § 341 does not apply) rather than excluded from gross income. Reg. § 1.1502-13(c)(6)(ii), (f)(7) ex. 4; cf. Arrowsmith v. Comm'r, 344 U.S. 6 (1952).

Comment: No acceleration would occur if, for example, S had exchanged its P stock for successor property in a recapitalization described in § 368(a)(1)(E). Reg. § 1.1502-13(j)(1), (j)(9) ex. 2. No gain would be recognized in the first place if S distributed the P stock to P in a complete liquidation of S under §§ 332 and 337.

### B. Old Law

G.C.M. 39,608 (Mar. 4, 1987) provided that S's \$30 gain under § 311(b) was deferred under Former Reg. § 1.1502-14(c)(1) until, for example, P actually sold the same shares to a nonmember, the shares were cancelled, or S left the group. In effect, potential indefinite deferral of gain (i.e., the equivalent of exemption) was available as long as P held the shares as treasury stock and S remained a member.

19. Sale Of Common Parent Stock Out Of Group



S becomes a member of the P consolidated group at a time when S owns 100 shares of P stock. The shares have a \$130 basis and \$100 value. S sells the shares to X after S becomes a member.

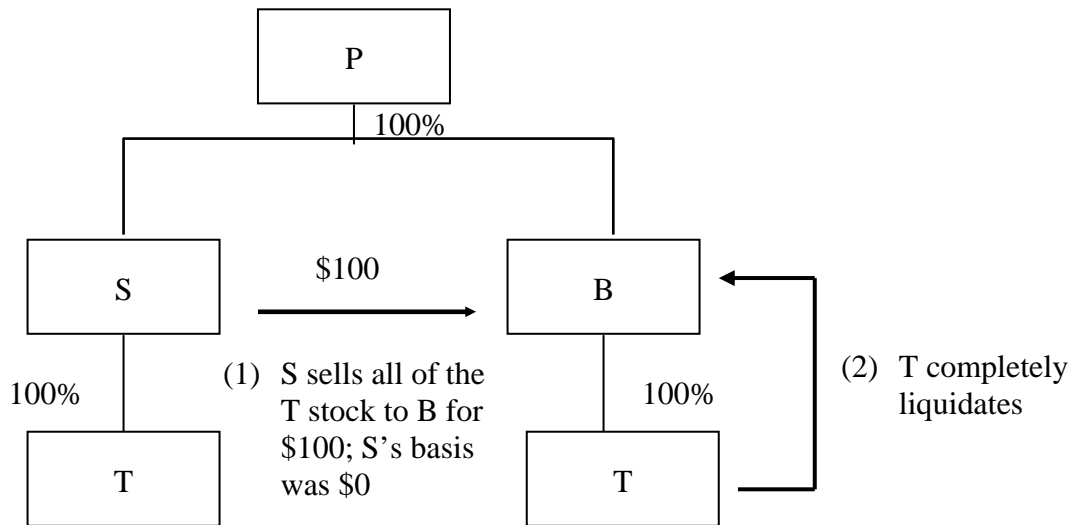
A. Current Law

The regulations generally continue separate-entity treatment. Reg. § 1.1502-13(f); cf. Reg. § 1.1502-13(g). However, S's \$30 loss on the stock of P, the common parent, is permanently disallowed. Reg. § 1.1502-13(f)(6)(i)(A). (If, instead of selling the P stock, S becomes a nonmember, S's basis in the P stock is reduced to \$100 immediately before S becomes a nonmember. Reg. § 1.1502-13(f)(6)(i)(B)). Any dividends from P to S are subject to whatever DRD is available. Reg. § 1.1502-13(f)(2)(ii); see also § 1509(e)(1) (Seagram's legislation).

Comment: Limited gain relief is also provided. S must acquire P stock directly from P in a capital contribution or § 351 transaction and must, pursuant to a plan, transfer the stock immediately to X in a taxable transaction. In addition, P must remain the common parent and S must remain a member. Reg. § 1.1502-13(f)(6)(ii). Note that this provision has been supplanted by Reg. § 1.1032-3. As a result, Reg. § 1.1502-13(f)(6)(ii) no longer applies to dispositions on or after May 16, 2000.

B. Old Law

Based on separate-entity rules, S generally recognized gain or loss on its disposition of P stock. Former Reg. § 1.1502-14. But see Rev. Rul. 80-76, 1980-1 C.B. 15 (no gain on S's use of P stock to compensate S's employee); Reg. § 1.1032-2 (no gain or loss on S's use of certain P stock in triangular reorganizations). See also Prop. Reg. § 1.337(d)-3 (redemption treatment when partnership acquires certain interests in stock of a partner). Moreover, any dividends from P to S were eliminated. Former Reg. § 1.1502-14(a)(1).

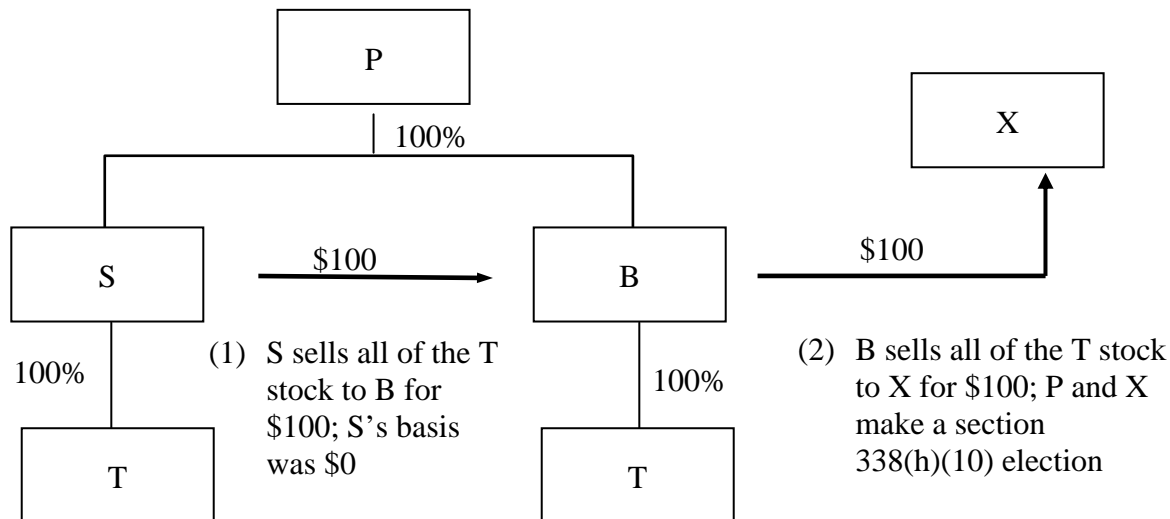
20. Section 332 LiquidationA. Current Law

B's CIs include amounts that are permanently disallowed or permanently eliminated (e.g., under § 332). Reg. § 1.1502-13(b)(3)(ii). Thus, if the value of T's assets is at least \$100 at the time of the distribution, the difference between B's RCI and its \$0 CI will be at least \$100, and the matching rule will require that S's entire \$100 intercompany gain be taken into account on T's liquidation. Reg. § 1.1502-13(f)(7) ex. 6. The regulations provide elective relief from the triggering of S's gain as a result of T's liquidation under certain circumstances. To qualify for relief, (i) B must transfer substantially all of T's former assets to a newly formed corporation ("new T"), (ii) the transfer must be pursuant to a written plan, a copy of which must be attached to a timely filed original return (with extensions), and (iii) the transfer must be completed within 12 months of the date the return is filed. Reg. § 1.1502-13(f)(5)(ii)(B). If the transfer to new T qualifies, B's stock in new T will be treated as a successor to the T stock, and S's II will be taken into account based on the new T stock. Reg. § 1.1502-13(j)(1). This relief is thus available only if T's liquidation was not inadvertent.

B. Old Law

Deferred gain attributable to member stock was restored when the stock was disposed of outside the group or redeemed. Former Reg. § 1.1502-13(f)(1)(i), (1)(vi). The IRS took the position that S's gain was restored on T's liquidation. See Notice 94-49, 1994-1 C.B. 358.

21. **Section 338(h)(10) Election**



A. **Current Law**

As with an actual § 332 liquidation, S must take its \$100 intercompany gain into account on the deemed liquidation under § 338(h)(10). Reg. § 1.1502-13(f)(5)(i). However, elective relief is provided, which would treat B as recognizing, with respect to each share of its T stock, the amount of loss or deduction B would recognize (determined after adjusting stock basis under § 1.1502-32 for T's gain or loss) if § 331 applied to the deemed liquidation, but only to the extent of the gain recognized by S on the intercompany sale to B of the T stock. Reg. § 1.1502-13(f)(5)(ii)(C). In effect, the group will pay tax on the greater of its T stock gain or T asset gain. Thus, if S's basis in the T stock equals T's net asset basis, S's gain and B's loss should offset and the group will effectively take into account only the gain on the deemed asset sale.

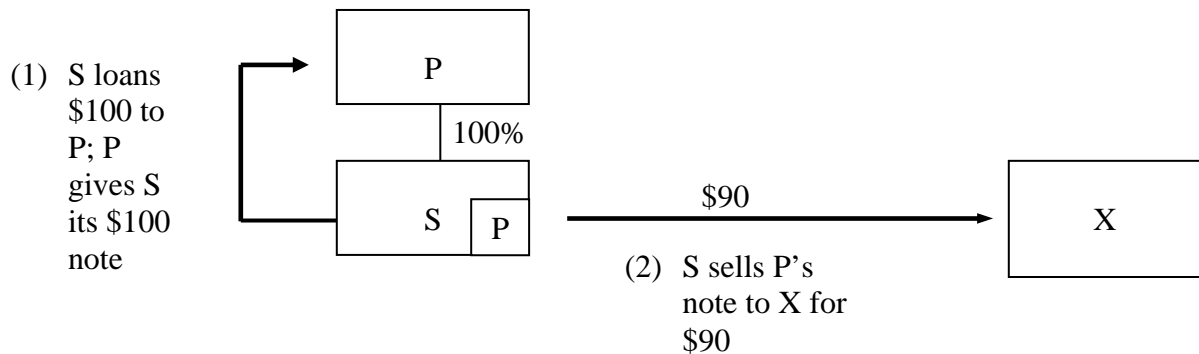
Comment: The proposed restrictions on the relief, relating to netting stock gain and loss, minority shareholders, noncash distributions, and determining a share-by-share limit on loss, were all deleted in the final regulations. See Preamble to Reg. § 1.1502-13, 60 Fed. Reg. at 36,676.

B. **Old Law**

As a result of the § 338(h)(10) election, T is deemed to liquidate (generally under § 332). Deferred gain attributable to member stock was restored when the stock was disposed of outside the group or redeemed. Former Reg. § 1.1502-13(f)(1)(i), (1)(vi). The IRS took the position that S's gain was restored on T's liquidation. See Notice 94-49, 1994-1 C.B. 358.

## **Member Obligations**

22. **Sale Of Intercompany Obligation To Unrelated Party Outside The Group**



A. Current Law

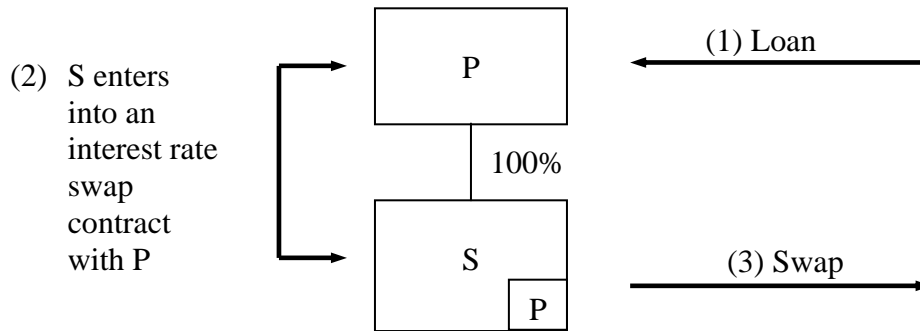
P is treated as retiring its debt immediately before S's sale, for the \$90 paid by X, and issuing a new instrument directly to X for \$90. Reg. § 1.1502-13(g)(3). As a result of the retirement, P takes into account \$10 of COD income (even if § 108(a) would otherwise apply) that is offset by S's \$10 ordinary loss. Reg. § 1.1502-13(g)(3)(ii)(B), -13(g)(5) ex. 2. X holds the "new" note with \$10 of OID that is taken into account by P and X over the life of the new note. Reg. § 1.1502-13(g)(3)(iii), -13(g)(5) ex. 2.

Proposed amendments to Reg. § 1.1502-13(g)(3) were issued on December 21, 1998, which clarify the form of the deemed satisfaction and reissuance. The proposed regulations clarify that the debtor (P) is deemed to satisfy the obligation immediately before the transfer for an amount equal to the cash received (\$90). The \$90 is then treated as transferred by the initial creditor (S) to the transferee (X) and advanced by X to the debtor (P) in a deemed reissuance of the obligation. Prop. Reg. § 1.1502-13(g)(3)(ii), (iii).

B. Old Law

S's loan of \$100 to P was generally respected for purposes of §§ 1271 et seq., but the income and deductions generally offset in consolidated taxable income. P's note had a \$100 issue price and stated redemption price. Thus, X held the note with a \$10 market discount (rather than \$10 of OID). S deferred its \$10 loss and took it into account ratably as P paid the principal of the note. Former Reg. § 1.1502-14(d).

23. **Mark-to-Market Accounting And Intercompany Obligations**



S is a dealer subject to section 475 mark-to-market accounting.

A. Current Law

The swap contract is clearly an obligation subject to the intercompany debt rules. Reg. § 1.1502-13(g)(2). Marking to market the P note under § 475 results in a deemed satisfaction and reissuance of the note at the end of each year, with P and S taking offsetting gain and loss into account. Reg. § 1.1502-13(g)(3), (g)(5) ex. 5; see also Prop. Reg. § 1.1502-13(g)(3)(i)(A). These rules result in significant recordkeeping and computational burdens that are not required for financial statement or internal management reporting purposes.

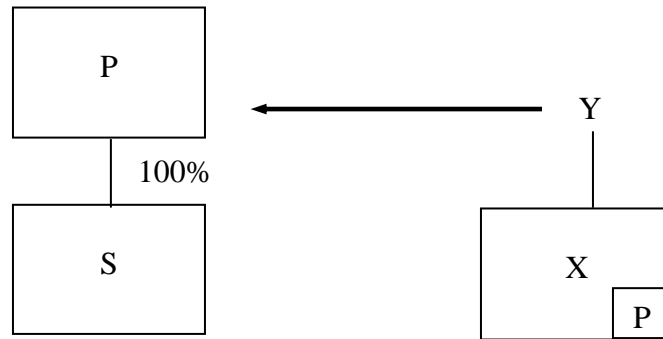
Comment: Reg. § 1.446-4(e)(9) provides an important exception to the general single-entity treatment of intercompany obligations. Under the regulations, a group may make a separate-entity election, effectively treating the members as if they were not members for purposes of their hedge accounting.

B. Old Law

S's contract with P was generally respected for purposes of § 1502, with income and deductions generally offsetting in the determination of consolidated taxable income. If S recognized gain or loss on the note under § 475, it was unclear whether the gain or loss was deferred, because Former Reg. § 1.1502-14(d) only required deferral on "an obligation of another member."



25. **Non-Intercompany Obligation Becomes An Intercompany Obligation**



X becomes a member of the P consolidated group at a time when X owns a P note with a \$130 adjusted issue price and \$100 stated redemption price. X acquired the note several years ago for \$130, and the note now has a \$90 value.

A. Current Law

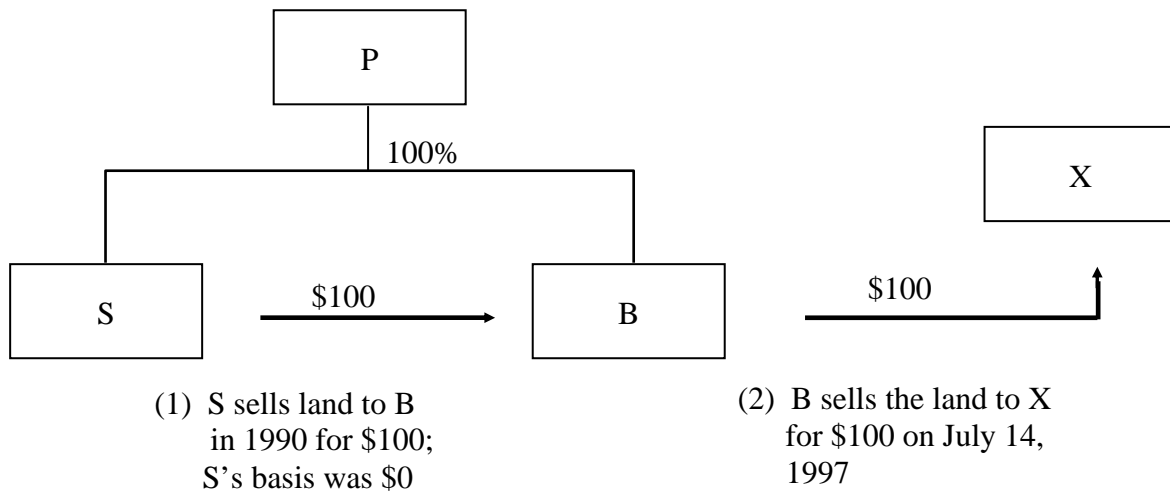
P is treated as satisfying its indebtedness for \$90 (determined under the principles of § 1.108-2(f)(2)) **immediately after** X becomes a member. Reg. § 1.1502-13(g)(4). The attributes of P's and X's items from the deemed satisfaction are determined on a separate-entity basis, and any loss of X is subject to limitation under § 382, the SRLY rules, and any other generally applicable provisions. Thus, P has \$40 of ordinary COD income, and X has a \$40 capital loss, both of which are taken into account in determining consolidated taxable income. P has the option of waiving all or any part of X's \$40 loss before X becomes a member, if P is concerned that the loss will not be absorbed and its later expiration will result in a negative investment adjustment. Reg. §§ 1.1502-13(g)(4)(ii)(E), 1.1502-32(b)(4). P is also treated as reissuing a new note to X after X becomes a member. The new note is an intercompany obligation with a \$90 issue price and \$100 stated redemption price. Thus, the new note will yield \$10 of OID.

B. Old Law

Unless § 108(e)(4) applied, no recognition event resulted merely from P buying X's stock. § 108(e)(4) only applies to discounted debt, and primarily applies only to take into account COD income.

## **Miscellaneous**

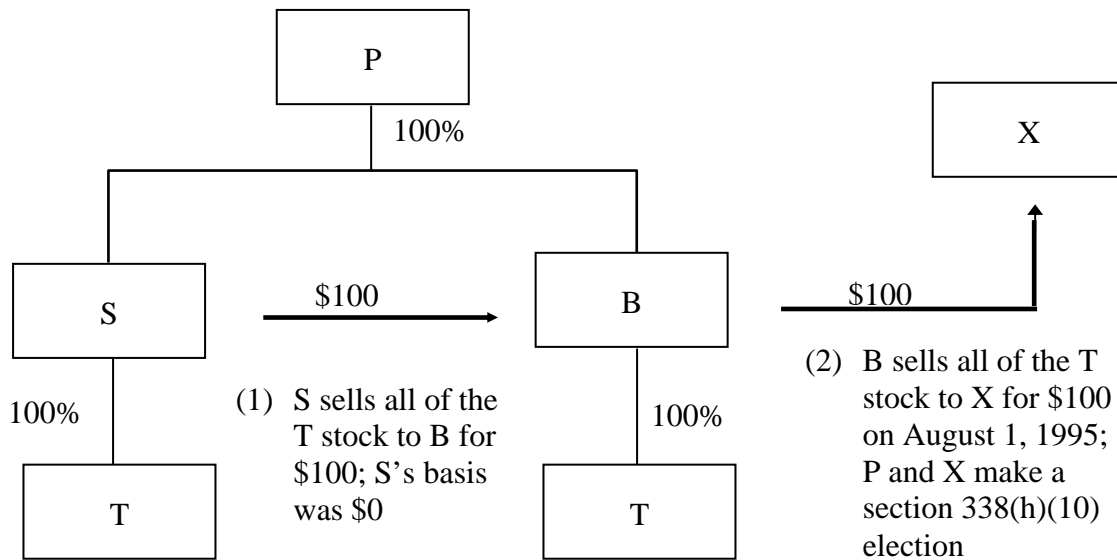
26. **Effective Dates--Generally**



In general, the current regulations apply only to “transactions” occurring in years beginning on or after July 12, 1995. Reg. § 1.1502-13(l)(1); cf. Reg. § 1.1502-32(h)(1) (disposition approach). If both the new and old regulations apply (or neither applies), then the old regulations apply. Although the term “transactions” is not defined, examples indicate that because S’s intercompany transaction occurred in 1990, S’s gain is taken into account under the old regulations. See also Reg. § 1.1502-13(l)(4), (5). If B were to engage in a second intercompany transaction in 1997, its transaction would be under the current regulations, but S’s gain would remain under the old regulations.

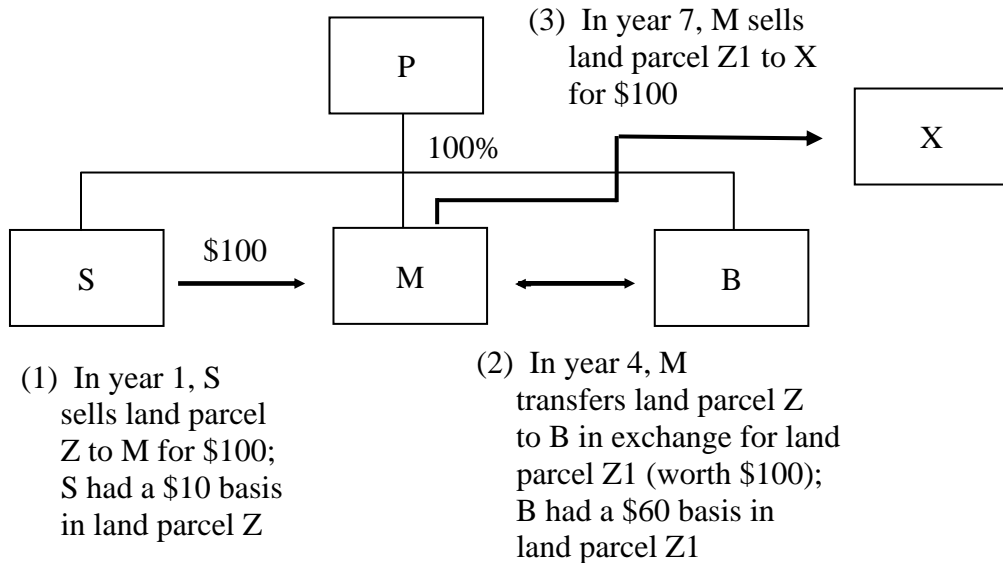
A special rule provides that the current regulations apply if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the current rules. Reg. § 1.1502-13(l)(2). The scope and application of this rule are unclear. For example, if B’s sale to X were accelerated to December 31, 1994, could there be an avoidance transaction or is the rule generally limited to avoidance intercompany transactions? If a transaction has the requisite avoidance, it is unclear how “appropriate adjustments” would be made in years beginning on or after July 12, 1995 to prevent avoidance, duplication, omission, or elimination of items or tax liability. For example, if B accelerated a gain into 1994 to preserve its capital (rather than ordinary) character, what adjustment must be made and in what returns must the adjustment appear?

27. **Effective Dates--Intercompany Stock Sale Before Effective Date; Section 338(h)(10) Sale After Effective Date**



Although the current regulations generally apply only if the intercompany transaction occurs in a year beginning on or after July 12, 1995, a group may elect to apply the current regulations to all “stock elimination transactions” to which prior law would otherwise apply. Reg. § 1.1502-13(1)(3). Stock elimination transactions are those transactions described in Reg. § 1.1502-13(f)(5) that occur on or after July 12, 1995. If an election is made, the relief under Reg. § 1.1502-13(f)(5), and not prior law, applies to all of S’s and B’s gain or loss from stock with respect to such transactions, regardless of when the prior intercompany transactions occurred. Because B sold the T stock with a § 338(h)(10) election on or after July 12, 1995, Reg. § 1.1502-13(f)(5) may be elected even though S’s intercompany sale occurred in 1990. If the election is made, B will be treated with respect to each share of its T stock as recognizing the amount of loss or deduction B would recognize (determined after adjusting stock basis under § 1.1502-32 for T’s gain or loss) if § 331 applied to the deemed liquidation, but only to the extent of the gain recognized by S on the intercompany sale to B of the T stock. Reg. § 1.1502-13(f)(5)(ii)(C).

28. **Inapplicability Of Section 1031 To Intercompany Exchanges**



A. Current Law

Reg. § 1.1502-80(f) makes § 1031 inapplicable to intercompany exchanges. Thus, B recognizes a \$40 gain on the exchange with M, B takes a \$100 cost basis in land parcel Z, and M takes a \$100 cost basis in land parcel Z1. S continues to defer its \$90 gain with respect to land parcel Z, while B (not S) takes its \$40 of gain into account when M sells land parcel Z1 to X for \$100:

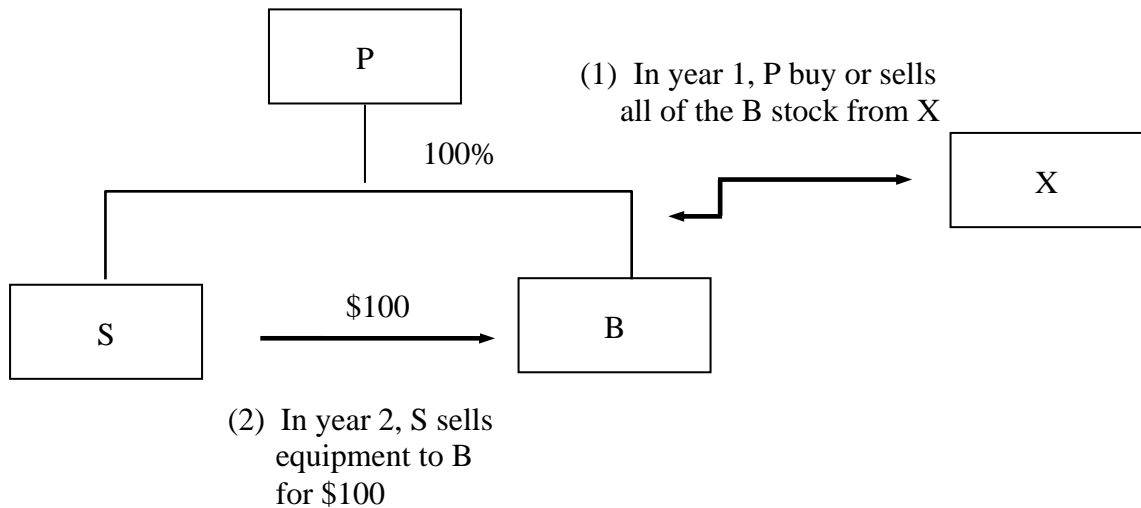
Comment: The retroactive feature of Reg. § 1.1502-13(l)(2) does not apply to make -80(f) retroactively applicable, although it may make -13(h) (anti-avoidance rule) apply to a prior-period transaction.

B. Old Law

Former Reg. § 1.1502-13(f)(1)(i) and -13(m) provided that S must restore its gain on the transfer of either land parcel Z or Z1 outside the group. B did not recognize any gain on the exchange with M because § 1031 applied. See also § 1031(f).

RCI	=	\$40 gain (if basis were \$60)
CI	=	<u>\$0</u> gain
Difference	=	<u>\$40</u>

29. **Accounting Methods**



The timing rules of Reg. § 1.1502-13 are a method of accounting, to be applied by each member in addition to its other methods. Clear reflection of income results only if the effect as a whole (including treatment of related costs and expenses) on consolidated taxable income is clearly reflected. Reg. § 1.1502-13(a)(3); see also Reg. § 1.446-1(c)(2)(iii) (providing that, pursuant to § 446, the timing rules of Reg. § 1.1502-13 are a method of accounting for consolidated return years beginning on or after November 7, 2001).

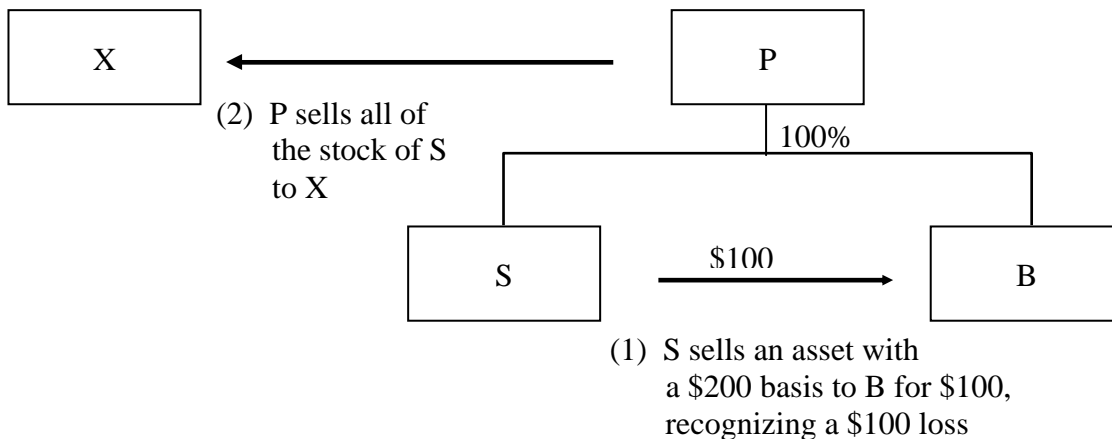
Automatic § 446(e) consent is granted (i) for each new member, with respect to its intercompany transactions, and (ii) for each former member, with respect to transactions with members that would have been intercompany transactions. Method changes are made on a cut-off basis. Reg. § 1.1502-13(a)(3).

The common parent may request consent to take all items from, or only items from a class of, intercompany transactions (other than transactions with respect to member stock or obligations) into account on a separate-entity basis, but the consent does not apply for purposes of § 267(f). Reg. § 1.1502-13(e)(3).

If a member changes its application of Reg. § 1.1502-13, § 446(e) (including § 481(a), computed on a consolidated return basis) is applicable, and the change generally will be made on a cut-off basis. Reg. § 1.1502-17(b).

If B acquires S's activity with the principal purpose to avail the group of a method otherwise unavailable (or unavailable without consent from the Commissioner) if S and B were divisions of a single corporation, B must determine its method for the activity as if the activity were acquired in a § 381 transaction, or must seek § 446(e) approval for a different method. Reg. § 1.1502-17(c).

30. **Elimination Of Section 267(f) Anomaly**



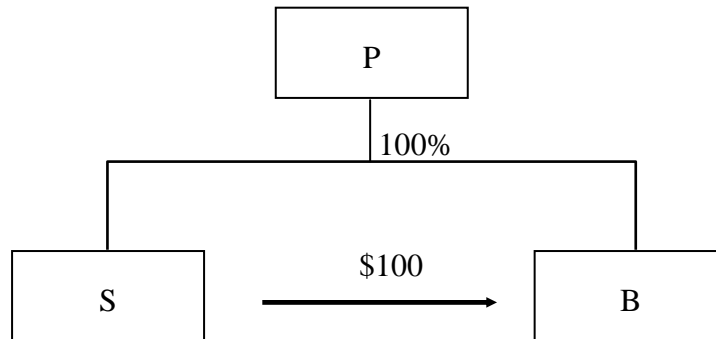
A. Current Law

§ 267(f) generally incorporates the timing principles of Reg. § 1.1502-13 (but not the principles relating to attributes or holding period, unless the transaction is within a consolidated group) for sales of loss property between members of a controlled group. Reg. § 1.267(f)-1(a)(2). Thus, provided X is not a member of the same controlled group as B, § 267(f) will no longer defer S’s \$100 loss otherwise accelerated under Reg. § 1.1502-13. There is, however, an anti-avoidance concern if the disposition of S’s stock is with a principal purpose of avoiding the purposes of § 267(f). Reg. § 1.267(f)-1(h), -1(j) ex. 8. Is the analysis influenced by whether X is related, but outside, the P controlled group?

B. Old Law

S’s \$100 loss was not restored on P’s sale of S to X. Former Reg. § 1.267(f)-1T(c)(6), (7). Instead, the loss was permanently disallowed to S, and the basis of the property in the hands of B was increased to \$200. Thus, the location of the loss shifted from S to B.

31. **Expansion Of Section 108(b) Attributes**



S sells asset with a \$200 basis to B for \$100, recognizing a \$100 loss

S owns property with a \$200 basis and \$100 value. S has no other assets (except cash) and no other attributes. Before the last day of a taxable year in which S has \$75 of COD income that is excluded under § 108(a), S sells the asset to B for \$100, recognizing a \$100 loss.

A. Current Law

For discharges occurring on or after September 11, 1995, any loss deferred under § 267(f) or Reg. § 1.1502-13 is treated as basis in property owned by S, thereby requiring such deferred loss to be reduced by \$75 under § 108(b). Reg. § 1.108-3(a).

B. Old Law

No mention is made in § 108(b) of deferred intercompany losses as attributes subject to reduction under § 108(b), and the existing consolidated return regulations are also silent on this subject. Thus, S would seem to be able to argue that its deferred loss was not reduced under § 108(b).