

ALI-ABA Course of Study
Consolidated Tax Return Regulations

Cosponsored by the ABA Section of Taxation

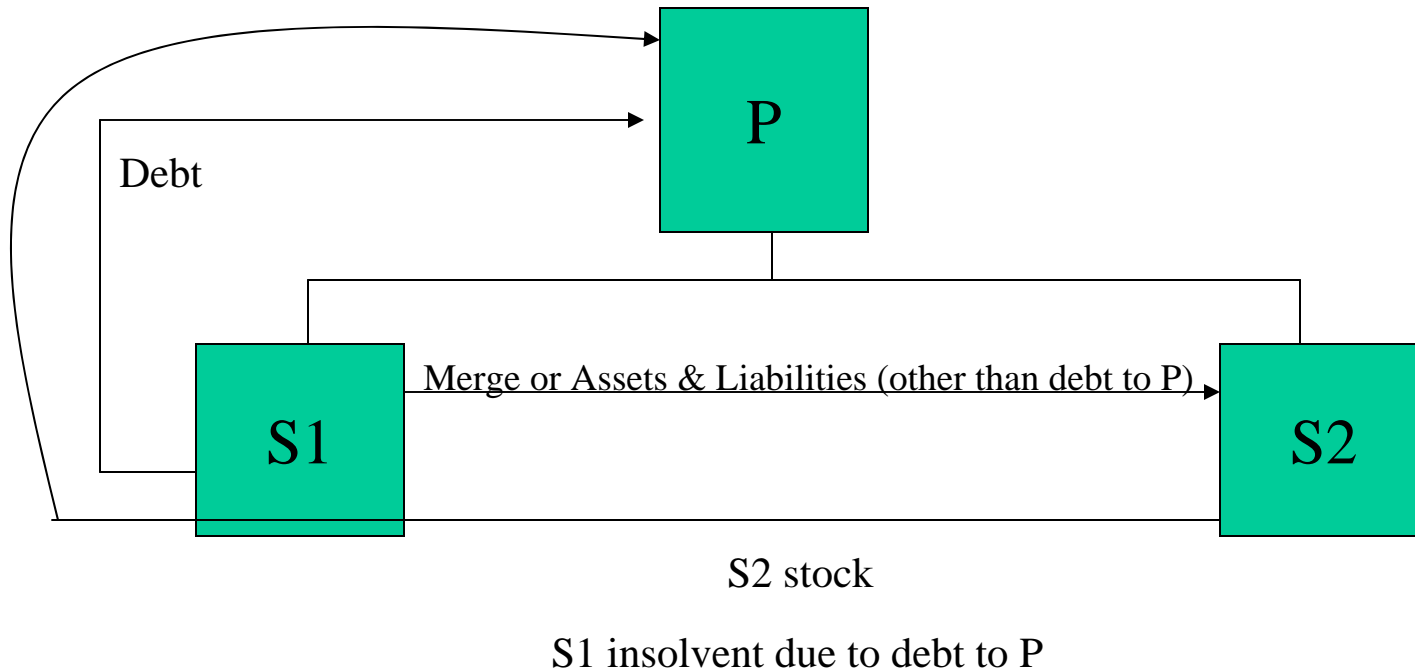
October 2-3, 2003
Washington, D.C.

ACQUISITION AND SEPARATION
ISSUES IN CONSOLIDATION

INSOLVENT CORPORATIONS

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Insolvency & Reorganizations (Parent Debt)



Questions:

- 1) Does *Norman Scott* apply to this transaction?
- 2) What is the result if P cancels the debt owed by S1 before the transaction?
- 3) What is the result if S1 transfers the P debt to S2 and thereafter P cancels the debt owed to it?
- 4) Is a worthless stock deduction inconsistent with tax-free reorganization treatment?

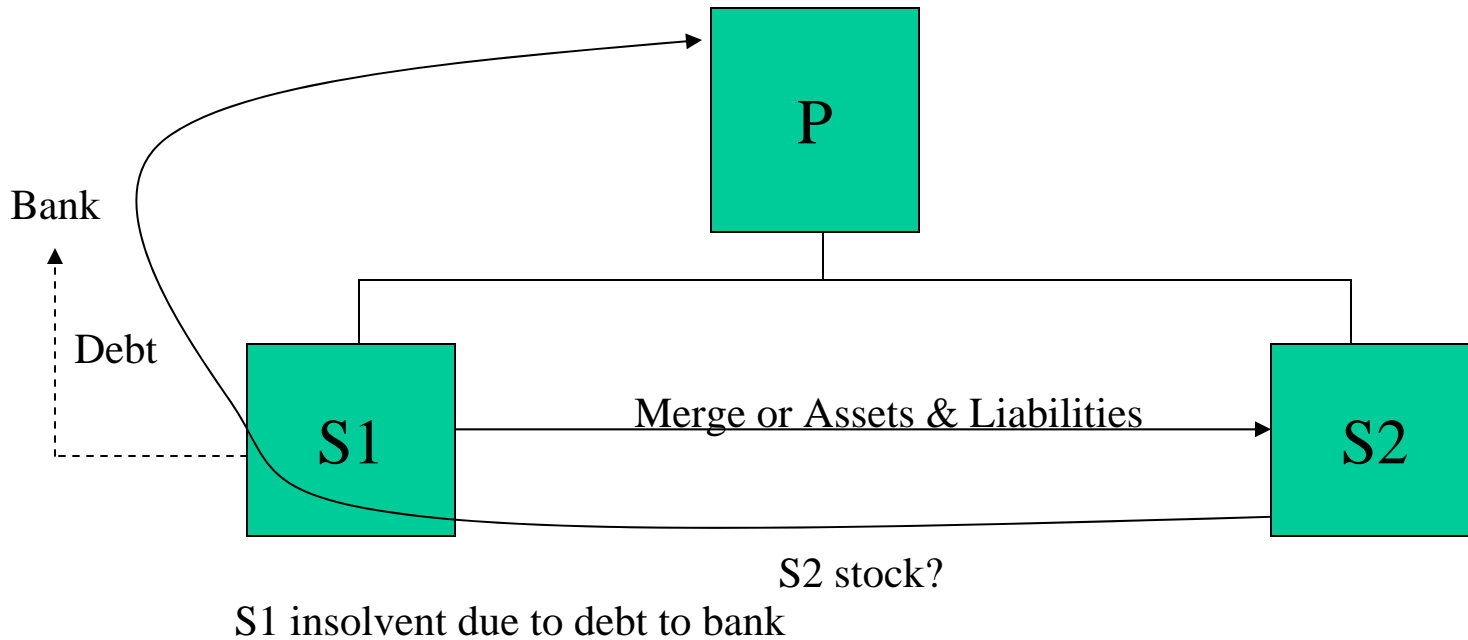
Authorities Where Shareholders Were Also Creditors

- *Norman Scott, Inc.*, 48 TC 598 (1967), held that mergers of two insolvent corporations into a third corporation owned by the same persons, who got more stock in the merger, could be treated as a Type A reorganization. The shareholders were also creditors, and therefore could be *Alabama Asphaltic* equity owners; the opinion did not decide whether they got the stock of the survivor by virtue of their target shareholder status or target creditor status.
- See also Rev. Rul. 54-610, 1954-2 CB 152, approved “C” reorganization where target shareholder/creditors received 64% of acquiring corporation’s stock and target creditors got 36% and shareholders who were not creditors got nothing; ruled that the “bondholders” got carryover basis treatment; discussed only the bond for stock swap, with no reference to what happened to basis of stock.

Authorities Where Shareholders Were Also Creditors

- GCM 33859 (6/25/68) The Chief Counsel recommended a Rev. Rul. to clarify the IRS reaction to *Norman Scott*. He attached a legal analysis by the Interpretive Division on a prior AOD recommendation to acquiesce in result only due to confusion in the Tax Court opinion. Ultimately, nothing other than the AOD was issued.
- The GCM analysis agreed that where the shareholders were also the creditors of the merging corporation, a Type A reorganization could occur. But it disagreed with the Tax Court's implication that the insolvency of a corporation eliminated the shareholder's equity interest, absent action by the creditors to replace the shareholders as had occurred in *Alabama Asphaltic*. It emphasized continued importance of nominal stockholder status.

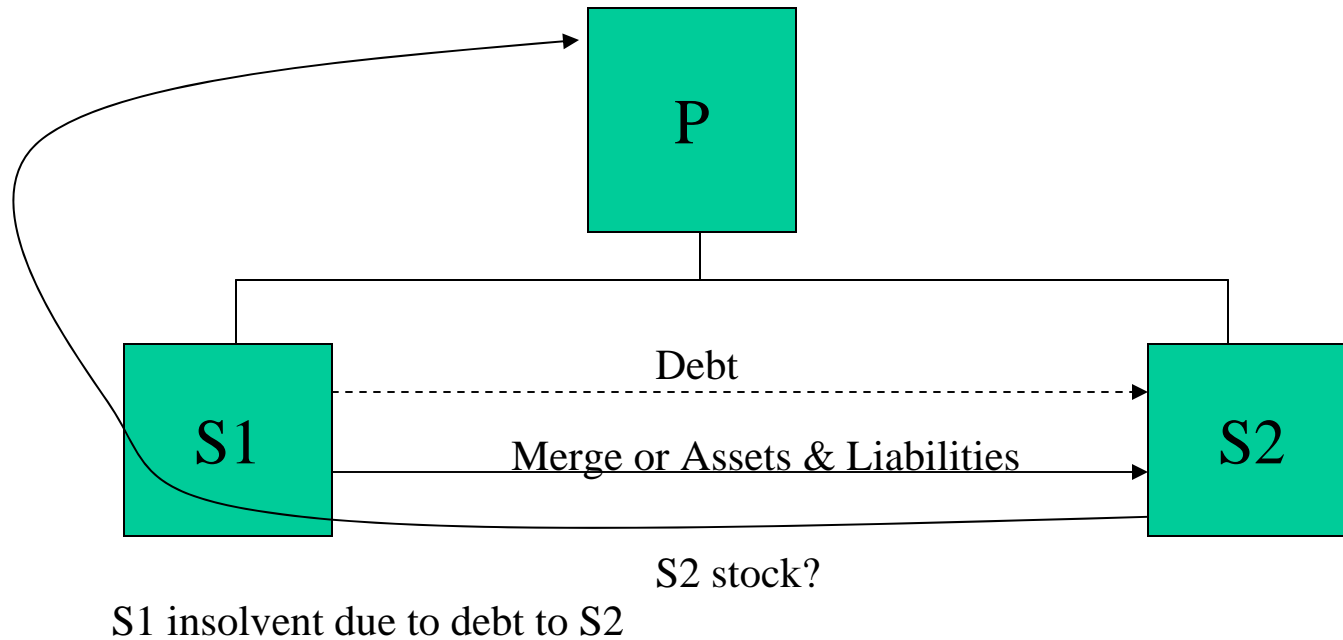
Insolvency & Reorganizations (Third Party Debt)



Questions:

- 1) Does *Norman Scott* apply to this transaction?
- 2) Does *Alabama Asphaltic* provide any guidance?

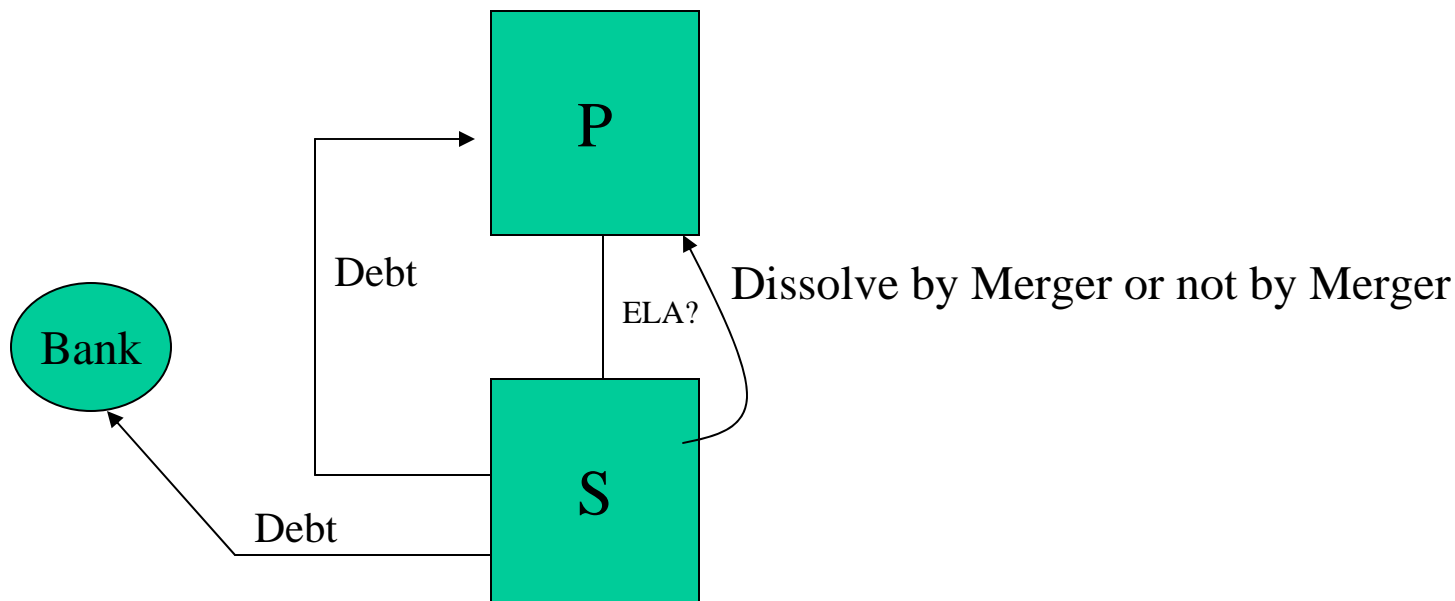
Insolvency & Reorganizations (S2 Debt)



Questions:

- 1) Because no equity technically is being transferred, can you have a tax-free reorganization?
- 2) Does *Norman Scott* apply to this transaction?
- 3) Does the analysis change if S2 merges into S1?

Insolvency -- Busted 332 and/or Upstream Reorganization?



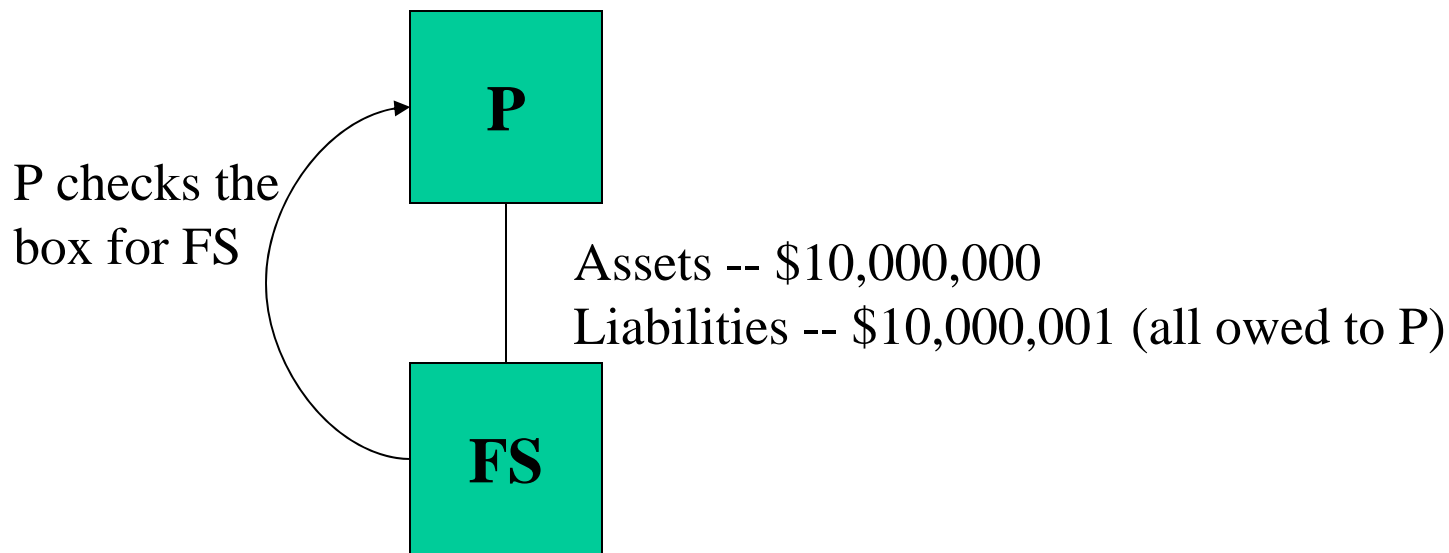
S is insolvent due to either debt to P or alternatively debt to Bank

Questions:

- 1) How does Rev. Rul. 68-602 apply if P cancels the debt owed to it by S? If P and S file a consolidated Federal income tax return, how does Treas. Reg. § 1.1502-13(g) apply?
- 2) What happens if the bank gets stock in cancellation of the debt owed to it by S?
- 3) What happens if S is in chapter 11 bankruptcy proceedings?
- 4) Does this transaction require disclosure under section 6011?

- § 332(a): “No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.”
- Treas. Reg. § 1.332-2(b): Section 332 applies only where the parent receives at least partial payment for its stock [otherwise, sec. 331 applies and stock loss can be recognized]
- Rev. Rul. 70-489, 1970-2 C.B. 53: Section 332 does not apply when parent liquidates its insolvent subsidiary even if the business of the sub is continued in the parent; therefore, parent can recognize loss on its sub stock.
- Bausch & Lomb Regulations -- Treas. Reg. section 1.368-2(d)(4)
- Treas. Reg. § 1.368-2(d)(1): debt assumption may so alter the character of a transaction so as to place it outside of the reorganization provisions
- Rev. Rul. 68-602, 1968-2 C.B. 135: Parent’s cancellation of a debt owed by an insolvent, wholly owned subsidiary immediately prior to the subsidiary’s liquidation was disregarded as transitory. As a result, the distribution to Parent of all of the insolvent subsidiary’s assets did not qualify under section 332 because Parent received nothing in exchange for its subsidiary’s stock.
- Treas. Reg. § 1.1502-13(g): Provides rules concerning the deemed satisfaction and reissuance of intragroup obligations.

Checking the Box for Insolvent Subs



Facts: P owns 100 percent of the stock of foreign sub FS. FS has assets worth \$10,000,000 and a debt owed to P of \$10,000,0001. P checks the box for FS.

Issues:

- 1) Is this a section 332 liquidation?
- 2) Can P claim a worthless stock deduction? Can P abandon the stock of FS?
- 3) What if the debt was instead owed to a third party?

Busting a 332 - FSA 200148004

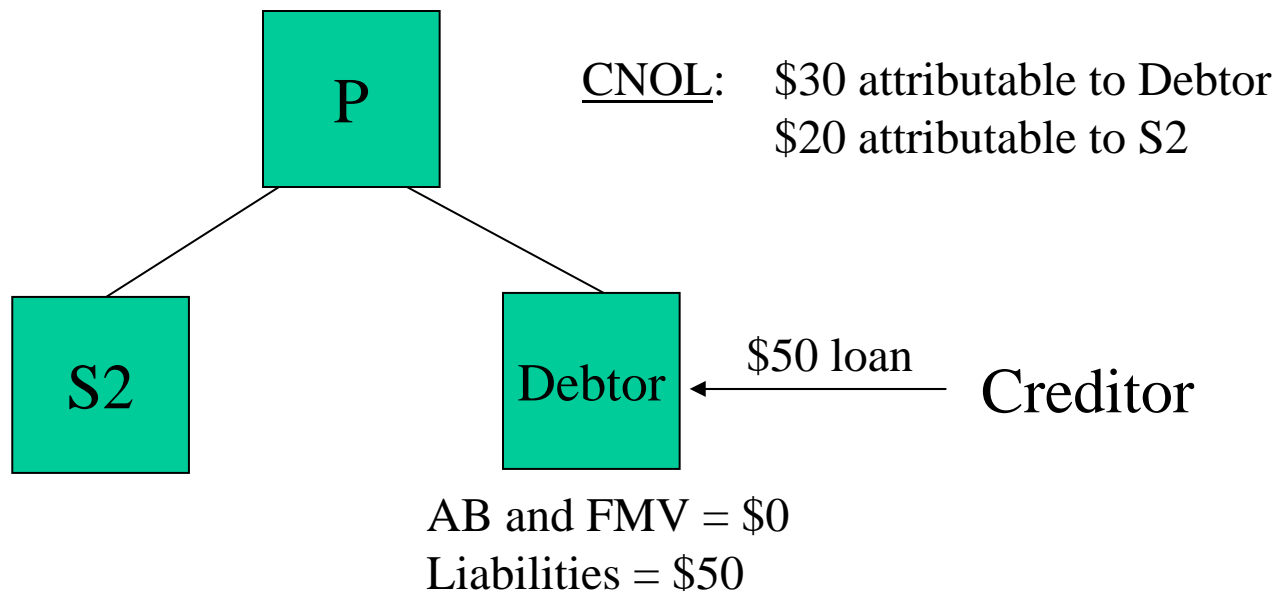
- Year 1 -- Corporation S1 owns more than 80 percent of the stock of FS. S1's sole shareholder borrows money from S1 and contributes the money to FS in exchange for stock in FS. As a result of the contribution, no shareholder owns more than 80 percent of the stock of FS.
- Year 2 -- FS Liquidates
- Held -- Treat as section 331 Liquidation
- Cites -- *Granite Trust, Day and Zimmerman*
- Distinguishes *Associated Wholesale Grocers*

Worthless Stock Deduction and Check the Box

- In FSA 200226004 (June 28, 2002), the Service concluded that a parent was not entitled to a worthless securities deduction with respect to its investment in two subsidiaries, the existences of which were terminated via check-the-box elections, because the businesses of the “dissolved” subsidiaries were continued in partnership solution, presenting the parent with the opportunity to recoup all or part of its lost investment in the stock via future appreciation in the partnership. The FSA did not address whether section 332 applied to the “dissolutions” and did not address the fact that the termination of the subsidiaries’ existences irrevocably eliminated the parent’s investment in their stock with no possibility of ever recovering that investment.

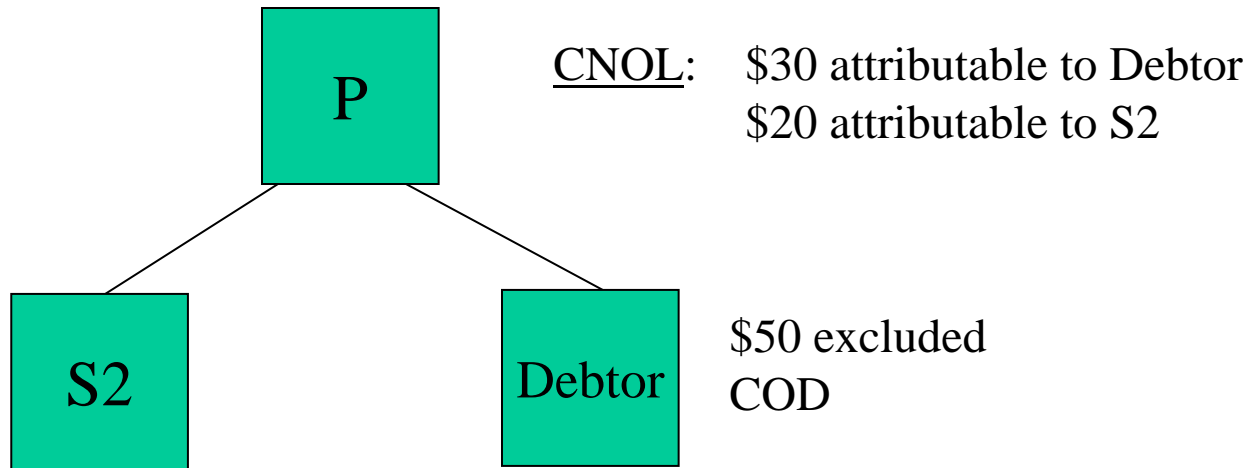
Consolidated Section 108(b)

The Question



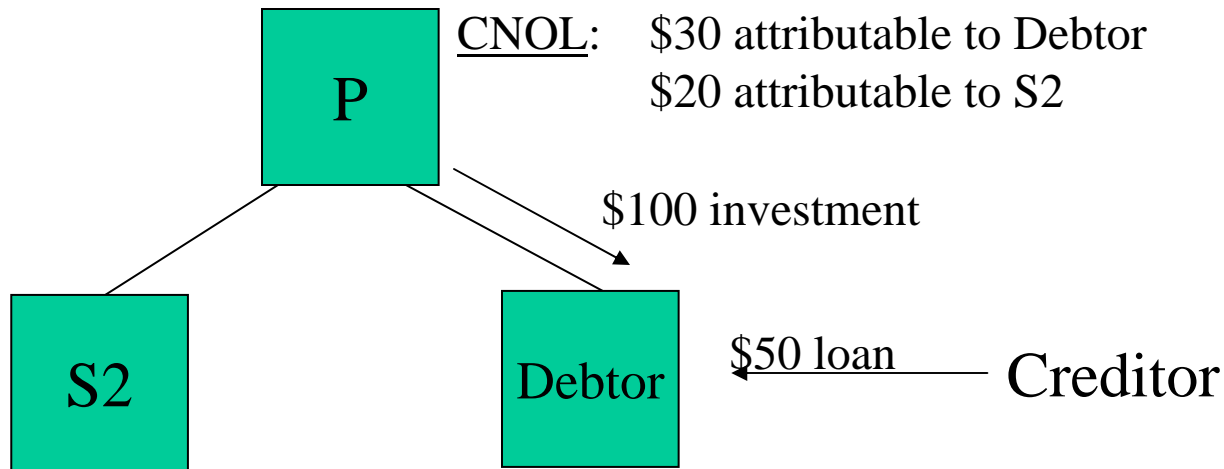
1. Creditor discharges the debt
2. \$50 COD income not taxable under § 108(a)(1)(B)
3. By how much should group reduce the CNOL?
 - § 108(b) refers to the “tax attributes of the taxpayer”
 - How would the Santorum/Conrad bill affect the analysis?

The IRS Challenge



1. Disavowing PLR 9121017, FSA 199912007 and ILM 200149008 assert a \$50 reduction in the CNOL
2. Because Debtor is severally liable for the consolidated tax under Treas. Reg. § 1.1502-6, the entire CNOL can be used by and is an attribute of Debtor
3. *United Dominion* confirms that there is no such thing as a “separate NOL”; thus, the CNOL is the only identifiable “tax attribute of the taxpayer”
4. There is no reason to “unbake the cake” other than for apportionment of CNOL to separate return year

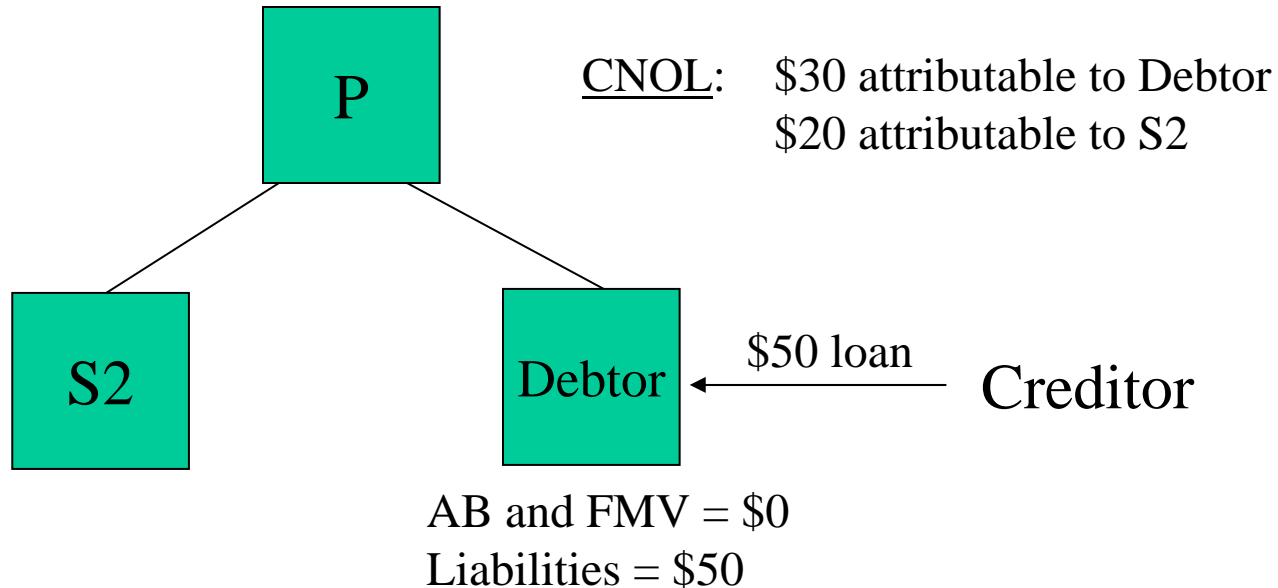
Taxpayer Counterarguments



1. ELA rules provide an appropriate backstop to consolidated attribute reduction
2. Consolidated attribute reduction also appears inconsistent with §1017(b)(3)(D)
3. Existence of only a single CNOL does not resolve determination of “tax attributes of taxpayer”
4. While the cake should not be “unbaked” to separate a single CNOL absent an apportionment event, it is necessary to know portion attributable to member so as to apply investment adjustment rules
5. If there were consolidated attribute reduction, it would still be necessary to know to whom the reduced CNOL is attributable
6. Thus, although the single CNOL is indivisible until an apportionment event, absorption or reduction determined on a member-by-member basis is required to ensure correct amount available for apportionment

Consolidated Section 108(b)

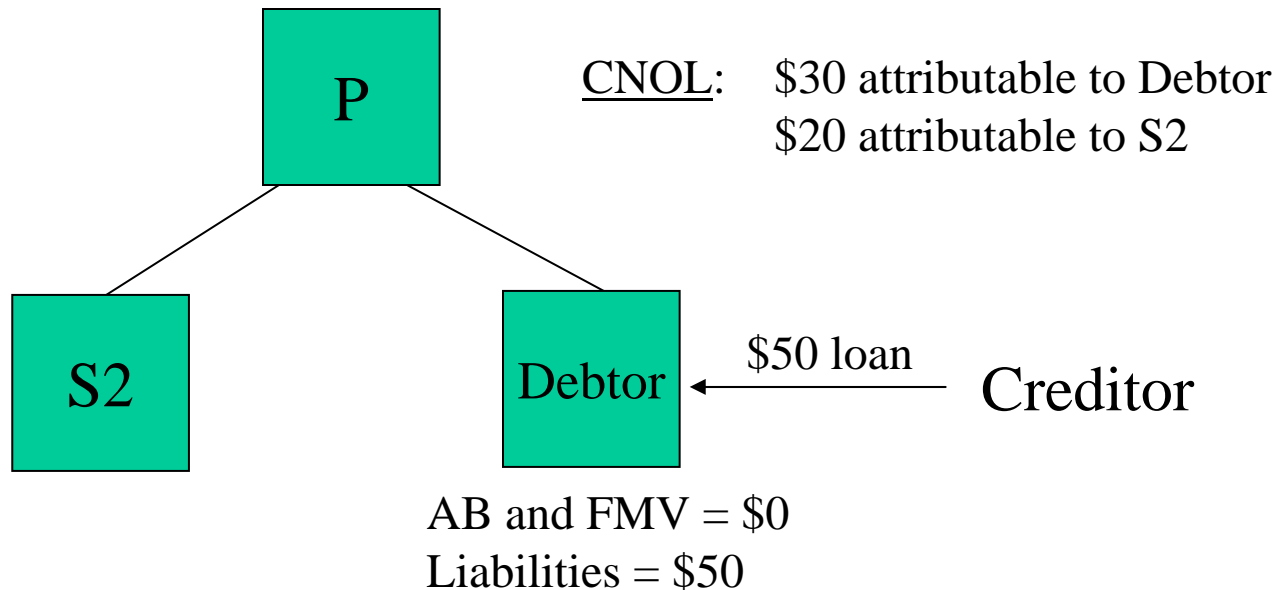
The IRS Response – Temp. Treas. Reg. § 1.1502-28T



1. New temporary regulations adopt a consolidated approach to section 108(b).
2. The IRS and the Treasury Department stated that a separate entity approach would have been “inconsistent with Congressional intent that income realized from debt discharge generally be deferred and not permanently eliminated.”
3. The IRS and the Treasury Department also stated that a consolidated approach “reflects the principle enunciated by the Supreme Court in United Dominion Indus., Inc. v. United States, 532 U.S. 822 (2001), that, in general, the only net operating loss of a consolidated group or its members for a consolidated return year is the consolidated net operating loss.”
4. The new temporary regulations are effective for discharges of indebtedness occurring after August 29, 2003.

Consolidated Section 108(b)

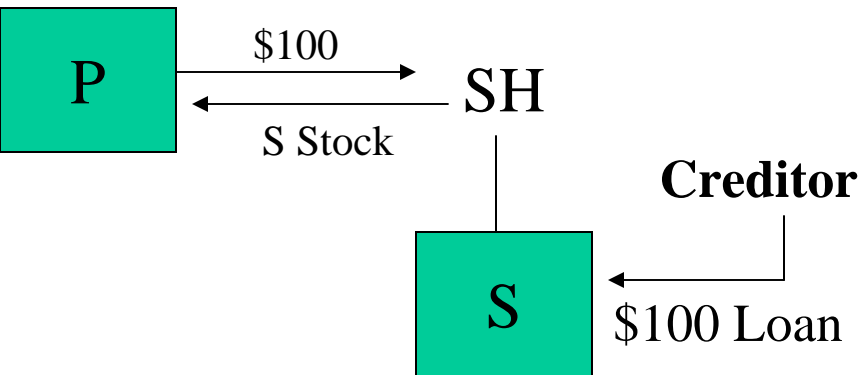
The IRS Response – Temp. Treas. Reg. § 1.1502-28T



1. First General Rule: Tax attributes attributable to the debtor member are reduced.
2. Second General Rule: To the extent that the debtor member reduced basis in stock of another member as a result of the first rule, such other member must reduce tax attributes attributable to it in an amount equal to the amount of the stock basis reduction.
3. Third General Rule: To the extent that excluded COD income is not applied to reduce tax attributes attributable to the debtor member and after the application of the Second Rule, such remaining excluded COD income shall be applied to reduce the remaining consolidated tax attributes of the group. However, basis in assets held by other members of the group is not subject to reduction under this rule.
4. Other Rules: The amount of COD income treated as excluded as a result of insolvency is determined only on the basis of the assets and liabilities of the debtor member. The limitation on the amount of basis reduction in section 1017(b)(2) is determined in a similar fashion.
5. Result: The \$50 of excluded COD income is applied first to reduce \$30 of the \$50 CNOL attributable to Debtor. Then, the remainder of the \$50 of excluded COD income is applied to reduce the \$20 of the \$50 CNOL attributable to S2. Accordingly, the P Group is left with a \$0 CNOL.

The Effect of COD on ELAs

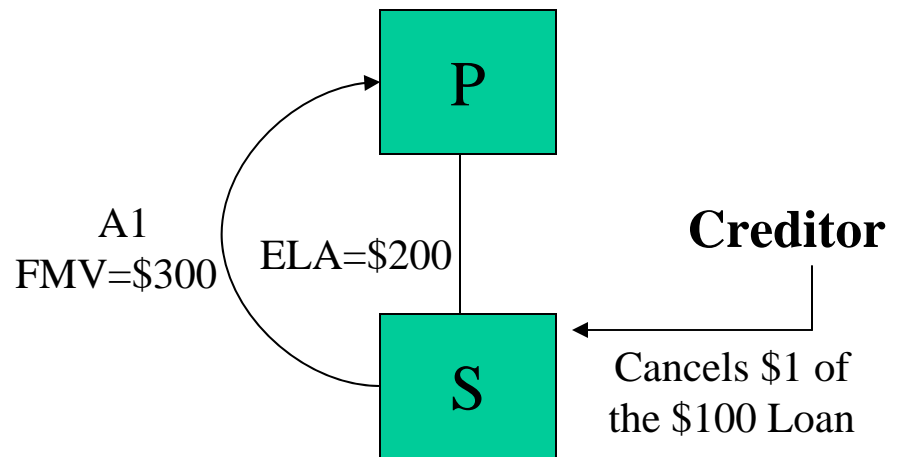
Step 1



A1- AB=\$0, FMV=\$100

A2- AB=\$0, FMV=\$100

Step 2



A2- FMV=\$99

Facts: P purchases 100 percent of the stock of S for \$100, and S becomes part of P's consolidated group. At the time S is acquired, S has two assets: (i) asset A1, which has an adjusted basis of zero and a FMV of \$100, and (ii) asset A2, which has an adjusted basis of zero and a FMV of \$100. S has no tax attributes, and \$100 debt (owed to Creditor), for which A2 has been pledged as security. Subsequent to P's acquisition of S, S distributes A1 to P, at a time when the value of A1 has increased to \$300. This results in an ELA of \$200. At the same time, the value of A2 has decreased to \$99, and creditor agrees to cancel \$1 of the \$100 debt owed by S.

Result: The \$1 of COD would be excluded under the insolvency exception, and \$1 of the \$200 ELA would be triggered since the excluded COD does not reduce attributes (Treas. Reg. § 1.1502-19(c)(1)(iii)(B); Temp. Treas. Reg. § 1.1502-19T(b)(1)(ii)). Prior to Temp. Treas. Reg. § 1.1502-19T(b)(1)(ii), the entire \$200 ELA was triggered under these circumstances. See Treas. Reg. § 1.1502-19(b)(1).

The Effect of COD on ELAs

(continued); Income Issue

- May assets be contributed to an insolvent member of a consolidated group to provide basis reduction and avoid triggering an ELA? See FSA 200135002; PLR 9650019.

- Does reduction of credit under section 108(b) trigger ELA?

⇒ ELA is triggered to extent COD is excluded from gross income and is not tax-exempt income.

⇒ Pursuant to Temp. Treas. Reg. § 1.1502-32T(b)(3)(ii)(C)(1), excluded COD that reduces credits is tax-exempt income despite the fact that it does not result in a negative basis adjustment. Prior rules did not treat excluded COD that reduces credits as tax-exempt income.

- Basis Reduction Rule:

Under Prop. Treas. Reg. § 1.1502-35(f), if a subsidiary (i) leaves the group and does not exist after leaving the group, or (ii) becomes worthless (Treas. Reg. section 1.1502-80(c)), then any consolidated NOL or capital loss attributable to such subsidiary is treated as absorbed immediately prior to such event, and any deemed absorption under Prop. Treas. Reg. § 1.1502-35(f) causes a downward basis adjustment with respect to subsidiary stock (and stock of higher-tier members).

Which Comes First: NOL Carryback or Attribute Reduction?

Restructuring Facts:

- \$50 of COD income, of which
 - \$40 is excludable due to insolvency,
 - \$10 is includible
- Remaining liabilities: \$60
- Tax attributes: \$25 of current year NOLs
\$70 of basis (non-depreciable)
- Issue: Assume that the debtor had in its prior taxable year reported \$11 of taxable income upon which it paid tax. Can it carry back the \$15 remaining NOL before applying the attribute reduction?

Carryback First

Reduce Attributes First

Refund:

All

None

Attributes Reduced

\$4 NOLs

\$15 NOLs

Due to COD:

\$10 Basis

\$10 Basis

Which Comes First: NOL Carryback or Attribute Reduction? (continued)

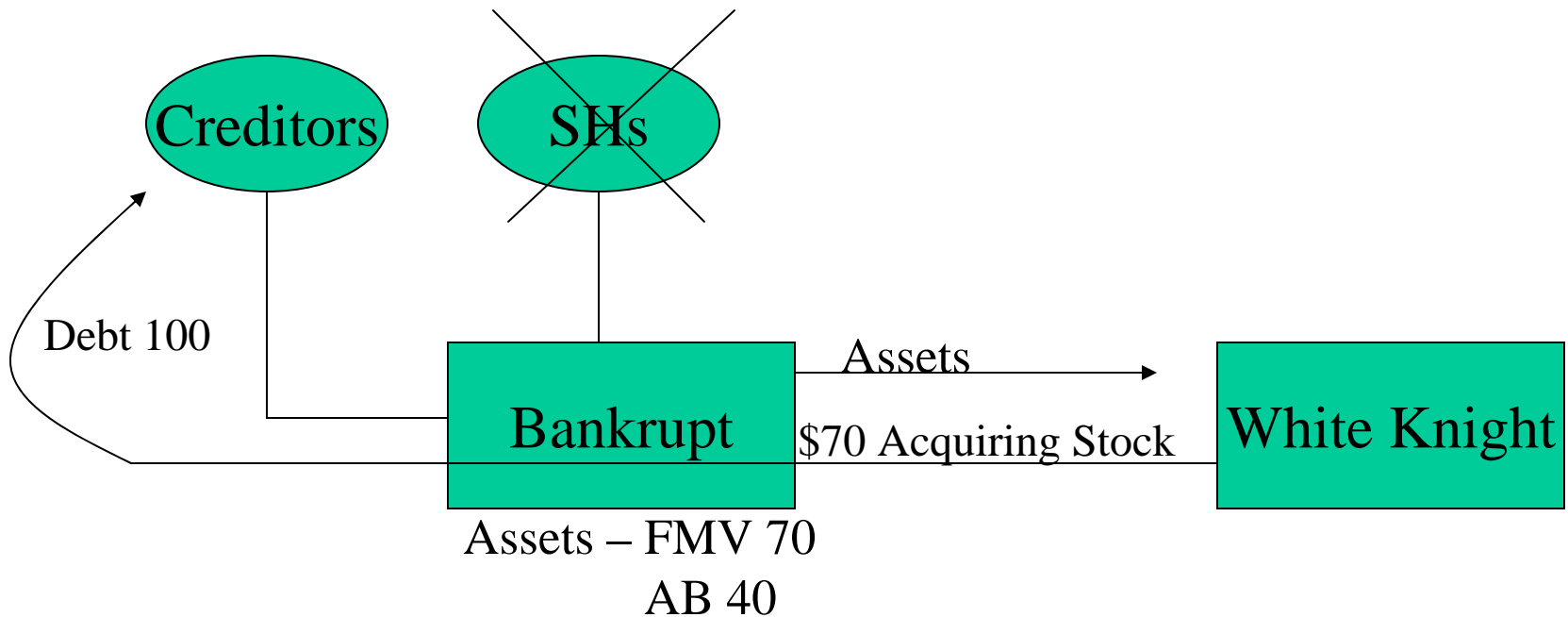
- § 108(b)(1) provides for the reduction of any NOL “for the taxable year of the discharge,” as well as NOL carryovers. Same rule applies for capital losses.
- § 108(b)(4)(A) provides that the reduction of attributes (other than basis) “shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.”
- Legislative history does not directly address this question, but basic policy of the exclusion of COD income is that the COD should only affect a debtor’s cash position on a going-forward basis.

Which Comes First: NOL Carryback or Attribute Reduction?

- Examples of where current year taxes are *actually* affected by carrybacks include the carry back of a capital loss that frees up a prior NOL carryforward. *See* Reg. § 1.1212-1(a)(3) and - 1(a)(3)(iv), Example 5.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Operating income/(loss)	(\$100)	--	\$100
Capital gain/(loss)	--	\$120	(\$120)
<hr/>			
Excluded COD			\$100

Basis Reduction – “G” Reorganizations



- Bankrupt’s only tax attribute is its adjusted basis in its assets
- Is the basis in assets subject to attribute reduction?

Basis Reduction – “G” Reorganizations

- Section 108(b)(5)(E) and 1017 – reduce basis at beginning of year following year of discharge
- FSA 200145009 – Basis in assets not subject to reduction because not held by bankrupt
- Legislative history to BTA 1980 suggests the opposite
- PLR 9409037 (basis reduced)/PLR 9629016 (less clear)/ PLR 8503064 (no opinion)