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

MEMORANDUM FOR SPECIAL LITIGATION ASSISTANT

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS:CORP

SUBJECT: Acceleration Rule

This Field Service Advice responds to your memorandum dated September 17, 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

Corp A =
Corp B =
Corp C =
Corp D =
State A =
State B =
Date 1 =

$a	=
$b	=
Corp E	=
$c	=
X	=
Year 1	=
$d	=
Corp F	=

ISSUES

1. Whether the Corp A & Subsidiaries consolidated group is entitled to claim an ordinary loss in under Treas. Reg. § 1.1502-13(d) upon the distribution of loss property from Corp D to Corp A, and Corp A's contemporaneous sale of its stock in Corp D to Corp F.

2. Assuming the Corp A & Subsidiaries consolidated group is entitled to claim an ordinary loss in under Treas. Reg. § 1.1502-13(d), whether Corp A in calculating its gain or loss on the sale of the Corp D stock, must reduce its basis in the Corp D stock by the amount of the ordinary loss under Treas. Reg. § 1.1502-32(b)(2)(i) and by the fair market value of the "X Property" distributed to Corp A by Corp D under Treas. Reg. § 1.1502-32(b)(2)(iv) (Assuming Corp A does not wish to include the fair market value of the "X Property" distributed to it in Corp A's income, under Treas. Reg. § 1.1502-13(f)(2)(ii).).

CONCLUSIONS

1. The Corp A & Subsidiaries consolidated group is entitled to claim an ordinary loss in under Treas. Reg. § 1.1502-13(d) upon the distribution of loss property from Corp D to Corp A, and Corp A's contemporaneous sale of its stock in Corp D to Corp F.

2. Assuming the Corp A & Subsidiaries consolidated group is entitled to claim an ordinary loss in under Treas. Reg. § 1.1502-13(d), Corp A in calculating its gain or loss on the sale of the Corp D stock, must reduce its basis in the Corp D stock by the amount of the ordinary loss under Treas. Reg. § 1.1502-32(b)(2) and

by the fair market value of the "X Property" distributed to Corp A by Corp D under Treas. Reg. § 1.1502-32(b)(2). (Assuming Corp A does not wish to include the fair market value of the "X Property" distributed to it in Corp A's income, under Treas. Reg. § 1.1502-13(f)(2)(ii).)

FACTS

Corp A is the common parent of the group of affiliated corporations making a consolidated return, pursuant to the provisions of I.R.C. § 1502 and the regulations thereunder.

Corp A in Year 1 acquired the stock of the Corp B, a State A corporation, from Corp C, an unrelated entity, for $a. Corp A renamed the company Corp D.

In Date 1, Corp A entered into an agreement to sell all of the stock of Corp D to Corp F Company, an unrelated State B corporation, for a base purchase price of $b. At the time, Corp D's only assets were the stock of Corp E, a State B corporation, and properties referred to alternatively as the "X Property".

The Stock Purchase agreement provides in pertinent part, that one minute prior to closing, Corp D will distribute the X Property to its parent Corp A. At the time of this distribution, the fair market value of the X Property was $c. Corp A then sold the stock of Corp D to Corp F, and Corp D thereby left the consolidated group. The X Property, however, remained with the Corp A consolidated group following the stock sale.

LAW

Treas. Reg. § 1.1502-13, "Intercompany transactions", provides rules for taking into account items of income, gain, deduction, and loss among members of a consolidated group. The purpose of the regulation is to prevent intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income. Treas. Reg. § 1.1502-13(a)(1). Under this section, the selling member, (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. Treas. Reg. § 1.1502-13(a)(2). The amount and location of S's intercompany items and B's corresponding items are determined on a separate entity basis, but the timing, character, source and other attributes of the intercompany items and corresponding items are redetermined under Treas. Reg. §1.1502-13 to produce the effect of transactions between a single corporation.

Intercompany transactions include S's distribution to B with respect to S Stock. Treas. Reg. 1.1502-13(b)(1)(i)(D).

The principle rules which implement single entity treatment are the matching rule of Treas. Reg. § 1.1502-13(c) and the acceleration rule of Treas. Reg. § 1.1502-13(d) and Treas. Reg. § 1.1502-13(a)(6)(i). Under the matching rule, S and B are treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The acceleration rule provides additional rules for taking items into account if the effect of treating S and B as divisions cannot be achieved. (for example if S or B becomes a nonmember)

The acceleration rule of Treas. Reg. § 1.1502-13(d) provides that S's intercompany items and B's corresponding items are taken into account under its provisions "to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation." The items are taken into account immediately before it first becomes impossible to achieve this effect, and for purposes of the rule, the effect cannot be achieved to the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income under the matching rule. (For example, if S or B becomes a nonmember.)

Treas. Reg. § 1.1502-13(f) provides additional rules with respect to the stock of members of the consolidated group.

Treas. Reg. § 1.1502-13(f)(2)(i) provides that a "distribution is not an intercompany distribution to the extent it is deducted by the distributing member." Treas. Reg. § 1.1502-13(f)(2)(ii) provides that an intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative basis adjustment reflected under Treas. Reg. § 1.1502-32 in B's basis in the stock of the distributing member (S).

Treas. Reg. § 1.1502-13(f)(2)(iii) provides that the principles of I.R.C. § 311(b) apply to S's loss as well as gain, from an intercompany distribution of property. Thus S's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember.

I.R.C. § 311(b) provides generally for the recognition of gain by the distributing corporation in the event it distributes appreciated property to the shareholder. Treas. Reg. § 1.1502-13(f)(2)(iii) extends this recognition to loss property as well, if the property is subsequently sold to a non member.

Treas. Reg. § 1.1502-32(a) sets forth the rules for adjusting a parent corporation's basis in the stock of its subsidiary (investment basis adjustments). Under Treas. Reg. § 1.1502-32(b)(2), the parent's basis in its subsidiary's stock is increased by positive adjustments and negative adjustments. The adjustment is made annually, in the net amount of the subsidiary's: (i) taxable income or loss; (ii) tax-exempt income; (iii) noncapital, nondeductible expenses; and (iv) distributions with respect to S's stock.

Law and Analysis

Issue 1-entitlement to claim an ordinary loss.

This issue involves whether the Corp A & Subsidiaries consolidated group is entitled to claim an ordinary loss in 1996 under Treas. Reg. § 1.1502-13(d) upon the distribution of loss property from Corp D to Corp A, and Corp A's contemporaneous sale of its stock in Corp D to Corp F.

Intercompany transactions include S's distribution to B with respect to the S stock. Treas. Reg. § 1.1502-13(b)(1)(i)(D). Therefore, the Date 1 Corp D distribution of the X property to Corp A is an intercompany transaction under Treas. Reg. § 1.1502-13(b)(1)(i)(D).

Treas. Reg. § 1.1502-13(f)(2)(iii) provides that the principles of I.R.C. § 311(b) apply to S's loss as well as gain, from an intercompany distribution of property. Thus S's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember.

In the instant case, Corp A's subsidiary, Corp D distributes the X property, with a fair market value less than its adjusted basis at the time of distribution, to Corp A just prior to the sale of the Corp D stock, not the sale of the X property.

We would interpret the reference to "property" in Treas. Reg. § 1.1502-13(f)(2)(iii), not to refer to the stock of Corp D, but rather to the X Property distributed by Corp D to Corp A. Since Corp A has not sold the X property outside the Corp A group, Treas. Reg. § 1.1502-13(f)(2)(iii) does not provide authority for the Corp A group's deduction of the "X Property" loss.

However, the acceleration rule of Treas. Reg. § 1.1502-13(d) provides that S's intercompany items and B's corresponding items are taken into account under its provisions "to the extent they cannot be taken into account to produce the effect of

treating S and B as divisions of a single corporation." The items are taken into account immediately before it first becomes impossible to achieve this effect, and for purposes of the rule, the effect cannot be achieved to the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income under the matching rule. (For example, if S or B becomes a nonmember.) Because the effect of treating S and B as divisions of a single corporation cannot be produced once S becomes a non member, S takes its gain or loss on the property into consolidated taxable income immediately before becoming a nonmember. (S's accelerated gain or loss is reflected in B's basis in the S stock.) (Treas. Reg. § 1.1502-32)

Therefore, Corp A's sale of the Corp D stock to Corp F triggers the acceleration rule under Treas. Reg. § 1.1502-13(d), since the "selling" member (Corp D), by virtue of the stock sale, leaves the Corp A consolidated group.

Because the effect of treating Corp D and Corp A as divisions of a single corporation cannot be produced once Corp D becomes a non member, Corp D's loss on the "X Property", which it distributed to Corp A, will be taken into the Corp A group's consolidated taxable income immediately before Corp D became a nonmember of the Corp A group. (Corp D accelerated loss is reflected in Corp A's basis in the Corp D stock.) (Treas. Reg. § 1.1502-32)

Therefore, we agree that Treasury Reg. § 1.1502-13(d) requires that Corp D recognize the loss upon the distribution of the X Property to Corp A, (Therefore, the Corp A and Subsidiaries consolidated group will be able to claim this loss.) since Corp D, by virtue of the stock sale immediately following the distribution, leaves the Corp A consolidated group.

Issue-2 Basis reduction in Corp D stock

This issue involves, assuming the Corp A & Subsidiaries consolidated group is entitled to claim an ordinary loss in 1996 under Treas. Reg. § 1.1502-13(d), whether Corp A in calculating its gain or loss on the sale of the Corp D stock, must reduce its basis in the Corp D stock by the amount of the ordinary loss under Treas. Reg. § 1.1502-32(b)(2)(i) and by the fair market value of the "X Property" distributed to Corp A by Corp D under Treas. Reg. § 1.1502-32(b)(2)(iv). Assuming Corp A does not wish to include the fair market value of the "X Property" distributed to it in Corp A's income, under Treas. Reg. § 1.1502-13(f)(2)(ii).

Distribution

Intercompany transactions include S's distribution to B with respect to the S stock. Treas. Reg. § 1.1502-13(b)(1)(i)(D). Therefore, the Date 1 Corp D distribution of the X property to Corp A is an intercompany transaction under Treas. Reg. § 1.1502-13(b)(1)(i)(D).

Treas. Reg. § 1.1502-13(f)(2)(i) provides that a "distribution is not an intercompany distribution to the extent it is deducted by the distributing member." In the instant case, Corp D did not deduct the distribution of the "X Property".

Treas. Reg. § 1.1502-13(f)(2)(ii) provides that an intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative basis adjustment reflected under Treas. Reg. § 1.1502-32 in B's basis in the stock of the distributing member (S).

Treas. Reg. § 1.1502-32(a) sets forth the rules for adjusting a parent corporation's basis in the stock of its subsidiary (investment basis adjustments). Under Treas. Reg. § 1.1502-32(b)(2), the parent's basis in its subsidiary's stock is increased by positive adjustments and negative adjustments. The adjustment is made annually, in the net amount of the subsidiary's: (i) taxable income or loss; (ii) tax exempt income (iii) non capital non deductible expenses (iv) distributions with respect to S's stock.

Therefore, we agree that if Corp A does not wish to include the fair market value of the "X Property" distributed to it in Corp A's income, under Treas. Reg. § 1.1502-13(f)(2)(ii), then Corp A in calculating its gain or loss on the Corp D stock must reduce its basis in the Corp D stock by the fair market value of the "X Property" distributed to it with respect to the Corp D stock under Treas. Reg. § 1.1502-32(a)(iv).

Ordinary loss

Under Treas. Reg. § 1.1502-32(b)(2)(i) the parents basis in its subsidiary's stock is increased by positive adjustments and decreased by negative adjustments in the net amount of the subsidiary's net income or loss.

Assuming that Corp A is entitled to a claimed loss in the amount of $d, Under the provisions of Treas Reg. § 1.1502-32(b)(2)(i), we agree that Corp A must reduce its basis in the Corp D stock by the amount of $d.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Built In loss

If the basis of the “X Property” was in excess of its fair market value when Corp A acquired the stock of Corp B then there may be an argument that the “X Property distributed to Corp A by Corp D was built in loss property. Therefore, there is a possibility that under Treasury Reg 1.1502-15 that Corp A’s ability to offset this loss against its income will be limited.

SRLY Rules and Built in Deductions.

Treas Reg. § 1.1502-15 provides rules limiting deductions if the deductions are economically accrued in a Single Return Limitation Year (SRLY) but recognized in or carried to a consolidated return year (“built-in deductions”). Except for a 15 percent de minimis rule, built in deductions are essentially treated as SRLY losses and are subject to the SRLY limitations if they are recognized during a 10 year recognition period following the groups acquisition of the assets that gave rise to the deduction.

“Built-in deductions” are those deductions or losses of a corporation which were economically accrued in a SRLY, but which are recognized in either in a consolidated return year or in a (non SRLY) separate return year and carried over in the form of a net operating or net capital loss to a consolidated return year. Treas. Reg. § 1.1502-15(a)(2). However, only the part of the deduction or loss that economically accrued in a SRLY will be a built in deduction.

The built-in deductions of a member are subject to limitations similar to those applying to net operating loss carryovers from SRLYs i.e., the built-in deductions are deductible only to the extent of the members own contribution to consolidated taxable income. Treas. Reg. §§ 1.1502-15(a), -21(c).

The built in deduction disallowed by reason of this limitation is treated as either a net operating loss or a net capital loss sustained in the year of disallowance and is carried back or forward to other taxable years (either consolidated or separate), subject to the limitations that apply to loss carrybacks or carryover’s from SRLY’s. Treas. Reg. § 1.1502-15(a)(1).

The built-in deduction limitation for a taxable year does not apply with respect to assets acquired by the group if the group acquired the assets more than ten years before the first day of such taxable year. In addition, the built-in deduction limitation does not apply if, immediately before the group acquired the assets (directly or by acquiring a new member) containing the built-in deductions, the aggregate basis of

all the assets acquired (or owned by an acquired member does not exceed their fair market value by more than 15 percent. Treas. Reg. § 1.1502-15(a)(4)(i).

In the instant case if the basis of the "X Property" was in excess of its fair market value when Corp A acquired the stock of Corp B then there may be an argument that the "X Property" distributed to Corp A by Corp D was built in loss property and subject to loss limitation under Treas. Reg. § 1.1502-15(a)(1).

The amount of any built-in deduction for the "X Property" will be limited to the excess of its adjusted basis over its fair market value at the time that Corp A acquired the stock of Corp B. If this excess is greater than or equal to Corp D's loss of $d on the distribution of its stock to Corp A, then the full amount of that loss may be subject to the built-in loss limitations of Treas. Reg. § 1.1502-15(a)(1).

In other words, only losses on the "X Property" that were accrued in SRLY years (any period before Corp A's purchase of Corp B) and were later recognized in a consolidated return year will be built in deductions. A loss of $d was recognized by the Corp A group as a result of Corp D's loss on the distribution of the "X Property" to Corp A in [redacted]. Therefore, if this loss amount was economically accrued before Corp A's purchase of Corp B, then the full amount of that loss will be subject to the built in loss limitation rules of Treas. Reg. § 1.1502-15(a)(1).

The built in deductions of a member are deductible to the extent of that members contribution to consolidated income. Treas. Reg. §§ 1.1502-15(a), -21(c).

Therefore, any built-in deductions with respect to Corp D's "X Property" will only be deductible by the Corp A group in [redacted] to the extent of Corp D's contribution to Corp A's consolidated taxable income in [redacted]

Any built-in deduction disallowed to Corp D by reason of this limitation is treated as a net operating loss sustained in the year of disallowance and is carried back or forward to other taxable years (either consolidated or separate), subject to the loss carrybacks or carryover's from SRLY's. Treas. Reg. § 1.1502-15(a)(1).

The built-in deduction limitation will not apply to Corp D's built in losses, if immediately before the Corp A Group acquired (indirectly by the acquisition of stock of Corp B) Corp B's "X Property", the aggregate basis of all the assets of Corp B, which were acquired indirectly by the Corp A group, did not exceed their fair market value by more than 15 percent.

The other exception to the built-in loss deduction limitation will not apply. The Corp A Group indirectly acquired the Corp B Assets in Year 1, the loss was recognized in [redacted]

[redacted], this is less than the ten year period required to meet the exception to the built in deduction limitation.

Further Factual development is needed to determine [redacted]

Anti Avoidance rules

Under Treasury Reg. 1.1502-13(h)(1) and Treas. Reg 267(f)-1(h), if a transaction is engaged in or structured with a principal purpose to avoid the purposes of these sections (including for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this transaction.

In the instant case, it could be argued that the distribution of loss property from Corp D to Corp A, and Corp A's contemporaneous sale of its stock in Corp D to Corp F were structured with a principal purpose to accelerate the loss on the "X Property, thereby distorting income. In other words, a principal purpose for the particular structuring of this transaction was tax avoidance.

Therefore, it could be argued that the Service could possibly disregard the accelerated loss on Corp D's distribution of the "X Property" to Corp A.

However further factual development is needed to determine whether [redacted]

Please call if you have any further questions.

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Corporate Branch