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subject: Phaseout of § 447(i) Suspense Accounts and Restructuring Transactions

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

How is the phaseout of a § 447(i) suspense account affected by the transfer of substantially all of a taxpayer's assets to a wholly owned subsidiary within its consolidated group in exchange solely for stock of the subsidiary?

CONCLUSION

In the factual situation described below, no acceleration of the suspense account balance occurs in the year of the restructuring transaction and the income of the wholly owned subsidiary should be added to the taxpayer's income in making the calculations under § 447(i)(5)(B)(i)(II).

FACTS

The fact pattern is as follows. The taxpayer is a C corporation and the parent of an affiliated group of corporations that file a consolidated tax return. The taxpayer engaged in the business of farming and qualified as a "family corporation," as that term is defined in § 447(d)(2)(C)(i). The taxpayer initially used the cash receipts and disbursements method of accounting.

Prior to 1997, the taxpayer was required by § 447 to change from the cash receipts and disbursements method of accounting to the accrual method of accounting. At that time, the taxpayer established a suspense account under § 447(i) in lieu of taking into account adjustments under § 481(a). The taxpayer was not required to make, and did not make, any adjustment to the suspense account until the Taxpayer Relief Act of 1997, P.L. 105-34, amended § 447(i) to provide for the phaseout of existing suspense accounts.

For its first several tax years following the amendment of § 447(i), the taxpayer reduced its suspense account by the applicable portion (as defined § 447(i)(5)(C)) and included that amount in gross income. Then the taxpayer was advised to engage in a restructuring transaction.

The taxpayer formed a new wholly owned subsidiary and transferred substantially all of its assets and liabilities to the subsidiary solely in exchange for the stock of the subsidiary. No gain or loss was recognized pursuant to § 351. The taxpayer retained the suspense account and de minimis assets from its farming business. After the restructuring transaction, the taxpayer's taxable income decreased dramatically. Each year the taxpayer reduces the suspense account by the amount calculated – using only its own income for purposes of § 447(i)(5)(B)(i)(II) -- and includes that amount in gross income.

The subsidiary is profitable, and its taxable income exceeds the taxpayer's taxable income for years prior to the restructuring transaction. In later years, the subsidiary acquired additional assets in successive acquisitions, mergers, and restructurings, thereby further increasing its taxable income. The subsidiary files a consolidated tax return with the taxpayer's group and uses the same method of accounting as the taxpayer. There are no intercompany transactions between the subsidiary and the taxpayer.

LAW AND ANALYSIS

Section 447(i)(5)(B) provides as follows:

> (B) PHASEOUT OF EXISTING SUSPENSE ACCOUNTS.—

(i) IN GENERAL.—Each suspense account under this subsection shall be reduced (but not below zero) for each taxable year beginning after June 8, 1997, by an amount equal to the lesser of—

(I) the applicable portion of such account, or

(II) 50 percent of the taxable income of the corporation for the taxable year, or, if the corporation has no taxable income for such year, the amount of any net operating loss (as defined in section 172(c)) for such taxable year.

For purposes of the preceding sentence, the amount of taxable income and net operating loss shall be determined without regard to this paragraph.

(ii) COORDINATION WITH OTHER REDUCTIONS.—The amount of the applicable portion for any taxable year shall be reduced (but not below zero) by the amount of any reduction required for such taxable year under any other provision of this subsection.

(iv) [sic] INCLUSION IN INCOME.—Any reduction in a suspense account under this paragraph shall be included in gross income for the taxable year of the reduction.

Section 447(i)(5)(C) provides that, for purposes of § 447(i)(5)(B), the term "applicable portion" means, for any taxable year, the amount which would ratably reduce the amount in the account (after taking into account prior reductions) to zero over the period consisting of such taxable year and the remaining taxable years in such first 20 taxable years. Section 447(i)(5)(D) provides that any amount in the account as of the close of the 20th year referred to in § 447(i)(5)(C) shall be treated as the applicable portion for each succeeding year thereafter to the extent not reduced under this paragraph for any prior taxable year after such 20th year.

In the factual situation described above, the taxpayer properly applied the § 447(i)(5)(B) rules during the years prior to the restructuring transaction. The issue on which you requested assistance concerns how the restructuring transaction affects the phaseout of the suspense account.

Section 447(i)(4) provides that the application of § 447(i) with respect to a taxpayer that is a party to any transaction with respect to which there is nonrecognition of gain or loss to any party by reason of subchapter C shall be determined under regulations prescribed by the Secretary. Because there are no regulations promulgated under § 447(i), we must discern the appropriate treatment from other sources. See International Multifoods Corp. v. Commissioner, 108 T.C. 579, 587 (1997).

The first matter to consider is whether the balance of a suspense account should be recognized in the year of a restructuring transaction when, as in the case at hand, a § 447(d)(2)(C)(i) family corporation transfers substantially all of its assets and liabilities to a subsidiary in a § 351 transaction. It is instructive to consider the rules applicable to § 481(a) adjustments because of the similarities between a § 447 suspense account and a § 481(a) adjustment, even though the rules are distinguishable to the extent that the annual amount of an adjustment under § 447(i)(5)(B) can vary based on a taxpayer's income. Section 447(f) provides rules coordinating the application of § 481 to corporations that are required by § 447 to change their method of accounting for any taxable year ending after June 8, 1997. See also § 447(i)(5)(A). In the absence of any regulations promulgated under § 447(f)(3), we look to the principles of § 1.446-1(e)(3)(ii) and its underlying administrative procedures for the rules concerning what happens when a taxpayer ceases to engage in a business and transfers its business to a subsidiary. Those rules also apply to taxpayers who have a § 481(a) adjustment resulting from being required by § 448 to change their method of accounting. Section 1.448-1(g)(3)(i); see also § 448(d)(7).

The general procedures for obtaining consent to change a method of accounting are contained in Rev. Proc. 97-27, 1997-1 C.B. 680, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432. Rev. Proc. 97-27 was in effect at the time § 447(i) was amended to provide for the phaseout of existing suspense accounts. Section 7.03(3)(a) of Rev. Proc. 97-27 provides that a taxpayer that ceases to engage in a trade or business or terminates its existence must take the remaining balance of any § 481(a) adjustment relating to the trade or business into account in computing taxable income in the year of the cessation or termination. Section 7.03(3)(a) also provides that, except as provided in sections 7.03(d) and (e), a taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer. Section 7.03(3)(e) provides that no acceleration of the § 481(a) adjustment is required when one member of an affiliated group filing a consolidated return transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another member of the same consolidated group in an exchange qualifying under § 351 and the transferee member adopts and uses the same method of accounting used by the transferor member. See also section 5.04(3)(c)(i) and (v) of Rev. Proc. 2002-9, 2002-1 C.B. 327, modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, amplified, clarified, and modified by Rev. Proc. 2002-54.

In the factual situation described above, substantially all of the assets and liabilities of the farming business were transferred by the taxpayer to the subsidiary solely in exchange for the stock of the subsidiary. No gain or loss was recognized pursuant to § 351. Also, the subsidiary files a consolidated tax return with the taxpayer's group and uses the same method of accounting as the taxpayer. Accordingly, no acceleration of the suspense account balance should occur in the year of the restructuring transaction.

The next matter to consider is how to apply the provisions of § 447(i)(5)(B)(i)(II) after the restructuring transaction. Under § 447(i)(5)(B)(i)(II), the annual reduction in a suspense account, and the corresponding inclusion in income, is limited to 50 percent of the taxable income of the corporation for the taxable year, or, if the corporation has no taxable income for such year, the amount of any net operating loss for such taxable year. The language of § 447(i)(5)(B)(i)(II) cannot be viewed in isolation, and it is necessary to consider that provision's place in the overall statutory scheme. Cf. Hospital Corp. of America v. Commissioner, 107 T.C. 73, 84-85 (1996), aff'd, 348 F.3d 136 (6th Cir. 2003), cert. denied, 543 U.S. 813 (2004).

The overall legislative objective of § 447(i)(5)(B) is to require a measured recognition of existing suspense accounts, which under the general rule of § 447(i)(5)(B)(i)(I) occurs over a 20-year period. The legislative history indicates that the purpose of the specific rule in § 447(i)(5)(B)(i)(II) is to provide further deferral if the increased tax obligation from suspense account recognition for any year would cause liquidity concerns relative to the corporation's income for that year. The legislative history of § 447(i) provides the following:

> [T]he Committee recognizes that requiring the recognition of previously established suspense accounts may impose liquidity concerns upon some farm corporations. Thus, the Committee provides an extended period over which existing suspense accounts must be restored to income and provides further deferral where the corporation has insufficient income for the year.

H.R. Rep. No. 148, 105th Cong., 1st Sess. 497-498 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 183 (1997).

In the factual situation described above, a measured recognition of the existing suspense account will occur and the liquidity concern is adequately addressed when the calculations are based on the combined income of the taxpayer and the wholly owned subsidiary that now holds the assets formerly held by the taxpayer. Cf. § 1.1502-6(a) (several liability of members of group). Therefore, the income of the wholly owned subsidiary should be added to the taxpayer's income in making the calculations under § 447(i)(5)(B)(i)(II). Moreover, the basic single entity concept underlying the consolidated group regime supports the combining of the incomes of the taxpayer and its wholly owned subsidiary in determining the proper amount to be restored to income from the suspense account.

Generally, once an affiliated group of corporations elects to file a consolidated tax return, the specialized consolidated return provisions supersede the general Code provisions, and the group of corporations must combine their items of income, gain, deduction, and loss to produce an effect as though the members of the group are merely divisions of a single corporation. Rev. Proc. 97-27 recognizes this single entity approach in providing that, despite the fact that a taxpayer has ceased to engage in a business, there will not be an acceleration of the § 481(a) adjustment if the ceasing of business was due to the taxpayer's transfer of substantially all of the assets of the business to another member of its consolidated group in a § 351 transaction. It should follow that the suspense account rules also must be applied consistently with the single entity approach and the non-acceleration of the § 481(a) adjustment (i.e., if the continuing existence and operation of the business within the consolidated group serves to justify non-acceleration of the § 481(a) adjustment, then it supports including all of the income of that business in calculating the proper suspense account reduction amount).

If you have any further questions, please call Robert Basso at (202) 622-4950.