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From:
Sent: Monday, January 25, 2010 2:47:27 PM
To:
Cc:
Subject: FW: Case with section 332 "tax exempt income" issue

- the email below was prepared by of in 2008 regarding whether the basis of stock of a subsidiary that is liquidated under section 332 is tax-exempt income within the meaning of Reg § 1.1366-1(a)(2)(viii). She concluded, based partly on an analogous consolidated return regulation, that it should not be "tax-exempt income" for that purpose.

As I indicated in my previous email, the taxpayer generally has accurately described the operation of section 332 in the nonconsolidated context. In such cases, with respect to the subsidiary's assets that are distributed to its parent, the subsidiary's gain or loss in its assets is not recognized at the time of the liquidation. However, such gain or loss is preserved because the parent takes a carryover basis in such assets. Thus, the gain or loss will be recognized upon the later sale of the assets by the parent. In contrast, the parent's gain or loss in its subsidiary stock will never be recognized. In effect the parent's basis in the subsidiary's stock is obliterated in the liquidation.

Of course, the fact that the taxpayer accurately described the operation of section 332 does not mean that the taxpayer is correct that amounts that are realized but not recognized under section 332 constitute tax exempt income for purposes of section 1366. As discussed below, we think the better view is that such amounts are not tax-exempt income.

In my earlier email I also indicated that I was looking into any differences in 332 treatment in the consolidated context because the taxpayer referred to certain consolidated provisions as bearing on the analysis of whether tax exempt income includes gain excluded under section 332, a nonrecognition provision. Lastly, I also indicated that I was looking into the questions of whether the step transaction should apply to the deemed liquidation that occurs pursuant to the Q Sub election. I will address both questions below.

First, with respect to section 332 liquidations in the consolidated group context, in most instances the liquidation of a solvent subsidiary will be subject to section 332. As is the case in the non-consolidated context, P will not recognize any gain or loss on exchanging stock for assets of A. P's basis in the assets received from S will be the same as S's adjusted basis. Again, any appreciation in P's S shares will be eliminated without recognition.

Please note that it is possible that the parent will recognize gain or loss at the time of the liquidation; however, this gain or loss is not the result of the 332 liquidation itself, which

continues to be tax-free to the parent and the subsidiary. Instead, the gain or loss recognized by the parent, if any, would result from previous intercompany transactions with respect to that stock (such as an earlier purchase of the subsidiary stock from another member of the group). Gain or loss from intercompany transactions normally is deferred and taken in account based on later events, such as when the property is depreciated or leaves the group. Since the parent's stock basis in the subsidiary disappears in the 332 liquidation, any further deferral with respect to the subsidiary's stock is not possible. Thus, the 332 liquidation, while tax-free, may "trigger" gain or loss previously incurred with respect to the subsidiary's stock.

With respect to the specific question at hand, whether the amounts that are realized but not recognized under section 332 constitute tax-exempt income within the meaning of section 1.1366-1(a)(2)(viii), we disagree with the taxpayer. We tend to think of tax- exempt income in the more traditional sense of interest on tax-exempt bonds, which increases basis but on which no tax is paid, or as dividends that are excluded from income or for which you get a dividends received deduction, as opposed to transactions in which the taxpayer exchanges one thing for another, as in a section 332 transaction where the taxpayer exchanges it stock in the subsidiary for the subsidiary's assets. In a section 332 transaction, the parent's basis in its subsidiary's stock is eliminated without gain or loss; however, the parent also succeeds to the subsidiary's tax attributes under section 381, including its net operating losses. Under the consolidated return regulations, the parent is considered to be the successor to the subsidiary in a section 332 transaction. See 1.1502-13(j)(2) and (j)(9), Ex 6.

The most analogous provision that we have to section 1.1366-1(a)(2)(viii) is the investment adjustment regulation cited by the taxpayer, section 1.1502-32(b)(3)(11)(A), which states that if, in the consolidated group context, a subsidiary liquidates into its parent, the subsidiary's tax-exempt income is its income and gain which is taken into account but permanently excluded from its gross income and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). The regulation then specifically states that the subsidiary's tax-exempt income does not include gain not recognized under section 332 from the liquidation of a lower-tier subsidiary. The language of the two regulatory provisions is strikingly similar. We are not persuaded by the taxpayer's efforts to distinguish the -32 regulation. See also 1.1502-13(c)(6)(ii) (an amount realized but not recognized under section 332 is not permanently and explicitly disallowed for purposes of deciding whether S's items of income or gain will be redetermined to be excluded from gross income); 1.1502-13(f)(7), Ex. 5 (intercompany stock sale followed by liquidation; noting that B's unrecognized gain under section 332 is not permanently and explicitly disallowed under the Code).

We also note that the taxpayer's view could lead to absurd results. For example, assume that Parent, an S corporation, has one shareholder, M, who has a $0 basis in Parent. Parent has one asset with a $0 basis and a fair market value of $100. Parent forms a wholly owned subsidiary, C1, which is a C corporation, by contributing the asset to C1. Parent has a $0 basis in C1 and C1 has a $0 basis in the asset. Then, C1 forms a wholly owned subsidiary, C2, which also is a C corporation, by contributing the asset to C2. C1 now has a $0 basis in C2 and C2 has a $0 basis in the asset. Further assume that, at a time with the asset's fmv remains $100, Parent makes Q Sub elections for both C1 and C2. Pursuant to the Q Sub elections, C1 is deemed to liquidate into Parent and then C2 is deemed to liquidate into Parent.

Under section 332 and related provisions, when C1 liquidates into Parent, C1 will not recognize the $100 gain on its asset (the stock it holds in C2) (section 337) and Parent will not recognize the $100 gain on C1 stock (sec. 332). Parent will take a $0 basis in the C2 stock. Then, when C2 liquidates into Parent, C2 will not recognize its $100 gain on the asset (sec. 337) and Parent will not recognize its $100 gain on C2 stock (sec. 332). At the end of the day Parent should end up where it started, with one asset with an adjusted basis of $0 and a fair market value of $100. M would continue to hold Parent stock with a $0 basis.

Under taxpayer's view, however, as we understand it, when C1 liquidates into Parent, resulting in Parent's realization but nonrecognition of $100 gain on its C1 stock, tax exempt income of $100 is created, which passes through to M and increases M's basis in Parent. Then, when C2 liquidates into Parent, Parent's realization but nonrecognition of $100 gain on its C2 stock creates another $100 of tax exempt income which passes through to M and increases M's basis in Parent. Now, Parent holds one asset with a basis of $0 and a fair market value of $100. However, M now has a $200 basis in Parent. Thus, under taxpayer's view, taxpayer can create unlimited basis simply by creating subsidiaries and then liquidating them. This cannot be right.

With respect to the application of step transaction, we generally do not apply the step transaction when a liquidation is followed by a sale of assets to an unrelated third party. However, when a liquidation is followed by the reincorporation of the assets, there may well be a step transaction issue. In this case there is a liquidation followed six months later by an incorporation, both by virtue of the S Sub provisions. The termination of the Q Sub elections that causes the reincorporation of the assets is occasioned by the sale of to an unrelated third party. Thus, this case presents an interesting issue concerning the application of the step transaction doctrine. However, because the sale is, according to the taxpayer, subject to various regulatory approvals and assuming that there is some "teeth" to those regulatory processes and that such approvals are not routinely granted, we do not think the step transaction will apply in this case. If further factual development indicates that the regulatory approvals are pro forma, please let us know and we will reexamine the step transaction issue.

I will be out of the office July 21-25. I will return on Mon., July 28.