# Office of Chief Counsel
# Internal Revenue Service
# memorandum

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subject:

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

LEGEND

Parent =

Sub 1 =

Sub 2 =

Foreign Sub 1 =

Foreign Sub 2 =

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|---|---|
| Foreign Sub 3 | = |
| Business A | = |
| State A | = |
| Country A | = |
| Country B | = |
| Date A | = |
| Date B | = |
| Date C | = |
| Date D | = |
| Date E | = |
| Date F | = |
| Date G | = |
| a | = |
| b | = |
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| f | = |
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| h | = |
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n =

o =

p =

ISSUE

Whether, upon the liquidation of Sub 1, Parent may include a loss of $n from its sale of f percent of Sub 1 stock to Foreign Sub 2, which had been deferred under section 267(f)(2)?

CONCLUSION

Upon the liquidation of Sub 1, Parent may not include the loss of $n from its sale of f percent of Sub 1 stock to Foreign Sub 2. This loss continues to be deferred pursuant to Treas. Reg. § 1.267(f)-1(c)(1)(iv).

FACTS

Parent, a publicly-traded State A corporation, conducts Business A in the U.S. and abroad through direct and indirect affiliates. Parent is the common parent of a group of domestic subsidiaries that together file a consolidated return for U.S. federal income tax purposes (the "U.S. Consolidated Group").

On Date A, Parent acquired 100 percent of the stock of Sub 1 in an exchange qualifying for non-recognition income tax treatment pursuant to section 368(a)(1)(B) of the Internal Revenue Code (the "Code"). Following the acquisition, Sub 1 was a direct, wholly-owned subsidiary of Parent and a member of the U.S. Consolidated Group. Since the acquisition, Sub 1 has provided its services predominately to and through Parent and its subsidiaries. As of Date B, Sub 1 had issued and outstanding o shares of a single class of common stock. As of that date, Parent had a built-in loss of $a in the stock of Sub 1.

Parent also owns all of the outstanding stock of Sub 2, a State A corporation and member of the U.S. Consolidated Group. Sub 2 conducts its business in the U.S. and abroad through wholly-owned affiliates, including Foreign Sub 1, a direct subsidiary organized under the laws of Country A, and Foreign Sub 2, an indirect, wholly-owned subsidiary that is a nonresident of Country B with its corporate address in Country A.

Parent claims that it needed to simplify its organizational structure and to centralize the management of its intangible assets, thereby obtaining cost efficiencies and additional value from such assets. Parent identified Foreign Sub 2 as the entity best suited to hold and manage Parent's foreign intellectual property. Parent decided to undertake the transaction described below, which resulted in the transfer of Sub 1's foreign intellectual property rights and other assets to Foreign Sub 2.

Parent and its subsidiaries engaged in the following steps:

1. On Date C, Parent purchased certain assets from Sub 1 for $b.

2. On Date C, Foreign Sub 1 subscribed to c ordinary shares of Foreign Sub 2 stock for $d, and immediately paid for the shares using funds that were borrowed pursuant to a promissory note.

3. On Date C, Parent sold e shares of common stock in Sub 1 (representing f percent of Sub 1's outstanding stock) to Foreign Sub 2 in exchange for g shares of h percent Cumulative Redeemable Preference Stock (the "Preferred Shares").

4. On Date D, Sub 1's board of directors adopted a plan of complete liquidation, which was approved by the Sub 1 shareholders (Parent and Foreign Sub 2) on that date.

5. Between Date E and Date F, Sub 1 distributed all of its assets to Parent and Foreign Sub 2 in redemption and cancellation of their equity interests.

6. On Date G, Sub 1 dissolved under State A law.

The Taxpayer claims that the Preferred Shares that Foreign Sub 2 issued to Parent in Step 3 above in exchange for f percent of Parent's stock in Sub 1 were nonqualified preferred stock within the meaning of section 351(g). Therefore, the Taxpayer claims that Step 3 should be treated as a taxable sale or exchange on which Parent recognizes the $n loss. Taxpayer concedes that any such loss on the sale would be deferred under section 267(f). However, Parent takes the position that it was entitled to take into account its $n loss when Sub 1 liquidated. In addition, Parent reported a loss of $p on the transfer of its remaining i percent of Sub 1 stock to Sub 1 in the liquidation transaction.

## LAW AND ANALYSIS

*Overview*

Section 267(f)(2) generally defers losses from the sale or exchange of property between members of a controlled group until the property is transferred outside the controlled group and the loss would be taken into account under consolidated return principles. The regulations under section 267(f)(2) were promulgated to prevent members of a controlled group from taking into account a loss or deduction solely as a result of a transfer of property between a selling member (S) and a buying member (B). Following the liquidation of Sub 1, Parent and Foreign Sub 2 remain members of the same controlled group. Therefore, Parent's $n loss on its sale of f percent of Sub 1 stock should be deferred until Parent and Foreign Sub 2 are no longer in a controlled group relationship.

*Law*

Treas. Reg. § 1.267(f)-1(a)(1) provides the purpose of the regulations under section 267(f):

> This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of the transfer of property between a selling member (S) and a buying member (B).

Pursuant to Treas. Reg. § 1.267(f)-1(a)(1), Parent's loss from the sale of Sub 1 stock is taken into account under the timing principles of Treas. Reg. § 1.1502-13, treating such sale as an intercompany transaction. For this purpose, the matching and acceleration rules of Treas. Reg. § 1.1502-13(c) and (d) apply with certain adjustments that provide that the rules of § 1.1502-13 apply on a controlled group basis and affect only the timing of a loss or deduction, and not its attributes. See Treas. Reg. §§ 1.267(f)-1(a)(2)(i) and 1.267(f)-1(c)(2).

Treas. Reg. § 1.267(f)-1(c)(1)(iv) provides:

> To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of section 1.1502-13 but is not redetermined because of paragraph (c)(2) of this section, then * * * S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship.

The intercompany transaction regulations of Treas. Reg. § 1.1502-13 provide rules for taking into account items of income, gain, deduction, and loss of consolidated group members from intercompany transactions. The purpose of the intercompany transaction regulations is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). Treas. Reg. § 1.1502-13(a)(1).

The regulations define "intercompany transaction" broadly, as any transaction between corporations that are members of the same consolidated group immediately after the transaction. The regulations further define "S" as the member transferring property or providing services, and "B" as the member receiving the property or services. Treas. Reg. § 1.1502-13(b)(1).

Treas. Reg. § 1.1502-13(a)(2) provides:

> Separate entity and single entity treatment.—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. The *amount* and *location* of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). * * * The timing, and the character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

Treas. Reg. § 1.1502-13(c)(3) provides that, "as divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring)."

S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction. Treas. Reg. § 1.1502-13(b)(2)(i). B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction). Treas. Reg. § 1.1502-13(b)(3)(i).

The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction was between those divisions. Treas. Reg. § 1.1502-13(b)(4). The regulations provide that, "[a]lthough neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or regulations that would affect its timing or attributes)." Id.

The attributes of an intercompany item or corresponding item are all of the item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income (and tax liability). The regulations provide that the treatment of an item as excluded from gross income or as a noncapital, nondeductible amount constitutes an "attribute". Treas. Reg. § 1.1502-13(b)(6).

The principal rule within the intercompany transaction regulations that implements single entity treatment is the matching rule of Treas. Reg. § 1.1502-13(c). Under the matching rule, S and B are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. Treas. Reg. § 1.1502-13(a)(6). The matching rule provides a timing rule, which directs when B and S must take into account their items from an intercompany transaction. Under this timing rule, B takes its corresponding item into account under its own, separate entity accounting method. Treas. Reg. § 1.1502-13(c)(2)(i). S does not take its intercompany item into account under its own accounting method; rather, it takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item (the item that B would have taken into account if S and B were divisions of a single corporation). Treas. Reg. § 1.1502-13(c)(2)(ii).

The matching rule also provides guidance regarding the manner in which the single-entity principles of the intercompany transaction regulations affect the attributes of intercompany and corresponding items. This rule provides that the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Thus, the activities of both S and B might affect the attributes of both intercompany items and corresponding items. Treas. Reg. § 1.1502-13(c)(1)(i).

*Application of the Principles of the Intercompany Transaction Regulations*

The appropriate application of Treas. Reg. § 1.267(f)-1(c)(1)(iv) is at the heart of the current controversy.[1] That provision states:

> To the extent S's loss would be redetermined to be a noncapital, nondeductible amount <u>under the principles of section 1.1502-13</u> but is not redetermined because of paragraph (c)(2) of this section, then * * * S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. [Emphasis added.]

Thus, by its own terms, Treas. Reg. § 1.267(f)-1(c)(1)(iv) requires an analysis of the hypothetical treatment of the transactions at issue under the principles of the intercompany transaction rules of Treas. Reg. § 1.1502-13. If such hypothetical treatment would result in S's item being redetermined to be a noncapital, nondeductible item, such item will continue to be deferred.

As discussed above, the matching rule is the principal means by which the intercompany transaction regulations enforce single entity treatment. The matching rule

[1] In order for Treas. Reg. § 1.267(f)-1(c)(1)(iv) to apply to the transaction, the transaction must not be directly governed by Treas. Reg. § 1.1502-13, and Treas. Reg. § 1.267(f)-1(c)(1)(iii) (dealing with subsequent transfers by B to nonmembers that are related to any member of the controlled group) must not apply. We assume that these requirements have been satisfied.

requires that the attributes of the intercompany item and the corresponding item be redetermined to the extent necessary to produce the effect of a transaction between divisions of a single corporation. Treas. Reg. § 1.1502-13(c)(1)(i). The recomputed corresponding item represents the single-entity outcome to the group (that is, the net tax impact that the group would have taken into account if S and B had been divisions of a single corporation). Generally, B takes its corresponding item into account under its separate method of accounting. S generally takes its intercompany item into account so as to reflect the difference between the recomputed corresponding item and the corresponding item. In other words, intercompany item taken into account in any given year should equal the recomputed corresponding item for that year, minus the corresponding item taken into account in that year (RCI - CI = II).

For purposes of applying the matching rule, Parent's intercompany item is the amount of loss that it had on the intercompany sale of the Sub 1 stock. Foreign Sub 2's corresponding item is the amount that Foreign Sub 2 actually recognizes (on a separate entity basis) as a result of Sub 1's liquidation. Here, we assume Parent's intercompany item to be the $n loss claimed by the Taxpayer. Further, assuming that Foreign Sub 2's basis in the Sub 1 stock is equal to its fair market value at the time of the liquidation, Foreign Sub 2 would recognize no gain or loss as a result of the liquidation. Therefore, Foreign Sub 2's corresponding item for this purpose is $0.

The recomputed corresponding item is the corresponding item that Foreign Sub 2 would take into account if Foreign Sub 2 (B) and Parent (S) were divisions of a single corporation. If Foreign Sub 2 and Parent were divisions of a single corporation, Foreign Sub 2 would take no basis increase in the Sub 1 stock on the transfer of the shares from Parent. Solely for purposes of arriving at the recomputed corresponding item, upon the liquidation, Foreign Sub 2 is treated as realizing $f of loss. However, that realized loss would be treated as unrecognized, by application of section 332. This is because, to the extent that the transactions are analyzed as if B and S were divisions of a single corporation, the liquidation is controlled by section 332, and not section 331. Although there is actually no single 80 percent shareholder, for purposes of computing the recomputed corresponding item, the previous intercompany stock sale is treated as the movement of that asset within a single corporation, and not as a sale between two corporations. Thus, for purposes of this computation, Sub 1 is treated as being wholly owned by a single shareholder.

In this case, Foreign Sub 2's corresponding item is assumed to be zero, as Parent claims that Foreign Sub 2 (B) took a fair market value basis in the Sub 1 stock. As described above, the single-entity, recomputed corresponding item would be an unrecognized loss of $n. Excludability or treatment as a noncapital, nondeductible item is an attribute.[2] Therefore, the intercompany item must be redetermined as being

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[2] Treasury Reg. § 1.1502-13(c)(6)(i) illustrates the meaning of the term "noncapital, nondeductible amount":

excluded (and therefore, a noncapital, nondeductible item) in order to ensure that the corresponding item and the intercompany item together equal the recomputed corresponding item (unrecognized $n [RCI] – 0 [CI] = unrecognized $n [II]). Compare Treas. Reg. § 1.1502-13(f)(7), ex. 5 (liquidation under section 332, following intercompany stock sale). This redetermination ensures single-entity treatment.

This outcome comports with the stated intent of the intercompany transaction regulations: preventing the existence of an intercompany transaction from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). Treas. Reg. § 1.1502-13(a)(1). That is, the overall tax impact on the group should not change based on whether or not the initial stock sale (an intercompany transaction) occurs. Taxpayer does not dispute that, had there been no stock sale, section 332 would have applied to the liquidation, and no loss would have been recognized on the subject stock. The mere existence of the stock sale (treated as an intercompany transaction for purposes of this analysis) should not change this answer.

*Responses to Taxpayer's Arguments*

The Taxpayer objects to the Service's application of the attribute redetermination rule of the intercompany transaction regulations, as outlined above. However, the precise nature of the Taxpayer's objection is not clear. The Taxpayer appears to acknowledge the existence of the redetermination rules and the fact that, under those rules, the attributes of the taxable items of B and S may be redetermined to produce single entity treatment. See Protest at 4-5 ("[C]ertain aspects of the transaction, namely timing and attributes, may be redetermined to produce the effect of transactions between divisions of a single corporation (known as 'single entity treatment').") However, despite this acknowledgement that the regulations call for single entity treatment, the Taxpayer appears to argue that Treas. Reg. § 1.1502-13 cannot and does not apply to create a hypothetical transaction from which a recomputed corresponding item is identified. See, e.g., Protest at 9 ("[T]he IRS . . . asserts that [Parent's] loss on the sale . . . is a nondeductible loss 'because if S and B were divisions of a single corporation the loss would not have been recognized under section 332.' This conclusion is incorrect

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> Under Treasury Regulation section 1.1502-13(c)(1), seller's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount. For example, seller's intercompany loss from the sale of property to buyer is treated as a noncapital, nondeductible amount if buyer distributes the property to a nonmember shareholder at no further gain or loss (because, if seller and buyer were divisions of a single corporation, the loss would not have been recognized under section 311(a).

In other words, seller's intercompany loss would be treated as a noncapital, nondeductible amount if the buyer's corresponding item is permanently disallowed or permanently eliminated. Treas. Reg. § 1.1502-13(b)(3)(ii) provides than an item permanently disallowed or permanently eliminated can include amounts not recognized under section 332. See Treas. Reg. § 1.1502-13(f)(7), *Example 5(c)*. Therefore, Parent's loss from the intercompany transaction would be redetermined to be a noncapital, nondeductible amount under Treas. Reg. § 1.1502-13 if Foreign Sub 2's corresponding item is not recognized for tax purposes.

because it ignores the actual transaction that occurred . . ."); Protest at 10 ("As discussed at length above, there are no consolidated return rules that would reconstruct the actual stock ownership; instead, the actual stock ownership must be respected.")

If the Taxpayer's position is that redetermination of items does not contemplate the generation of single entity outcomes that are different from the outcomes that would occur on a separate entity basis, the Taxpayer is clearly incorrect. See Treas. Reg. §§ 1.1502-13(a)(2) ("The timing, and the character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment)"); and 1.1502-13(b)(4) ("The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions"). The operation of these provisions is described in detail, above.

In making its argument, the Taxpayer cites portions of the intercompany transaction regulations that actually support the government's position. The Taxpayer cites to an example in Treas. Reg. § 1.1502-13(c)(6) that illustrates the operation of the attribute redetermination rule. That example related to an intercompany sale followed by a distribution of the same property, and states:

> S's intercompany loss from the sale of property to B is treated as a noncapital, nondeductible amount if B distributes the property to a nonmember shareholder at no further gain or loss (because, if S and B were divisions of a single corporation, the loss would not have been recognized under section 311(a)). [Emphasis added.]

With regard to the example, the Taxpayer states: "The example does not treat S as having distributed the property because that would ignore the fact that B actually distributed the property. Instead, S's loss from the sale to B is redetermined to be nondeductible." Protest at 6.

This redetermination of a loss to be noncapital, nondeductible is exactly the point at issue in this case. Treas. Reg. § 1.267(f)-1(c)(1)(iv) requires additional deferral where a loss would have been redetermined to be a noncapital, nondeductible item if the intercompany transaction regulations had applied. For purposes of applying the matching rule of the intercompany transaction regulations, the single entity answer is the tax result of the hypothetical transaction that would have occurred if S and B had been two divisions of a single corporation. This example illustrates the regulation's requirement that such a hypothetical transaction be constructed and examined. In the example, the distribution of the property was examined as if it had been a distribution of built-in loss property by the hypothetical S-B single entity to a nonmember shareholder. On the basis of the tax results of the hypothetical transaction, S's intercompany loss is redetermined to be a noncapital, nondeductible item. In the current case, if Parent and

Foreign Sub 2 had been divisions of a single corporation, Parent's loss on the earlier stock sale would have been redetermined to be a noncapital, nondeductible amount because the liquidation would have constituted a section 332 transaction, rather than a section 331 transaction.[3]

In the alternative, the Taxpayer's position may be that, although redetermination may generally occur to produce single entity treatment, such treatment is not applicable where member stock is the asset that is the subject of the sale. See Protest at 5 ("S and B are not treated as divisions of a single corporation for purposes of analyzing a transaction involving a member, S's, stock.") In support of this position, the Taxpayer points to a statement in Treas. Reg. § 1.1502-13(c)(3), which provides that section 1032 is not to be applied on a single entity basis. See Protest at 5.

The Taxpayer is mistaken. The government agrees that, pursuant to the regulations, section 1032 is not applied on a single entity basis. However, where stock of a member other than B or S (or stock of a non-member) is the property that is the subject of the intercompany transaction, the ownership of that stock is clearly analyzed on a single entity basis. For instance, Treas. Reg. § 1.1502-13(f)(7)(i), example 5, involves the intercompany sale of stock of T, followed by a section 332 liquidation of T into B. The analysis of the attributes and timing of the items in that example illustrates that B and S are indeed treated as a single entity, and that the possible redetermination of timing and attributes is considered based on the tax results from a hypothetical recast of the transaction, with B and S treated as divisions of a single corporation.[4]

In addition, Taxpayer appears to imply that the government has taken the position that a liquidation of Target would not be a triggering event with regard to Parent's loss on the Sub 1 stock under the intercompany transaction regulations. See Protest at 8. That is not the government's position. Under the regulations, Target's liquidation would be a triggering event and S's intercompany item would be taken into account as taxable gain, or as an excluded loss.

*Deferral under section 267(f)(2) and the regulations thereunder.*

Treasury Reg. § 1.267(f)-1(c)(1)(iv) provides:

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[3] The government does not argue that section 332 actually governs the taxability of the liquidation. Section 331 governs the transaction, and the issue herein is simply the proper timing of the losses under the rules of section 267(f). The hypothetical liquidation of Sub 1 into a sole shareholder is applicable only with regard to applying the principles of the intercompany transaction regulations under section 267(f).

[4] See Treas. Reg. § 1.1502-13(f)(7)(i), Example 5(b) ("Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's corresponding item are redetermined as if S and B were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of B's gain under 332, S's gain remains capital because B's unrecognized gain under section 332 is not permanently and explicitly disallowed . . .").

> To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of section 1.1502-13 but is not redetermined because of paragraph (c)(2) of this section, then * * * S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship. [Emphasis added.]

As discussed above, the rules of section 267(f) and the regulations thereunder generally apply only the timing rules of the intercompany transaction regulations and not the attribute redetermination rules. See Treas. Reg. § 1.267(f)-1(c)(2). Therefore, a seller's loss is generally deferred until it is taken into account under the timing principles of the matching and acceleration rules of Treas. Reg. § 1.1502-13(c) and (d). However, Treas. Reg. § 1.267(f)-1(c)(1)(iv) makes clear that the operation of the attribute redetermination rules is taken into account in certain circumstances. Specifically, to the extent that a seller's loss would be redetermined to be a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13 (and thus, the loss would be disallowed under those principles), that loss continues to be deferred and is not taken into account until the buyer and seller are no longer in a controlled group relationship. In other words, Treas. Reg. § 1.267(f)-1(c)(1)(iv) provides for continued deferral where the intercompany transaction regulations would have disallowed the loss at issue.

The Preamble to the final regulations under section 267(f) explains the addition of this rule:

> [T]he regulations clarify that to the extent S's loss would have been treated as a noncapital, nondeductible amount under the attribute rules of the regulations under § 1.1502-13, the loss is deferred under section 267(f) until S and B are no longer in a controlled group relationship with each other. Section 267 is intended to prevent a taxpayer from taking a loss into account from the sale or exchange of property when the property continues to be held by a member of the same controlled group. Under § 1.1502-13, S's loss might be taken into account but redetermined to be noncapital or nondeductible, permanently preventing the loss from being taken into account. It could be argued that this is the result of the attribute provisions of § 1.1502-13, which do not apply under section 267(f), not a result of the timing provisions of § 1.1502-13, and thus, a controlled group member could take its loss into account. The change made in the final regulations assures that the purpose of section 267 is not defeated as a result of the non-application of the attribute redetermination rules of § 1.1502-13 for purposes of section 267(f).

T.D. 8597, 1995-2 C.B. 147, 154 [Emphasis added].

The section 267(f) rules, on their face, were written to result in deferral of loss, and not its complete disallowance, in contrast with the intercompany transaction regulations.

Therefore, the section 267(f) regulations generally invoke only the timing rules of the intercompany transaction regulations, and not the attribute redetermination rule. However, as indicated by the Preamble, the drafters were concerned that a failure to apply the attribute redetermination rules would result in taxpayers claiming that they may take into account losses on intercompany sales when neither the property sold nor either of the transacting parties had left the controlled group ("It could be argued that this is the result of the attribute provisions of § 1.1502-13, which do not apply under section 267(f), not a result of the timing provisions of § 1.1502-13, and thus, a controlled group member could take its loss into account."). To prevent this outcome, the final regulation included Treas. Reg. § 1.267(f)-1(c)(1)(iv), the paragraph here at issue.

As discussed above, for purposes of the matching rule, Treas. Reg. § 1.1502-13(c)(1)(i) provides that the separate entity attributes of the seller's intercompany items and buyer's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if the seller and the buyer were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.

In applying the principles of Treas. Reg. § 1.1502-13, Parent and Foreign Sub 2 are treated as divisions of a single corporation, and Parent's sale of the Sub 1 stock to Foreign Sub 2 is a transaction between divisions. To the extent that the sale of f percent of the Sub 1 stock is treated as occurring between divisions of a single corporation, the liquidation of Sub 1 is nontaxable under section 332 because the hypothetical single corporation owns all the stock of Sub 1 at the time of the liquidation. Therefore, Parent's (S's) loss would be recharacterized under the intercompany transaction regulations as a noncapital, nondeductible amount to mirror the nontaxable nature of the liquidation in the hypothetical transaction. Where such a redetermination would occur, Treas. Reg. § 1.267(f)-1(c)(1)(iv) imposes continuing deferral. Thus, Parent's loss must be further deferred until Parent and Foreign Sub 2 are no longer in a controlled group relationship.

*Responses to Taxpayer's Arguments*

The Taxpayer argues that the requirements for the application of Treas. Reg. § 1.267(f)-1(c)(1)(iv) have not been met. The Taxpayer posits three requirements: First, there must be a sale at a loss. Second, the sale must be governed by the intercompany sale rules of section 267(f), and not the intercompany transaction rules of Treas. Reg. § 1.1502-13. The government agrees with the Taxpayer's basic formulation of those two requirements. However, the Taxpayer incorrectly asserts that there is a third requirement that "the acquired corporation (T) liquidates under section 332 of the Code (in actuality, not on some hypothetical divisional basis)." Protest at 10.[5] Although the

[5] Although the Taxpayer never directly asserts that the example in Treas. Reg. § 1.267(f)-1(c)(1)(iv) acts to limit the application of that regulation to section 332 transactions, its Protest may be so read. However, it is a long-established principle that examples in regulations are illustrative only. See, e.g., Solomon v.

Taxpayer's argument is not perfectly clear, it appears that the Taxpayer either argues (1) that the intercompany transaction regulations do not call for the creation of a hypothetical transaction from which single entity outcome is determined, or (2) that Treas. Reg. § 1.267(f)-1(c)(1)(iv) does not invoke the single entity redetermination rules of the intercompany transaction regulations to create a hypothetical transaction from which the single entity outcome is determined.

The first interpretation of the Taxpayer's argument constitutes a rehash of its argument with regard to the general application of the intercompany transaction regulations. As discussed in detail above, the most basic requirement of the intercompany transaction rules is the imposition of "single entity treatment." To achieve this treatment, the regulations expressly provide for the examination of the hypothetical transaction to which the Taxpayer appears to object. See Treas. Reg. § 1.1502-13(b)(4) ("Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account"); and § 1.1502-13(c)(1)(i) ("The separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.").

Further, the text of Treas. Reg. § 1.267(f)-1(c)(1)(iv) and the Preamble to that regulation refute any argument that Treas. Reg. § 1.267(f)-1(c)(1)(iv) does not invoke the attribute redetermination principles of the intercompany transaction regulations. Rather, the regulations expressly provide for application of the redetermination rules of the intercompany transaction regulations. ("To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of section 1.1502-13 but is not redetermined because of paragraph (c)(2) of this section . . .").

In addition, the Taxpayer argues that application of Treas. Reg. § 1.267(f)-1(c)(1)(iv) would violate the intent behind that regulation, because "Section 1.267(f)-1(c)(1)(iv) of the Regulations was included in the final regulations merely to ensure that the seller's deferred loss would not be *permanently* deferred in the case of a liquidation under Section 332 of the Code." Protest at 11. The Taxpayer further argues that, because the taxation of this transaction is actually controlled by section 331 and not 332, permanent denial of the loss was never an issue, and, therefore, this regulation can have no application. Protest at 10, 12.

The Taxpayer is incorrect. Absent Treas. Reg. § 1.267(f)-1(c)(1)(iv), permanent deferral was not the problem. This is because Treas. Reg. § 1.267(f)-1(c)(2) applies to turn off the redetermination of attributes, and to ensure that the section 267(f) regulations imported only the timing provisions of the intercompany transaction regulations. Thus, on the occurrence of the nonrecognition transaction (and the disappearance of the

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C.I.R., 67 T.C. 379, 386 (1976) (examples in Treasury regulations are merely illustrative and do not purport to limit application of the statute).

target stock), the intercompany item would be triggered. See Treas. Reg. § 1.1502-13(f)(ii), ex. 5. Under strict application of the intercompany transaction regulations, the intercompany loss would be triggered, but its attributes would be redetermined to result in the loss being excluded. However, because Treas. Reg. § 1.267(f)-1(c)(2) turns off the attribute redetermination rules, there was the possibility that the loss would be currently allowed, although the controlled group remained in control of all pertinent assets. This result would run afoul of the basic purpose of the rules under section 267(f), which is to defer losses until a separation of the controlled group members, or their disposal of the asset. Therefore, Treas. Reg. § 1.267(f)-1(c)(1)(iv) extended deferral. The section 267(f) regulations thus invoke the attribute redetermination rules of the intercompany transaction regulations as a mechanism to determine when the possibility of such improper inclusion might exist. Any item that would have been redetermined to be a capital, nondeductible item under the principles of § 1.1502-13, instead is further deferred, and not disallowed. This understanding of the regulation has been adopted by experts within the tax bar.[6]

Contrary to the Taxpayer's claims, application of Treas. Reg. § 1.267(f)-1(c)(1)(iv) to this transaction fits within the expressed intent of the section 267(f) regulations. Treas. Reg. § 1.267(f)-1(a)(1) provides that "[t]he purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of the transfer of property between a selling member (S) and a buying member (B)." If the regulation did not apply in this case, the existence of the intercompany sale

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[6] The leading commentator in the consolidated return area discusses the purpose of § 1.267(f)-1(c)(1)(iv) as follows:

> This continued deferral rule was introduced in the final regulations. IRC Section 267 is intended to prevent a taxpayer from taking a loss into account from the sale or exchange of property when the property continues to be held by a member of the same controlled group. The government rejected the argument that the recharacterization under Treas. Reg. § 1.1502-13 as a noncapital, nondeductible amount is simply the result of the attribute provisions of Treas. Reg. § 1.1502-13, which do not apply under IRC Section 267(f). When Congress incorporated the intercompany transaction rules into IRC Section 267(f), it could not have foreseen the attribute redetermination that the current regulations require. Thus, a controlled group member should not expect to take the loss into account simply because a corresponding noncapital, nondeductible amount is allowed to a consolidated group.
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> The additional deferral under IRC Section 267(f) is intended to prevent the perceived purpose of IRC Section 267 from being defeated as a result of the inapplicability of the attribute redetermination rules of Treas. Reg. § 1.1502-13 for purposes of IRC Section 267(f). Many instances where recharacterization as a noncapital, nondeductible amount is required involve transactions in member stock that never leaves the group. Where Treas. Reg. § 1.1502-13 permits restoration of a loss, the restoration appears to have been premised on the recharacterization, and the government was not satisfied to allow the loss under IRC Section 267(f) simply because of the timing rules of Treas. Reg. § 1.1502-13.

Dubroff, et al., Federal Income Taxation of Corporations Filing Consolidated Returns, §31.11[3][b][iv]; see also, Hennessey, et al., The Consolidated Tax Return, ¶ 6.02[9], Example 6-21 (the addition of §1.267(f)-1(c)(1)(iv) results in the continued deferral of an item that would otherwise be includable in income.)

would result in the controlled group taking into account a loss that it otherwise could not have, as a result of having entered into the intercompany sale. Absent the intercompany sale of Sub 1 stock, Sub 1 would have been wholly owned by Parent at the time of the liquidation, and, thus, section 332 would have been applicable to the liquidation.

Finally, the Taxpayer argues that "[u]nder the NOPA's faulty reasoning, every taxable liquidation within a controlled group would constitute a tax-free liquidation under Section 332 of the Code." Protest at 9. Taxpayer either misunderstands or misconstrues the government's argument. Section 267(f) is not the equivalent of the application of Treas. Reg. § 1.1502-34, which treats all stock ownership of a corporation by members of a consolidated group as held by a single shareholder for purposes of applying section 332. Section 267(f) and the regulations thereunder adopt certain principles of the intercompany transaction regulations and apply these principles only where an intercompany sale has occurred. Therefore, where there is split ownership of the stock of a member of a controlled group, but that split ownership is not the result of an intercompany sale of target stock, there will be no application of section 267(f). However, any time there has been an intercompany stock sale, the transaction must be tested against the rules of section 267(f).

We express no opinion about the Taxpayer's purported business purposes or any other issues raised by the facts of this transaction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 622-7790 if you have any further questions.

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