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Memorandum

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to: David Cao, Senior Counsel (Large Business & International)

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subject: Taxpayer's protest.

This Chief Counsel Advice (CCA) supplements CCA 201726012 (the "Original CCA"). This advice may not be used or cited as precedent. This CCA responds to Taxpayer's protest (the "Protest") dated July 20, 2018, and strictly focuses on Taxpayer's arguments relating to §1.1502-13 (the "intercompany transaction regulations").

I. Overview and Summary

This CCA addresses §1.1502-13 issues relating to certain nonrecognition transfers of interests in tiered partnerships among members of Taxpayer's consolidated group ("Taxpayer Group"). As a result of these intercompany transfers of partnership interests, the partnerships adjusted the basis in their respective assets allocable to the transferred interests under section 743(b) ("Section 743(b) Adjustment"). These Section 743(b) Adjustments caused the Taxpayer Group to claim increased depreciation and amortization deductions for the years at issue (the "Increased Deductions"). Thus, by shifting ownership of partnerships within a consolidated group, the Taxpayer Group significantly reduced its taxable income by claiming Increased Deductions for the years at issue. This CCA focuses on the application of the §1.1502-13 rules to the Increased Deductions.

The same §1.1502-13 analysis applies to each of the intercompany transfers of partnership interests, and our analysis does not differentiate between the transfers under section 332 and section 368. We will generally refer to the transferor of the partnership interest as the Seller (or S), and the transferee as the Buyer (or B).

The Original CCA detailed the purpose and operation of the rules under §1.1502-13. After analyzing the facts at issue, the Original CCA concluded that §1.1502-13 prevents the Taxpayer Group from claiming increased deductions from depreciation and amortization attributable to the Section 743(b) Adjustments. Specifically, the Increased Deductions were redetermined to be noncapital, nondeductible amounts.

Taxpayer's Protest asserts that the analysis and conclusion of the Original CCA are flawed and must be rejected. On review of the Protest, it appears that Taxpayer misapprehends the general operation of the intercompany transaction regulations, as well as their application to the specific facts in this case. The following statement from the Protest may be helpful in understanding the Taxpayer's baseline position:

> Regulations Section 1.1502-80(a)(1)…provides that, "[t]o the extent not excluded, other rules operate in addition to, and may be modified by, these [R]egulations." <u>The Consolidated Return Regulations neither exclude, nor specifically address, application of Section 743(b) and the resulting tax impacts occurring as a result of a non-recognition transaction between group members</u>. Thus, Section 743(b) applies to intercompany transactions in the same manner as it applies to transactions between deconsolidated entities, unless modified by the Intercompany Transaction Regulations. (Emphasis added.)[1]

Before addressing each of Taxpayer's specific arguments, we review the purpose and basic operation of the intercompany transaction regulations.

II. Purpose and Function of the Intercompany Transaction Regulations

Congress granted the Treasury Department broad authority to prescribe regulations applicable to a group of corporations filing a consolidated return. Section 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group…may be returned, determined, computed, assessed, collected, and adjusted, in such manner as <u>clearly to reflect the income tax liability</u> and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, <u>the Secretary may prescribe rules that are different from the provisions</u>

[1] Protest at 44.

> of chapter 1 that would apply if such corporations filed separate returns. (Emphasis added.)

Treasury issued the intercompany transaction regulations in §1.1502-13 in accordance with this grant of authority. These regulations often override rules that are otherwise applicable to corporations filing separate returns and provide a different result for consolidated groups.

A. Basic Operation of the Intercompany Transaction Regulations

Section 1.1502-13 provides rules for taking into account items of income, gain, deduction, and loss of consolidated group members from intercompany transactions. As stated in §1.1502-13(a)(1), the purpose of these 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)." (Emphasis added.)

These regulations generally apply "single entity treatment" to prevent consolidated groups from obtaining a different bottom-line tax outcome as a result of engaging in intercompany transactions. Section 1.1502-13(a)(2) provides for this single entity treatment, instructing that, "The *timing*, and the *character* and *source*, and other *attributes* of the [selling member's items] and [buying member's 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)." (Emphasis added.)

The matching rule in §1.1502-13(c) is the principal rule to implement single entity treatment. Section 1.1502-13(c) provides the rules for taking into account S's items and B's items, in order to reach a single entity answer for each consolidated return year. Section 1.1502-13(c)(2) provides a timing rule to account for S's and B's items. The application of this timing rule is not at issue in this case.

Central to the current case, §1.1502-13(c)(1)(i) contains a broad conceptual rule that redetermines the "attributes" of S's and B's items in each taxable year,[2] where necessary, to reach a single entity answer (the attribute redetermination rule):

> 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…. (Emphasis added.)

[2] *See* §1.1502-13(c) ("For each consolidated year, B's corresponding items and S's intercompany items are taken into account under the following rules….").

The above quotation sets forth the fundamental framework for the operation of the regulation. To apply the attribute redetermination rule, one must first establish S's and B's items (on a separate entity basis) and identify the attributes of those items. Attributes are broadly defined in §1.1502-13(b)(6) as follows:

> 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). For example, attributes include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in-gain or loss under section 382(h) or 384. (Emphasis in original.)

The definition of "attributes" is very broad, and the regulation includes some representative examples of common attributes. Of special import to this case is treatment of an item as "excluded from gross income or as a noncapital, nondeductible amount." Together, §1.1502-13(c)(1)(i) and (b)(6) make clear that, even though "amount" is not an attribute, the taxability of that amount is an attribute.[3]

After identifying the attributes of S's and B's separate entity items, the net tax impact of those items is analyzed and compared to the tax items that the group would have had if the transaction had occurred between divisions of a single corporation (that is, single entity treatment). If the separate entity results are consistent with single entity treatment, then no attributes are redetermined under §1.1502-13. However, if the net effect of the separate entity items differs from single entity treatment, then §1.1502-13(c)(1)(i) requires redetermination of S's and/or B's attributes, in order to reach the single entity result.

Although, as explained, the overall goal of the §1.1502-13 rules is single entity treatment, the regulations also provide for separate entity treatment in certain notable cases. However, where separate entity treatment is intended or expected, the regulations explicitly provide for such treatment. *See*, *e.g.*, §1.1502-13(d)(5) (providing separate entity treatment for banks and insurance companies); §1.1502-13(f) (applying rules with a heavier separate entity balance with regard to transactions in group member stock); §1.1502-13(c)(6) (applying special requirements solely with regard to the redetermination of S's items, which results in separate entity treatment where those requirements are not met); §1.1502-13(d) (providing an "Acceleration Rule" that takes S's and B's items into account immediately before single entity treatment becomes impossible to achieve).

[3] That is, an otherwise taxable item may be "zeroed out." In contrast, an amount that never existed cannot be created as an application of §1.1502-13.

B. Purpose and Function of the Intercompany Transaction Regulations

The current intercompany transaction rules (including the matching rule) were intentionally drafted as broad, conceptual rules. The principle-based nature of the rules allows for their flexible application to a wide universe of intercompany transactions. The intentional shift away from the mechanical, bright-line rules of the pre-1995 intercompany transaction regulations is explicitly discussed in the preamble to the final regulations. Under the sub-heading "General v. mechanical rules." the preamble states:

> The prior intercompany transaction regulations were generally mechanical in operation. The proposed regulations rely less on mechanical rules and, instead, provide broad rules of general application based on the underlying principles of the regulations. To supplement the broad rules, the proposed regulations provide examples illustrating the application of the rules to many common intercompany transactions.
>
> Some commentators supported the proposed regulations' use of broad rules based on principles. Others suggested that the final regulations should retain the mechanical rules of prior law. Mechanical rules provide more certainty for transactions clearly covered by those rules. For transactions that are not clearly covered, however, mechanical rules provide much less guidance.
>
> The final regulations retain the approach of the proposed regulations. This approach is flexible enough to apply to the wide range of transactions that can be intercompany transactions. For example, the final regulations do not require special rules to coordinate with the depreciation rules under section 168, the installment reporting rules under sections 453 through 453B, and the limitations under sections 267, 382, and 469. Flexible rules adapt to changes in the tax law and reduce the need for continuous updating of the regulations.[4] (Emphasis added.)

The preamble explanation affirms that §1.1502-13 was written in a conceptual manner, to have application to a wide range of possible intercompany transactions. These regulations do not contain bright-line rules that apply redetermination only to specific situations or specific Code sections. In fact, that option was expressly rejected by the drafters. The preamble further indicates that the examples were not intended to be exclusive, but merely illustrate application of the regulations to common intercompany transactions.

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[4] TD 8597, 1995-2 CB 147, Supplementary Information, Part C.2.

It is important to note that the application of §1.1502-13 is not optional. Whether the single entity answer works to the taxpayer's benefit or detriment is of no moment; the rules apply.

III. Application of §1.1502-13 to This Case

Taxpayer contends that, as a result of its intercompany transfers of partnership interests in nonrecognition transactions, B is entitled to claim Increased Deductions that would significantly reduce the group's taxable income for the years at issue.[5] Taxpayer's reporting position, allowing additional deductions created by intercompany transactions to lower the group's taxable income, is disallowed by the intercompany transaction regulations. To ensure single entity treatment, the Original CCA applied the broad principle-based rules in §1.1502-13 to redetermine B's Increased Deductions to be noncapital, nondeductible amounts. *See* §1.1502-13(b)(6) (defining "attributes").

The essence of Taxpayer's Protest is that, because there is no specific rule in §1.1502-13 (nor a specific example) that provides for the application of these regulations to effectuate single entity treatment in the case of nonrecognition intercompany transfers of partnership interests, redetermination of the Increased Deductions must be rejected. Our explanation of the application of §1.1502-13 to this case responds to that basic claim.

To understand the application of §1.1502-13 to an intercompany transfer of a partnership interest, it is helpful to begin with Example 9 under the matching rule in §1.1502-13(c)(7)(ii)(I) ("Example 9"). This example illustrates how §1.1502-13 applies to reach a single entity answer in the garden-variety intercompany sale of a partnership interest (*i.e.*, a taxable transaction).

Example 9

In Example 9, S sells a partnership interest to B and recognizes intercompany gain on the sale. The partnership has made a section 754 election. Therefore, the section 743(b) adjustments on the sale of the partnership interest result in additional depreciation to B. The total increase in depreciation under these facts corresponds to S's gain recognized on the sale. Because the sale is subject to single entity treatment under §1.1502-13(c), S does not immediately take its gain into account (as it would in a nonconsolidated situation). Rather, S defers taking its gain into account until later events trigger an inclusion under the matching rule. In this example, S takes a portion of its gain into account annually, to offset the increased depreciation deductions that

[5] We note that the IRS does not herein argue that there would be no Increased Deductions if the transactions had occurred between two nonconsolidated corporations. The issue at hand is whether the application of the matching rule under §1.1502-13 causes those Increased Deductions to be redetermined to reach a single entity result.

flow to B as a result of the section 743(b) adjustment. These items offset in amount, and, on a net basis, the group reaches a single entity result.

Example 9 makes clear that, in the case of an intercompany sale of a partnership interest, the intercompany transaction regulations apply in each year to produce a net zero for the group. This is because, if S and B were divisions of a single entity, there would be neither increased depreciation nor gain associated with the transferred partnership interest. Under the specific facts of the example, there was no need to redetermine the attributes of S's and B's items to be excluded from gross income or to be noncapital, nondeductible amounts to reach a single entity answer. Such redetermination was unnecessary because the items of S and B offset each other in amount. However, the timing portion of the matching rule was applied, to bring a portion of S's intercompany gain into income each year to offset B's increased depreciation. *See* §1.1502-13(c)(2). Different facts can require application of different aspects of the intercompany transaction regulations, and application of the rules to more complex facts requires a clear understanding of the principles §1.1502-13(c).[6]

As the Original CCA points out, the facts of this case are distinguishable from those in Example 9. Here, S recognizes no gain or loss on its transfer of partnership interests to B. Therefore, unlike in Example 9, the timing of S's item is not at issue. Instead, a different aspect of the matching rule applies (*i.e.*, the attribute redetermination rule) to ensure single entity treatment. Similar to Example 9, the matching rule applies here to achieve the appropriate single entity result of neither increased deductions nor increased gain, on a net basis, from the intercompany transfer of partnership interests. In the current case, S has no intercompany gain available to offset B's Increased Deductions. Accordingly, a redetermination of B's Increased Deductions is required to achieve a single entity result.

As discussed in part II of this CCA, §1.1502-13 provides that attributes of both S's and B's items (including the taxability of such items) are redetermined as necessary to reach single entity treatment for the group for any given year. *See* §1.1502-13(c)(1)(i) and (b)(6) (defining attributes broadly to include treatment as a noncapital, nondeductible amount). Ordinarily, where S's and B's items offset in amount, the status of B's item (based on both S's and B's activities) will control. Section1.1502-13(c)(4)(i)(A). Where items do not offset, attributes redetermined under §1.1502-13(c)(1)(i) are allocated to S's and B's items in a "reasonable" manner taking into account all the facts and circumstances (including the purposes of §1.1502-13). Section 1.1502-13(c)(4)(ii). Here, as S's item is zero gain or loss, the amounts do not offset. Therefore, the reasonable allocation rule must be applied to cause redetermination of B's items to be a noncapital, nondeductible amount. We note that Taxpayer proposes no alternative application of §1.1502-13(c) that would result in single entity treatment.

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[6] S*ee* Jerred G. Blanchard, Jr., et al., *Federal Income Taxation of Corporations Filing Consolidated Returns*, § 31.03(1)(c) (stating, "[l]ess common transactions that are not illustrated in the regulations must be analyzed in light of the purposes of the rules.").

For illustration purposes, assume that prior to the nonrecognition intercompany transaction, S would have been allocated $330x in depreciation deductions from the partnership. Further assume that, as a result of the Section 743(b) Adjustments, B would (absent the application of §1.1502-13) be allocated additional depreciation of $100x from the partnership.

The following chart illustrates the §1.1502-13(c) redetermination:

Entity	**Item**
S	No gain/loss
B	$330x original depreciation/amortization PLUS ~~$100x Increased Deductions~~ *$100x noncapital, nondeductible amount*
Group (single entity result)	$330x original depreciation/amortization

As illustrated, to carry out the purpose of §1.1502-13, the matching rule applies to put the Taxpayer Group in the *same* position it would have been in, absent these intercompany partnership transfers. Using the hypothetical numbers above, the redetermination ensures the group has $330x of deductions, rather than the $430x ($330x **+ $100x**) of deductions Taxpayer is claiming. Accordingly, this redetermination accomplishes the fundamental objective of §1.1502-13: single entity treatment.

IV. Taxpayer's Protest

As detailed in part II, *supra*, the regulations provide principle-based rules that apply to result in single entity treatment. Moreover, instances in which separate entity treatment is applied are exceptions to this general rule and are explicitly provided for in the regulations. In its Protest, Taxpayer repeatedly argues that the redetermination applied in the Original CCA is not authorized, because there are no specific rules in the consolidated return regulations that provide for such redetermination. However, the generally applicable rules under §1.1502-13 apply to the Taxpayer's transaction, and cause the redetermination described in the Original CCA.

Taxpayer makes four main arguments against the analysis in the Original CCA. We address each of these arguments in turn.

A. Taxpayer's Argument A and IRS Response

"Matching rule does not redetermine B's corresponding item to be a noncapital, nondeductible amount"

Taxpayer proffers three separate subarguments under its general Argument A. We separately address each of these subarguments.

1. Nonrecognition transactions and §1.1502-13

Taxpayer first appears to argue that the matching rule cannot apply to intercompany nonrecognition transactions, because S has no intercompany item with which to match.

This is a curious argument. As explained in depth in part II, *supra*, the intercompany transaction rules are broad, principle-based rules that apply to ensure single entity treatment. The matching rule does not differentiate between recognition and nonrecognition transactions. Indeed, if the matching rule were inapplicable to nonrecognition transactions as Taxpayer contends, then consolidated groups would be free to attempt to alter their bottom-line income (and tax liability) by engaging in certain types of intercompany transactions.

The Taxpayer emphasizes that the Original CCA treated S as having an intercompany item of $0, rather than having "no intercompany item." Taxpayer appears to argue that where there is no intercompany item, §1.1502-13 does not apply.[7] Taxpayer cites to §1.1502-13(c)(7)(ii)(C) ("Example 3") to support its position.

The Taxpayer's reliance on Example 3 in support of this argument is misplaced. In fact, this example actually illustrates the application of §1.1502-13 to redetermine attributes of B's items arising from nonrecognition transactions, where necessary, to achieve single entity treatment. The example involves an intercompany section 351 transfer of land from S to B where S recognizes no gain or loss, and B later sells the land to an unrelated party at a gain. While the example states that "S has no intercompany item," that characterization did not prevent §1.1502-13 from applying. Rather, the example analyzed B's items from the transaction under the §1.1502-13 single entity framework. Pursuant to the facts in the example, B held the land for investment (on a separate entity basis, B would have recognized a capital gain from the sale); however, the given facts state that if S and B had been divisions of a single corporation, the combined activities of S and B would cause the single entity to recognize ordinary income from the sale. Thus, even though S had "no intercompany item," the example applied the matching rule to redetermine B's corresponding item from a capital gain to an ordinary

[7] Protest at 49-51.

gain.[8] This redetermination ensured that the group obtained a single entity outcome in the context of an intercompany nonrecognition transaction.

The same line of analysis applies in the current case. Whether we label S as having no intercompany item or an intercompany item of $0, the matching rule will apply to redetermine the attributes of B's item, as necessary, to achieve the single entity answer.

2. No specific rule to redetermine B's item

Taxpayer also argues that only S's items, and not B's items, can be redetermined to be noncapital, nondeductible amounts. More specifically, the Taxpayer argues that "there is no rule which allows S's intercompany item to redetermine B's corresponding item. B's corresponding item is redetermined only in the limited circumstances illustrated by the regulatory examples…."[9] The Taxpayer supports this contention by citing to §1.1502-13(c)(6)(i), which applies only to S's items.

Taxpayer appears to misunderstand the import and function of §1.1502-13(c)(6)(i). This provision invokes the application of the general attribute redetermination rule of §1.1502-13(c)(1)(i) to S's items to reach single entity treatment. The regulations then introduce special limitations on redetermining S's income or gain items as excluded from gross income. Section 1.1502-13(c)(6)(i) states:

> (6) Treatment of intercompany items if corresponding items are excluded or nondeductible. — (i) In general. — Under paragraph (c)(1)(i) of this section, S's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount. For example, 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)). Paragraph (c)(6)(ii) of this section, however, provides limitations on the application of this rule to intercompany income or gain…. (Emphasis added.)

[8] We also note that Taxpayer's assertion that S can never have an intercompany item of $0 is false. For example, in taxable intercompany transactions, where the fair market value of the property S sold to B equals S's basis in that property, S will recognize gain/loss of $0, and S will have an intercompany item of $0.

[9] Protest at 51. Taxpayer's argument appears to be internally inconsistent. It claims that no rule exists to authorize the redetermination of B's items, but then it acknowledges that B's items are sometimes redetermined (citing to examples). Taxpayer does not explain how an example could illustrate a redetermination that was not authorized by a rule contained in the regulation.

Section 1.1502-13(c)(6)(ii) goes on to list the requirements for redetermining S's income or gain items to be excluded from gross income, explaining that the limitations apply "[n]otwithstanding the general rule of paragraph (c)(1)(i) of this section…."

By its terms, §1.1502-13(c)(6)(ii) places limitations on the redetermination of S's income as an excluded amount. The restrictions apply exclusively in that context, and operate to prevent certain redeterminations of S's income items as excluded amounts under the general rule. On its face, the limitations are inapplicable to the redetermination of S's loss and deduction items. Therefore, those items may be redetermined, free of any limitations under §1.1502-13(c)(6). Similarly, these restrictions have no application whatsoever to the redetermination of B's items. Because the limitations in §1.1502-13(c)(6)(ii) are inapplicable to the redetermination of any of B's items, the general attribute redetermination rule of §1.1502-13(c)(1)(i) applies, unimpeded by §1.1502-13(c)(6).

In the current case, without redetermination, the Taxpayer group would have greater deductions available to it than on a single entity basis. Thus, the general attribute redetermination rule provides the authority to redetermine B's item to be a noncapital, nondeductible amount, where necessary, to achieve the single entity answer.

3. Regulatory scheme

The Taxpayer's third subargument is best understood when viewed in its entirety:

> Third, the regulatory scheme is that S's intercompany item is redetermined to match B's corresponding item. This mechanism is deeply embedded in the Intercompany Transaction Regulations. The Regulations do not authorize the reverse directionality. If B's corresponding item could also be redetermined based upon the characterization of S's intercompany item, then the regulatory scheme would be in hopeless conflict, absent a rule providing guidance as to which one controls. The reason there is no rule to resolve any such conflict is because no such rule is needed, as there is no rule which allows S's intercompany item to redetermine B's corresponding item. B's corresponding item is redetermined only in the limited circumstances illustrated by the regulatory examples, where the character and source of B's income or loss is redetermined, based on viewing S and B's activities in the aggregate, in order to prevent the Intercompany Transaction Regulations from being used to achieve a result which is not achievable in the separate company context.[10]

[10] Protest at 50–51.

Contrary to Taxpayer's assertion, redetermination of corresponding items does not result in chaos. Rather, §1.1502-13 includes rules governing whether intercompany items or corresponding items are to be redetermined. *See* part III, *supra*. Specifically, §1.1502-13(c)(4)(ii) provides that to the extent S's and B's items do not offset in amount, the attributes redetermined under §1.1502-13(c)(1)(i) will be allocated to S's and B's items in a reasonable manner.

In this case, the amounts do not offset (S has zero gain/loss on the intercompany transfer of the partnership interest, while B has Increased Deductions). Therefore, §1.1502-13(c)(4)(ii) applies to allocate the redetermined attributes to S's and B's items in a reasonable manner. This was the methodology employed in the Original CCA. Because B's deductions were inflated beyond what the S/B single entity would be able to claim, those Increased Deductions were redetermined to be noncapital, nondeductible amounts.

In summary, B's Increased Deductions are redetermined to be a noncapital, nondeductible amount, because—(1) §1.1502-13(c)(1)(i) provides that the attributes of S's and B's items are redetermined as necessary to reach the single entity answer; (2) whether an item is treated as a noncapital, nondeductible amount is an attribute of that item under §1.1502-13(b)(6); and (3) nothing under §1.1502-13 restricts the ability to redetermine B's item to be a noncapital, nondeductible amount.

B. Taxpayer's Argument B and IRS Response

"The [Original CCA's adjustment] does not achieve single entity treatment and is contrary to the purpose of the Intercompany Transaction Regulations"

The Taxpayer next argues that the redetermination in the Original CCA fails to achieve single entity treatment. This argument does not dispute that, in the years at issue, the redetermination made by the Original CCA reaches a single entity result. Rather, it focuses on the tax posture of the Taxpayer in future years, and argues that, cumulatively, the redetermination in the Original CCA will cause the Taxpayer to be overtaxed, compared with the single entity result.[11]

The Original CCA applied §1.1502-13 to redetermine the Increased Deductions as noncapital, nondeductible amounts, thereby denying the group additional depreciation and amortization for the years at issue. The Taxpayer argues that this redetermination

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[11] The partnership basis issue under section 705 was not addressed in the Original CCA because it was not relevant to the years under exam. The Original CCA provided specific advice regarding §1.1502-13 relevant to the years in question, and based on the facts provided, B's basis in the partnership was not relevant for determining the group's consolidated tax liability for those years. Consequently, the Original CCA focused only on the immediate effects of the Increased Deductions and did not address all collateral consequences that may impact future tax years.

will nevertheless cause B's basis in the partnership to be reduced by the nondeductible amounts under section 705(a). Taxpayer further argues that this lower basis in the partnership will result in the group recognizing overall more gain (or less loss) than it otherwise would if S and B were simply divisions of a single entity. Taxpayer then posits that this non-single entity result can be cured only if the Increased Deductions do not reduce B's basis in the partnership under section 705.[12] However, Taxpayer claims that the consolidated return regulations lack the authority to change the application of section 705 in relation to an intercompany transaction.

Contrary to Taxpayer's assertions, §1.1502-13 not only provides the authority for, but actually requires, the result Taxpayer proffers. As detailed in part II.A., *supra*, §1.1502-13(c)(1)(i) requires redetermination of the attributes of S's and B's items to achieve the single entity result. Further, attributes are broadly defined in §1.1502-13(b)(6), and include treatment of an item as subject to a particular Code section. *See* §1.1502-13(b)(6) (treating application of section 382(h) or 384 as an attribute); §1.1502-13(c)(7)(ii)(E)(5) (redetermining B's gain to be ineligible for section 453 treatment); and §1.1502-13(c)(7)(ii)(R) (changing the application of section 250 to S's item).

It is true that treating the Increased Deductions as noncapital, nondeductible amounts would not itself prevent the application of section 705 to decrease B's basis in the partnership interest. However, in each subsequent taxable year, to the extent necessary to reach a single entity result, §1.1502-13 will redetermine the attributes of B's Increased Deductions to clearly reflect the group's taxable income.[13] Thus, in those future years, the Increased Deductions could be redetermined to be items to which section 705 does not apply, as is necessary to ensure single entity treatment.

In summary, redetermining the attributes of B's Increased Deductions here does not put the Taxpayer in a worse (or better) position. Rather, consistent with the overall purpose of §1.1502-13, the redetermination in the years at issue places the Taxpayer in the same position it would have been in if the intercompany transfers were between divisions of a single corporation. In future years, to the extent necessary (as suggested by the Taxpayer), additional redeterminations will be made to ensure single entity treatment.

C. Taxpayer's Argument C and IRS Response

"The examples relied upon by the [Original CCA] are not instructive with respect to the [intercompany partnership transfers]"

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[12] This was also the solution suggested in the leading consolidated return regulations treatise. *See* Blanchard, *supra*, at §31.05[1][a], FN 331.3.

[13] Under §1.1502-13(c), the necessity of redetermination is evaluated on an annual basis.

Taxpayer argues that the examples cited in the Original CCA (§1.1502-13(c)(7)(ii)(E)(5), “Example 5(e)” and Example 9 in §1.1502-13(c)(7)(ii)(I)) are not instructive with respect to the intercompany transactions at hand.[14] Despite the Taxpayer’s own caption for this section, Taxpayer’s analysis suggests that Taxpayer actually reads the examples to be somewhat instructive, albeit not directly on point for these facts.[15]

This argument is essentially the counterpart to Taxpayer’s Argument A—unless there is a specific rule providing for the exact results (see Argument A) or a specific example directly on point (Argument C), §1.1502-13 cannot apply in the manner explained in the Original CCA. In other words, Taxpayer effectively asserts that the matching rule is limited by the illustrative examples in §1.1502-13(c)(7). This is simply untrue.

As discussed and documented in part II.B., *supra*, the current intercompany transaction regulations were intentionally drafted as broad principle-based rules, rather than mechanical rules, and their more common applications are illustrated through examples. Thus, contrary to Taxpayer’s apparent contention, the examples in §1.1502-13(c)(7) do not limit the scope of the regulations.

The Original CCA included discussions of Examples 9 and 5(e) to illustrate certain aspects of the matching rule relevant to this case. Specifically, Example 9 illustrates how §1.1502-13(c) applies to intercompany transfers of partnership interests that result in section 743(b) adjustments. *See* part III, *supra*, for further discussion of Example 9. Example 5(e) illustrates how §1.1502-13 can apply to redetermine the attributes of B’s corresponding item (rather than the attributes of S’s intercompany item), where necessary to reach single entity treatment. In other words, while the examples do not contain precisely the same facts as the present case, they are nevertheless instructive on the application of §1.1502-13. The examples illustrate that multiple features of §1.1502-13 may apply in tandem to achieve single entity treatment in unusual or complex cases.[16]

One particular assertion in the Protest with regard to Example 5(e) is useful in highlighting Taxpayer’s apparent misunderstanding of the intercompany transaction rules. In this example, S sells land to B at a loss. B subsequently sells the land at a gain to an unrelated person (X) in exchange for a note that is paid in installments. If S and B were divisions of a single entity, the single entity would have sold the land to X at a loss and would not have been eligible for installment sale treatment under section

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[14] We note that the denominations of the matching rule examples in §1.1502-13(c)(7) have been updated since the Original CCA and the Taxpayer’s Protest. To avoid confusion, we continue to use the label “Example 5(e)” in this CCA.

[15] *See*, *e.g.*, Protest at 56 (“Example 9 is only partially instructive….”).

[16] A leading consolidated treatise describes this possibility, noting that “relationships illustrated in one transaction are frequently relevant in other contexts, and taxpayers must study all of the examples to understand the basic relationships.” Blanchard, *supra*, at § 31.03(1)(c).

453. The example makes clear that it is applying §1.1502-13(c)(1)(i) to redetermine B's gain as ineligible for installment sale treatment under section 453, to ensure single entity treatment. Therefore, this example is instructive and directly refutes Taxpayer's argument that the broad redetermination rule of §1.1502-13(c)(1)(i) does not apply to B's items.

Taxpayer appears to assert that the contents of Example 5(e) somehow limit the application of the general rules in §1.1502-13.[17] Taxpayer misreads Example 5(e) to suggest that B's attributes can only be redetermined if, "without the redetermination, through the use of an intercompany transaction, the taxpayer would have achieved tax treatment otherwise unavailable to it under the Code."[18] In actuality, under the facts of Example 5(e), outside of a consolidated group, B would have been entitled to the installment sale treatment under section 453. That is, on a separate entity basis, B did recognize gain and would be eligible for section 453. It is only when viewed in the single entity context (combining the results of S and B) that the transaction results in a net loss.[19] Therefore, contrary to Taxpayer's argument, §1.1502-13(c)(1)(i) applied in Example 5(e) to redetermine B's gain to not be eligible for section 453 (installment sale treatment), although B otherwise would have been eligible for installment reporting, on a separate entity basis.

Similarly, in this case, if S and B had not filed consolidated returns, B would be entitled to claim the Increased Deductions (under separate entity treatment). As in Example 5(e), it is only the application of §1.1502-13 that causes the results to be reevaluated and redetermined as if S and B were a single entity. Indeed, this is the basic function of the intercompany transaction regulations—to redetermine the separate entity treatment of S's and B's items, where the otherwise applicable separate entity treatment is incompatible with the single entity result.[20] Thus, Example 5(e) illustrates the application of §1.1502-13(c)(1)(i) to redetermine the separate entity treatment of B's item that would otherwise apply, outside of the consolidated return context.

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[17] As noted in part II, *supra*, limitations on the application of the general matching rule do exist, but where they do, they are explicitly denoted in the text of the rule.

[18] Protest at 58. *See also*, Protest at 51 (asserting that corresponding items are redetermined only "to prevent [§1.1502-13] from being used to achieve a result which is not achievable in the separate company context.").

[19] *See* Example 5(e) ("if S and B were divisions of a single corporation, B would succeed to S's basis in the land and the group would have $20x loss from the sale to X, installment reporting would be unavailable….")

[20] *See* §1.1502-13(c)(1)(i).

D. Taxpayer's Argument D and IRS Response

"The [Original CCA's] analysis cannot be applied in the context of a negative section 743(b) basis adjustment"

Finally, the Taxpayer argues the Original CCA's §1.1502-13 analysis is flawed because that same approach cannot work if the Section 743(b) Adjustments resulted in less (not more) depreciation and amortization deduction.

Taxpayer's hypothetical fact pattern is not relevant to the resolution of the current issue. As stated, the current intercompany transaction regulations are broad principle-based rules, rather than mechanical rules. The application of these rules under §1.1502-13 is dependent on all the facts of a particular case, and speculating about unrelated, theoretical fact patterns is not meaningful to resolving the issue before us: the proper application of §1.1502-13 to items associated with Taxpayer's intercompany transactions.[21]

V. Conclusion

Just as in the Original CCA, we conclude that §1.1502-13 redetermines B's Increased Deductions to be noncapital, nondeductible amounts. This redetermination is compelled by the fundamental purpose of §1.1502-13: "to clearly reflect the 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)." Section 1.1502-13(a)(1).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have further questions, please call Susan Massey at (202) 317-6848, or Julie Wang at (202) 317-6975 (not toll-free numbers).

[21] We note that Taxpayer suggested a solution for its hypothetical situation—redetermining a portion of B's distributive share of taxable income from the partnership to be excluded from gross income, to offset the effect of the reduced deduction to B. In that case, B would have less deduction, but also less taxable income, from the partnership, and the group could achieve a single entity answer. This was also the solution suggested in the leading consolidated return regulations treatise. *See* Blanchard, *supra*, at §31.05[1][a], n. 331.3.