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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

November 17, 1998

CC:DOM:FS:CORP
TL-N-445-98
UILC: 108.00-00
1.1502.13-00
1.1502.20-00
1.1502.32-00
Number: **199908005**
Release Date: 2/26/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Basis, Loss Disallowance, and Worthlessness Issues

This Field Service Advice responds to your memorandum dated August 17, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S = SS =

SF =
SFF =
X =
Y = b =

date b =
date c =
date d =
date e =
date f =

date h =
date i =

date j =
date k =
date l =
date m =
date n =
date p =
date q =
date r = date s
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date u = date v
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x amount =
y amount =
z amount =
xx amount =
yy amount of stock and options =
zz amount =
years a and b =
year c = year
d =
year e =
year f =
year g =
b amount =
c amount =
d amount = e
amount =
f amount =
g amount =
h amount = i
amount =
j amount =
k amount =
l amount =
m amount =
n amount =
p amount =
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ISSUE 1

What is the proper treatment of the tax benefits derived by P during tax years d and g from S's net operating losses -- namely, should P adjust its basis in its stock in S to account for the tax benefits the P group derived from S's losses?

CONCLUSION 1

Ultimately, the tax benefits P derived from the absorption of S's losses has no impact on P's basis in its S stock.

ISSUE 2

Whether under Treas. Reg. § 1.1502-13(g)(3) S reports income in year g at the time of the worthlessness of S's debt owed to P and, if so, in what amount.

CONCLUSION 2

Under Treas. Reg. § 1.1502-13(g)(3), S reports income in year g at the time of the worthlessness of S's debt owed to P in the amount of the balance of the debt S owed to P, computed by treating no portion of this debt as partially worthless in year d.

ISSUE 3

Whether the loss that S recognized on its transfer of its B% stock ownership of SFF to P as a partial payment of its debt owed to P is restored to income upon the insolvency of S.

CONCLUSION 3

The loss that S recognized on its transfer of its B% stock ownership of SFF to P as a partial payment of its debt owed to P is not restored to income upon the insolvency of S.

ISSUE 4

What is the proper treatment of cash, stock options, and restricted stock transferred by P to employees of S, and how do these transactions affect P's basis in S's stock?

CONCLUSION 4

The proper treatment of cash, stock options, and restricted stock transferred by P to employees of S is discussed in greater detail below. Overall, the amounts are not treated as part of P's purchase price for the S stock; however, P does increase its basis in its stock in S by P's deemed capital contribution of cash to S to pay S's employees for vested options.

ISSUE 5

How should the loss disallowance for tax years d and g be computed under Treas. Reg. § 1.1502-20.

CONCLUSION 5

We have a limited knowledge of the facts necessary in this case to make the Treas. Reg. § 1.1502-20 computations for years d and g. However, we have a few comments on this computation.

ISSUE 6

How is the loss disallowance computed at the time of the worthlessness of the S stock during year g?

CONCLUSION 6

P would compute the loss disallowance under Treas. Reg. § 1.1502-20 immediately after the time of the worthlessness of the S stock on a per share basis.

FACTS

P, the parent of a consolidated group, acquired all of the stock of S on date b in a taxable transaction, paying x amount of cash, y amount of expenses, and z amount of stock and options. P filed Form 8023, corporate qualified stock purchase election and, on the protective carryover election statement, indicated that it had paid xx amount of cash of, yy amount of stock and options and zz amount of expenses. P and S were both engaged in the business of b.

Prior to the acquisition of S, certain S employees held incentive stock options (ISOs) to acquire S stock; nonqualified stock options (NQSOs) to purchase S stock; and restricted S stock. In connection with S's acquisition, all vested options to acquire S stock, including vested ISOs and NQSOs, were surrendered for cash. All nonvested S options, including nonvested ISOs and NQSOs, were exchanged for nonvested P options. These substituted options were intended to be incentive stock options under section 422 of the Code for P stock (Substituted ISOs), if issued in substitution for incentive stock options for S stock, or nonvested, nonqualified stock options for P stock (Substituted NQSOs), if issued in substitution for nonvested, nonqualified stock options for S stock. Copies of S's ISO and NQSO plans and P's ISO and NQSO plans were not submitted.

Individuals who held restricted S stock surrendered that stock to S prior to the merger. When the merger became effective, P issued an equivalent amount of restricted P stock (Replacement Restricted Stock) to those individuals. An agreement regarding this surrender and substitution, submitted by the revenue agent, indicates that there was a vesting schedule and a right of first refusal connected with the Replacement Restricted Stock, but does not indicate that the stock would be forfeited if employment terminated. Copies of S's restricted stock plan and P's restricted stock plan were not submitted with the incoming request.

S, in the P group, generated taxable income in years a and b. Since year c, however, S consistently generated separate company net operating losses. Until year d, the tax benefits derived from S's net operating losses were used to reduce the intercompany loan account between P and S. As of year d, however, P ceased accounting for the tax benefits and ceased reducing the amount of the intercompany debt.

Following P’s acquisition of S, S owed substantial accounts payable amounts to unrelated third parties. S owed b amount of payables at the end of year a and approximately c amount of payables at the end of year b. S also owed unrelated parties other short-term liabilities of approximately d amount at the end of year a and e amount at the end of year b. In order to pay these unrelated third parties, S entered into various loan agreements with P and SS, a finance subsidiary of P.

In year c, S obtained an advance of f amount from P and used it to reduce the third party accounts payable. On date c, SS granted S a unsecured line of credit of h amount. At that time, S drew i amount and used it to repay a portion of P's prior advances. Later, on date d, S drew another g amount. As of date e, S's balance sheet showed current assets of approximately j amount and current liabilities of k amount. The amount due P had been paid down to l amount. Due to S's deteriorating financial condition, P charged off and deducted m amount of the debt owed to it by S on its year d tax return. P also issued a new set of loan documents for the balance of the loan when it came due.

S made various payments throughout years e and f to P and SS. The credit line with S was renewed for h amount on date f, due date g. The amount outstanding at the time of the renewal was n amount. On date h, SS loaned S another p amount and on date i, SS loaned S an additional q amount. On date j, SS loaned S r amount, increasing the balance due to s amount. On date k, S entered into a new revolving loan agreement with P whereby the maximum line of credit was increased to t amount. Also on that date, the loan from SS to S was taken over by P, and SS filed a plan of complete liquidation. On date l, P extended its revolving loan agreement with S to date m under terms similar to the date k agreement.

On date n, P sold u % of its stock in S to X, a person not related to P or S, for v amount. Thereafter, P filed a Form 1139 for year d claiming a consolidated capital loss of w amount. In addition, S claimed a loss of x amount on the disposition of its SF stock to X. The losses on these two stock sales were absorbed by P via carryback in year f, and a refund was issued in accordance with the Form 1139.

On date q, P announced it had signed a letter of intent with an unrelated third party, Y, whereby Y was to purchase all of the operating assets of S. Following P's announcement of its intent to sell S, S, transferred B amount of stock ownership in SFF to P as a partial payment of C amount of its debt owed to P. Prior to the transfer, P owned the remaining interest in SFF not owned by S; consequently, after the transfer, P was the 100% owner of SFF. On date q, P announced the sale had been finalized. Thereafter, on date s, P repurchased for D amount from X the stock in SF that it had previously sold to X.

On date p, S adopted a plan of liquidation, and, on date q, S sold the bulk of its assets to Y for approximately z amount. A portion of the sale proceeds were used to pay off third party liabilities. Following the sale of the operating assets of S to Y, the revolving loan agreement between P and S was amended. The amendment reflected the terms of the sale whereby S had sold substantially all of its operating assets and was ceasing continuation of its prior business operation. In the agreement it was clearly stated that the borrower, S, was insolvent. The amount owed to P as of that date was a total of E amount. The revolving loan note was ratified and confirmed and remained in full force and effect. Net sale proceeds of F amount were transferred on date u to P in partial payment of S's debt to P. To date, no additional amounts have been transferred.

In year g, P took a deduction for G amount of worthless debt. P also took a deduction for H amount of worthless stock as adjusted by the loss disallowance rules under Treas. Reg. § 1.1502-20.

ISSUE 1

What is the proper treatment of the tax benefits derived by P during tax years d and g from S's net operating losses -- namely, should P adjust its basis in its stock in S to account for the tax benefits that the P group derived from S's losses?

In the instant case, P did not accrue or pay any tax allocation amounts to S in years d and g for P's use of S's losses. P asserts that the group did not have a tax sharing agreement, and P had no obligation to pay tax allocation amounts to S. However, irrespective of whether P had an obligation to pay amounts to S under any tax sharing agreement, Treas. Reg. § 1.1502-32(b)(3)(iv)(D) requires consolidated group members to adjust stock basis in other group members to reflect amounts attributable to federal tax expenses.

Treas. Reg. § 1.1502-32(b)(3)(iv)(D) specifically requires members to take into account taxes by applying the principles of I.R.C. § 1552, the percentage method under Treas. Reg. § 1.1502-33(d)(3), and assuming a 100% allocation of any decreased tax liability. The right to receive a payment is treated as a positive adjustment under Treas. Reg. § 1.1502-32(b)(3)(ii), and the obligation to make a payment is treated as a negative adjustment under Treas. Reg. § 1.1502-32(b)(3)(iii). If the obligation is not paid, the amount not paid is generally treated as a distribution, contribution, or both, depending on the relationship between the members.

Since P absorbed S's losses, Treas. Reg. § 1.1502-32(b)(3)(iv)(D) provides that S is treated, for stock basis purposes, as having a right to receive a tax allocation payment from P, and S's right to receive this payment effectively increases P's

basis in its S stock by this tax allocation amount. See Treas. Reg. § 1.1502-32(b)(3)(iv)(D); Treas. Reg. § 1.1502-33(d)(6), Ex. 2. However, this increase to P's basis in its stock in S is effectively offset by a corresponding decrease to P's basis in its stock in S by the amount of the distribution that Treas. Reg. § 1.1502-32(b)(3)(iv)(D) also treats S as having made to P since P did not pay this tax allocation amount to S. Since these increases and decreases to P's basis in its S stock for years d and g offset each other, P's failure to adjust its stock basis in S for the tax benefits it derived from S's losses ultimately has no impact on P's basis in its S stock for years d and g.

ISSUE 2

Whether under Treasury Regulation § 1.1502-13(g)(3) S reports income in year g on S's debt owed to P ; and, if so, in what amount.

IN GENERAL

The new regulations under Treasury Regulation § 1.1502-13(g)(3) for intercompany transactions are generally effective for transactions occurring in tax years beginning on or after July 12, 1995. As discussed below, we believe Treas. Reg. § 1.1502-13(g)(3) applies to the worthless of S's intercompany debt owed to P since the debt became worthless in year g. Further, we believe the entire balance of this debt, determined by treating no portion of this debt as having become worthless in year d, became worthless in year g. Under Treas. Reg. § 1.1502-13(g)(3), S realizes discharge of indebtedness income on the worthlessness of the intercompany debt, which the regulations deem satisfied (for zero) and then reissued (for zero), and this COD income is not excluded from income under section 108(a). See Treas. Reg. § 1.1502-13(g)(3)(ii)(B). Thus, in year g, P claims a bad debt deduction, but S has an offsetting amount of corresponding income, both of which (i.e., P's deduction and S's income) are ordinary. See Treas. Reg. 1.1502-13(g)(5), Ex. 3.

WORTHLESSNESS IN YEAR G

I.R.C. § 166(a)(1) provides that a deduction may be taken for any debt that becomes completely worthless within the taxable year. I.R.C. § 166(a)(2) allows a taxpayer to deduct a partially worthless debt, as long as the debt has been charged off, the deduction does not exceed the portion of the debt charged off, and the district director agrees that the debt is partially worthless. I.R.C. § 166(a)(2); Treas. Reg. § 1.166-3(a)(i). Section 166 allows deductions for worthless business and nonbusiness debts. I.R.C. § 166(d); Treas. Reg. § 1.166-5. A business bad debt is one which is created, acquired or incurred in the course of a taxpayer's trade or business. Treas. Reg. § 1.166-5(b)(1), (2). A business bad debt deduction

may be taken if the debt is partially or completely worthless. I.R.C. §§ 166(a)(1), (2), (d)(1); Treas. Reg. § 1.166-5(a)(2).

Whether a debt has become partially worthless within the taxable year is a question of fact which is determined by examining all pertinent evidence, including the objective circumstances surrounding the debt, such as the value of the collateral and the financial condition of the debtor. Treas. Reg. § 1.166-2(a); American Offshore, Inc. v. Commissioner, 97 T.C. 579, 594 (1991); Dallmeyer v. Commissioner, 14 T.C. 1282, 1291 (1950), acq., 1950-2 C.B. 2; Baldwin v. Commissioner, T.C. Memo. 1993-433, 66 T.C.M. 769, 778. The taxpayer has the burden of proving whether the debt is partially or totally worthlessness, and must show that either the entire debt or a portion of the debt lacked both liquidating and potential value at the close of the taxable year. Riss v. Commissioner, 478 F.2d 1160, 1166 (8th Cir. 1973); Dustin v. Commissioner, 53 T.C. 491, 501 (1969), aff'd, 467 F.2d 47 (9th Cir. 1972). A deduction is appropriate where "the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment." Treas. Reg. § 1.166-2(b). To satisfy this burden, a taxpayer may present evidence that an identifiable event has occurred which negates any possibility of potential future recovery of the debt. Riss, 478 F.2d at 1166; Dustin, 53 T.C. at 501; Minneapolis St. Paul & S. Ste. M. R.R. v. U.S., 164 Ct. Cl. 226, 240-41 (1964); Findley v. Commissioner, 25 T.C. 311, 319, aff'd, 236 F.2d 959 (3rd Cir. 1956); Dallmeyer, 14 T.C. at 1291. Identifiable events include a debtor's bankruptcy, insolvency, sale of assets, disappearance, death, refusal to pay or abandonment of business. Cole v. Commissioner, 871 F.2d 64, 67 (7th Cir. 1989); Dustin, 53 T.C. at 503.

Courts have denied a bad debt deduction where there is evidence that the debtor made payments toward the principal or interest during the year at issue. Cole, 871 F.2d at 68; Appalachian Trail Co. v. Commissioner, T.C. Memo. 1973-119, 32 T.C.M. 520, 522; Clemens v. Commissioner, T.C. Memo. 1969-235, 28 T.C.M. 1225, 1231, aff'd, 453 F.2d 869 (9th Cir. 1971). Similarly, a creditor's continuation of loans or the advancement of additional monies to debtor are factors which may negate a finding of worthlessness. See, e.g., Riss, 478 F.2d at 1166; Simon v. Commissioner, T.C. Memo. 1978-485, 37 T.C.M. 1849-67, 1849-70.

Before a partial worthlessness deduction may be taken, a taxpayer must charge off the amount of debt which is partially worthless. I.R.C. § 166(a)(2); Treas. Reg. § 1.166-3(a)(2). See generally Bender v. Commissioner, T.C. Memo. 1967-26, 26 T.C.M. 144, 146. A taxpayer may take a deduction subsequent to the year that it has charged off the amount, or at such time as the debt becomes totally worthless. Findley, 25 T.C. at 318, 319; E. Richard Meinig Co. v. Commissioner, 9 T.C. 976, 978 (1947), acq., 1948-1 C.B. 2.

In the present case, the debts are business debts, as P is a corporation which made the loans in the course of its business, and thus it may be considered for a partial worthlessness deduction. The field has presented several facts in its memorandum to support the argument that the debt which S owed to P was not partially worthless in year d. First, the loan between S and P was renewed at the end of the year d tax year. Second, the debt was not written off by P in year d. Third, S paid accrued interest on the debt in year d. Fourth, P did not charge off the debt from its books during the year d tax year.

These facts, taken together, demonstrate that P was not entitled to take a deduction for the partially worthless debt of S in year d. S's ability to pay interest on the debt negates a finding of partial or total worthlessness in year d. Moreover, P's actions in year d indicate that it did not believe the debt owed by S was worthless. P did not charge off the portion of the debt for which it took a deduction, which evidences its intent not to abandon the amount owed to it as an asset from its books. There is no indication in your memorandum that P charged off the relevant portion of the debt in any prior tax year. Moreover, P's renewal of the loan in year d indicates that it possessed confidence in S's ability to pay its debt.

The field has indicated that it believes P was entitled to take a worthless debt deduction in year g. Five facts which support this contention are: S's consistent net operating losses sustained since year c, declaration of insolvency, its entry into a liquidation plan, the sale of its operating assets, and cessation of its business, all of which occurred in year g. A corporation's insolvency, liquidation, as well as the termination of its business, and the sale of its operating assets, have been considered by many courts to be "identifiable events" in determining the worthlessness issue, although they are not dispositive factors. See Cole, 871 F.2d at 67; Dustin, 53 T.C. at 503. In Baldwin v. Commissioner, the Court found the petitioner's debt to be worthless where the debtor corporation was insolvent, pledged its corporate assets to pay its liabilities and generated overall losses. Baldwin v. Commissioner, T.C. Memo. 1993-433, 66 T.C.M. 769, 779. Although S continued to pay interest on the debt until date v, assuming that other factors did not exist in year g which would have created potential value, the above events, all of which occurred during year g, collectively suffice to establish worthlessness by the close of that year, and thus entitle P to a deduction.

CANCELLATION OF INDEBTEDNESS

I.R.C. § 61(a)(12) provides that to the extent a taxpayer has been relieved of an indebtedness, the taxpayer has recognized income, commonly known as cancellation of indebtedness income [hereinafter "COD income"]. I.R.C. § 108(a) sets forth an exception to the COD income rules for debtors who are insolvent. Insolvency is defined as the excess of liabilities over the fair market value of assets

immediately prior to the time of the discharge of indebtedness. I.R.C. § 108(d)(3). If a taxpayer is insolvent at the time his or her indebtedness is discharged, then the taxpayer may exclude the COD income from his or her tax return to the extent that the taxpayer is insolvent. I.R.C. § 108(a)(3).

Treas. Reg. § 1.1502-13(g)(3)(ii)(B) provides that any gain or loss resulting from an intercompany obligation is not excluded from income under section 108(a). Treas. Reg. § 1.1502-13(g)(2)(ii) provides that an intercompany obligation is defined as any obligation existing between group members during the period of time that both creditor and debtor are members of the group. The effect of this provision is to promote the matching principle by permitting an ordinary loss to be taken by the creditor member, and ordinary income to be declared by the debtor member. As discussed above, if P was entitled to take a worthless debt deduction in year g, then S had an offsetting amount of corresponding income that S was required to include in income in year g. <u>See</u> Treas. Reg. 1.1502-13(g)(3); Treas. Reg. 1.1502-13(g)(5), Ex. 3.

We believe the worthlessness of the intercompany debt is a transaction to which Treas. Reg. 1.1502-13(g)(3) applies. Treas. Reg. § 1.1502-13(b)(1)(iii), which describes the timing of intercompany transactions, states that each payment which the debtor company makes on a loan constitutes a separate transaction. The point in time at which the intercompany debt became worthless may be classified as a separate transaction. Since the worthlessness of the debt occurred in year g, Treas. Reg. § 1.1502-13(g)(3) applies to the worthlessness of this debt.

Additionally, as already discussed, we believe the entire balance of the intercompany debt that S owed to P, determined by treating no amount as partially worthless in year d, was the amount of intercompany debt that became worthless in year g. The field has indicated the following identifiable events that occurred with respect to S over a period of months during year g: a declaration of insolvency in an amendment to the revolving loan agreement, entry into a liquidation plan, the sale of its operating assets, and cessation of its business. As stated above, these events, all of which occurred subsequent to the effective date of the regulations, establish the worthlessness of the intercompany debt. Accordingly, Reg. § 1.1502-13(g)(3)(ii)(B) would apply to create an ordinary deduction for the full amount of the debt for P, and ordinary income in that same amount for S, and S's tax attributes would not be reduced. T.D. 8597, 1995-2 C.B. 153.

<u>ISSUE 3</u>

On date r, S transferred its B% stock ownership of SFF to P as a partial payment of its debt to P. S recognized a loss on this transaction, but P, relying on I.R.C. § 267(f)(2) and Treas. Reg. § 1.1502-13, maintains that the loss recognized on this

transaction remains deferred until the SFF property leaves the group. You ask whether S's deferred loss is restored to income upon the insolvency of S.

I.R.C. § 267(f)(2) provides for deferral of a loss from the sale or exchange between members of a consolidated group. For transactions occurring in tax years beginning on or after July 12, 1995, Treas. Reg. 1.267(f)-1(c) provides the rules under which the loss is deferred. Treas. Reg. 1.267(f)-1(c) provides that the loss is 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) with appropriate adjustments.

As already indicated, you ask whether S's insolvency resulted in S's taking into account under section 267 and Treas. Reg.§ 1.267(f)-1 the loss that S had recognized, but deferred, on the transfer of the SFF stock to P. Under the matching and acceleration rules of Treas. Reg. § 1.1502-13(c) and (d), S's deferred loss is not taken into account upon S's insolvency. At that time, S is still a member of the group. S's deferred loss continues to be deferred and, as a result, P's basis in its S stock is not reduced by the amount of that loss.

ISSUE 4

What is the proper treatment of cash, stock options, and restricted stock transferred by P to employees of S in exchange for S stock and options, and how does these transactions affect P's basis in S's stock?

Overall, we believe the cash, stock, and options that P transferred to S's employees are not treated as part of P's purchase price for the S stock. However, we believe P's basis in its stock in S is increased by the amount of cash that P is deemed to have contributed to S to pay S's employees for the vested options.

CASH PAYMENTS FOR VESTED OPTIONS

P's cash payments to S employees for their vested S options, which included ISOs and NQSOs, were for certain vested ISOs and NQSOs. Although section 421 of the Code generally governs the treatment of ISOs, the cancellation of such stock options prior to their exercise disqualifies these options. Therefore, assuming the vested ISOs and NQSOs to acquire S stock did not have a readily ascertainable fair market value at the time they were granted, section 1.83-7(a) of the regulations governs their disposition. Under those rules, section 83 of the Code applies to the payment received by the employees to cancel the vested ISOs and NQSOs. Upon receipt of the payment, the employees were required to include the amount received, less any amount paid for the ISOs and NQSOs, in income. Consistent with section 1.83-6(d)(1) of the regulations and Rev. Rul. 80-76, the payment by P

is treated as a contribution to capital of S and an immediate transfer by S to its employees, and S, as service recipient, is entitled to the 83(h) deduction to the extent the amount satisfies sections 162 and 212. Although P's payment is a capital expenditure, the payment discharged a compensation liability that existed prior to the acquisition of S. See Rev. Rul. 73-146. Thus, S is entitled to deduct the amounts paid by P to purchase the vested S options from S employees. Because the payments were fully vested, S is entitled to the deduction in accordance with its method of accounting.

Consequently, at or about the time of the P's acquisition of the S stock, P's deemed contribution of the cash to the capital of S increased P's basis in its stock in S by the amount of the cash. See I.R.C. section 358. Additionally, S's deduction of the amounts resulted in decreasing P's basis in its stock in S by the amount of this deduction. See Treas. Reg. 1.1502-32.

SUBSTITUTED ISOs

Turning to the Substituted ISOs, if the requirements of section 424(a) are met, the issuance of the Substituted ISOs by P to S's employees will not be treated as a new grant under section 422 of the Code. This is true, however, only if the excess aggregate value of the outstanding option after the substitution is the same as the excess aggregate value of the outstanding option before the substitution and the new option does not give any employee additional benefits that they did not have before the substitution. Assuming these requirements are met, the employees do not have income when the options are substituted. Assuming the original ISOs and Substituted ISOs qualify under section 422 of the Code, neither P nor S is entitled to a deduction on the grant or exercise of the Substituted ISOs for P stock, and there is no deemed contribution to capital by P when it issues its stock to S's employees. Consequently, at or about the time of the acquisition, the Substituted ISOs have no impact on P's basis in its stock in S.

SUBSTITUTED NQSOs

Turning to the Substituted NQSOs, assuming neither the original options nor Substituted NQSOs have a readily ascertainable value, there is no taxable event when the substitution occurred. The S employees do not realize income, gain, or loss, and S is not entitled to a deduction under section 83(h) of the Code. Further, P has not made a contribution to capital of S by granting the Substituted NQSOs to S's employees. Thus, at or about the time of the acquisition, the substitution of the NQSOs have no impact on P's basis in its S stock.

REPLACEMENT RESTRICTED STOCK

Concerning the Replacement Restricted Stock, the exchange of the restricted S stock for the restricted P stock is disregarded for purposes of section 83 of the Code. Thus, at or about the time of the acquisition, the substitution of the NQSOs have no impact on P's basis in its S stock.

ISSUE 5

How should the loss disallowance for year d and year g be computed under Treas. Reg. § 1.1502-20?

Treas. Reg. § 1.1502-20 generally provides that no deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary. For these purposes, a disposition of stock of a subsidiary is any event in which gain or loss is recognized in whole or in part. This loss disallowance rule prevents the elimination of corporate level gain on the disposition or consumption of built-in gain assets of an acquired subsidiary that might otherwise occur. It also prevents the duplication of losses which may otherwise occur when a subsidiary's stock is sold before a loss carryover or unrealized loss of the subsidiary is reflected as a negative adjustment to the basis of its stock.

Under Treas. Reg. § 1.1502-20(c)(1), the amount of basis reduction on a deconsolidation of a share of stock, or the amount of loss disallowed as a deduction on the disposition of a share of stock, is limited to the sum of the following three factors with respect to the share:

> (1) The share's allocable part of income or gain as determined under the rules at Treas. Reg. § 1.1502-20(c)(2)(iii), net of directly related expenses, from extraordinary gain dispositions of any member of the consolidated group;
>
> (2) The amount of the positive adjustment, if any, with respect to the share under the investment adjustment rules for each consolidated return year, but only to the extent the amount exceeds the amount described in (1), above, for that year; and,
>
> (3) The amount of the duplicated loss, defined in Treas. Reg. § 1.1502-20(c)(2), with respect to the share.

In the instant case, we have a limited knowledge of the facts necessary to make the Treas. Reg. § 1.1502-20 computations for year d and year g. However, we have a few comments on this computation. Because S had COD income in year g (see Issue #2), S had extraordinary gain in year g of an amount equal to the amount of this COD income, and this extraordinary gain increased the amount of P's

disallowed loss by an equivalent amount under the Treas. Reg. § 1.1502-20 computation. However, this COD income also increased the amount of P's basis in its stock, to which the loss disallowance rules applied, by the same equivalent amount.

Overall, therefore, S's inclusion of the COD income generated additional income to S that S should have reported. However, it did not also generate a net adjustment to the amount of P's allowed worthless stock deduction since S's inclusion of the COD income in income increased P's basis -- and thus, its worthless stock deduction -- by the same amount by which P's loss disallowance increased at the time of the worthless of its S stock.

Initially, we also expressed a concern that P might have a duplicated loss that should have been disallowed under the Treas. Reg. § 1.1502-20 computation. However, after talking with the Revenue Agent in this case, our concerns over whether P had a duplicated loss have been allayed. The Revenue Agent indicated that at the time P purchased S, I amount of the purchase price that P paid for the S stock was attributable to goodwill, rather than hard assets, of S.

ISSUE 6

How is the loss disallowance computed at the time of the worthlessness of the S stock during year g?

During year d, P had loss disallowance attributable to the sale of u % of its stock in S. Also, during year g, P had loss disallowance on the worthless of its stock in S, and this worthlessness occurred after P had repurchased the u% of S stock that it had sold in year d.

The loss disallowance under Treas. Reg. § 1.1502-20 upon the worthlessness of the S stock in year g is computed in the same manner as loss disallowance under other circumstances: on a per share basis. As indicated in Issue #5, Treas. Reg. § 1.1502-20(c)(1) provides that the loss disallowance amounts are computed on a per share basis.

Based on our knowledge of the facts of this case, we believe the approach you used in computing the Treas. Reg. § 1.1502-20 loss disallowance amounts in the instant case approximates the loss disallowance amounts that would have resulted from an actual computation of the loss disallowance on a per share basis. The approach you used was as follows. You computed what P's loss disallowance would have been at the time of the year d sale if 100% (rather than u%) of the shares had been sold at that time, but you then determined that P's actual loss disallowance at that time was only u% of that amount computed on 100% of the stock. Next, at the time of the worthlessness of P's S stock in year g, you

computed what the loss disallowance would have been on 100% of the shares, but you then determined that P's actual loss disallowance at that time was only that loss disallowance amount computed on 100% of the S stock, less the amount of loss disallowed in year d on the S stock.

Please note, however, that the loss disallowance computations for year g need to be modified to include the COD income discussed in Issue #2.

CASE DEVELOPMENT AND LITIGATION HAZARDS

For our office to fully understand the payments for vested options, the substituted nonvested options, and the substituted restricted stock, we need the original plans of S and P.

Additionally, concerning the Substituted NQSOs, we note that when S's employees exercise the Substituted NQSOs, P will transfer its stock to the employees. Assuming the P stock is not subject to a substantial risk of forfeiture and consistent with section 1.83-6(d)(1) of the regulations and Rev. Rul. 80-76, P will be required to treat the transfer of its stock to S employees as a contribution to the capital of S and S will be entitled to claim a deduction under section 83(h) of the Code provided the deduction meets the requirements of section 162 and 212.

We have insufficient facts to determine if and to what extent S's employees ended up exercising any Substituted NQSOs. Consequently, we have not addressed any impact of any exercise of Substituted NQSOs on P's basis in its S stock.

Concerning the Replacement Restricted Stock, we note that when the Replacement Restricted Stock becomes vested, S employees must include the value of the stock, less any amount paid for the stock, in income, and consistent with section 1.83-6(d)(1) of the regulations and Rev. Rul. 80-76, P will be required to treat the transfer of stock to S employees as a contribution to the capital of S. Because S is the service recipient, S is entitled to the section 83(h) deduction in the taxable year in which or with which ends the taxable year of the S employees in which the amounts are included in their gross income.

We have insufficient facts concerning if and to what extent any vesting of the Replacement Restricted Stock actually occurred. Consequently, we have not addressed any impact of any vesting of the Replacement Restricted Stock on P's basis in its S stock.

Accordingly, as indicated in the base of this memorandum, we believe the cash, stock, and options that P transferred to S's employees are not treated as part of P's purchase price for the S stock. However, at or about the time of the acquisition, P's

basis in its stock in S does increase by the amount of cash that P is deemed to have contributed to S to pay S's employees for the vested options. Additionally, as just discussed, we have not addressed any impact on P's basis in its S stock as a result of any exercise of the NQSOs or any vesting of the Replacement Restricted Stock.

Please note that you should check some of your computations, including the Treas. Reg. § 1.1502-20 computation, because some numbers failed to tie, or add down or across.

Lastly, concerning a potential CC:INTL issue, we understand that neither the field nor the taxpayer has raised the issue of the source of the losses generated by S's sale of foreign corporation stock for purposes of computing P's consolidated foreign tax credit limitation. Under Treas. Reg. § 1.861-8(e)(7), any loss derived from the disposition of stock in a foreign corporation is allocable to foreign source income. See also Black & Decker v. Commissioner, 986 F.2d 60 (4th Cir. 1993). However, taxpayers may cite International Multifoods Corp. v. Commissioner, 108 T.C. No. 26 (1997) and Prop. Treas. Reg. § 1.865-2(a) as authority for sourcing stock losses according to the seller's residence. We presume that the taxpayer has taken the position that S's stock losses are allocable to U.S. source income.

If you have any further questions, please call (202) 622-7930.

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By: ______________________________
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