Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Application of the consolidated return rules to a worthless stock deduction claimed by a member of a consolidated group and the transfer of a built-in gain asset within a consolidated group.

Advice has been requested regarding the tax treatment of: (1) a worthless stock deduction claimed by a member of a consolidated group; (2) the taxable transfer of a built-in gain intangible asset by one member of a consolidated group to another member of the group, for no consideration and without any disclosure on the group's tax return; and (3) the transfer, within a consolidated group, of a built-in gain intangible asset, for no consideration and without any disclosure on the group's tax return, followed years later by the sale of the transferor's stock to an unrelated person when no amortization deductions or income inclusion were ever reported on the asset transfer. The following general facts and situations illustrate the questions presented:

FACTS: P is the common parent of a consolidated group that owns Asset 1 (basis $10, value $10) and all the stock of S1 (basis and value of $5). On January 1, Year 1, P purchases for $10, from an unrelated person, all the stock of S, a domestic entity that has elected to be treated as a corporation. At the time of the purchase, S has two assets, Wanted Intangible (basis $0, value $15) and Unwanted Asset (basis and value of $5). Wanted Intangible is an amortizable section 197 intangible. S also has an outstanding debt of $10 owed to P, which is treated as debt for federal income tax purposes. On February 1, Year 1, S sells Unwanted Asset to an unrelated person for $5 and distributes the $5 cash proceeds to P. After S sells Unwanted Asset and distributes cash proceeds to P, the following transactions occur each of the steps of which are unrelated to the earlier transactions and each other:

Situation 1 (Wanted Intangible not distributed):

On December 31, Year 1, when the value of Wanted Intangible is still $15, S elects, under §301.7701-3(c)(1)(i), to be disregarded as an entity separate from its owner. On the consolidated tax return for Year 1, P claims a worthless stock deduction with respect to its equity ownership in S.

Situation 2 (Wanted Intangible distributed):

Step 1: On May 14, Year 1, when the value of Wanted Intangible is still $15, S distributes Wanted Intangible to P.

Step 2: On December 31, Year 1, S elects, under §301.7701-3(c)(1)(i), to be disregarded as an entity separate from its owner. On the consolidated tax return for Year 1, P claims a worthless stock deduction with respect to its equity ownership in S.

Situation 3 (Wanted Intangible transferred to another member without consideration or disclosure on tax return):

Step 1: On May 14, Year 2, when the value of Wanted Intangible is still $15, S transfers Wanted Intangible to S1 in exchange for no consideration and P cancels S's liability. The transfer is not disclosed on the group's consolidated return.

Step 2: On December 31, Year 2, S elects, under §301.7701-3(c)(1)(i), to be disregarded as an entity separate from its owner. On the consolidated tax return for Year 2, P claims a worthless stock deduction with respect to its equity ownership in S.

Situation 4: (Asset 1 contributed to S, then Wanted Intangible transferred within group without consideration or disclosure, and S later sold when no amortization deductions or income inclusion had ever been reported):

Step 1: On May 1, Year 1, P contributes Asset 1 to S.

Step 2: On January 1, Year 2, S transfers Wanted Intangible to S1 in exchange for no consideration. The transfer is not disclosed on the group's consolidated return.

Step 3: On January 1, Year 7, P sells S to an unrelated person for $15. The group's consolidated returns do not include any amortization deduction for S1 with respect to Wanted Intangible or any income for S with respect to the transfer of Wanted Intangible.

LAW:

Section 1.1502-32 provides rules that adjust the basis of the stock of a subsidiary to prevent duplication of items and promote a clear reflection of a consolidated group's income. Adjustments with respect to a subsidiary's stock under §1.1502-32(b)(2) include positive adjustments for taxable income and tax-exempt income, and negative adjustments for losses and distributions. Negative adjustments for distributions are necessary because a distribution by a subsidiary to its owning member reduces the value of the subsidiary. Thus, §1.1502-32 prevents basis from being overstated or understated and preserves any potential gain or loss on a disposition of the subsidiary's stock.

Section 1.1502-13 applies to intercompany transactions, defined under §1.1502-13(b)(1) as, a transaction between corporations that are members of the same consolidated group immediately after the transaction. In an intercompany transaction, generally S is the transferor and B is the transferee. Section 1.1502-13 provides rules that clearly reflect taxable income of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income. S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. B's income, gain, deduction, and loss from an intercompany transaction or from property acquired in an intercompany transaction are its corresponding items.

Generally, §1.1502-13 provides for the deferral of income with respect to intercompany transactions. Under the matching rule, provided in §1.1502-13(c)(2), S and B are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. Under the acceleration rule, provided in §1.1502-13(d), S and B's items from intercompany transactions are taken into account when and to the extent they can no longer be taken into account to produce the effect of treating S and B as divisions of a single corporation. Under §1.1502-13(f)(2), a distribution by a subsidiary to an owning member, to which section 301 applies, is not included in the gross income of the distributee member.

Under §1.1502-13(g)(3)(i)(B)(*1*), a transaction in which an intercompany obligation is extinguished is not a triggering transaction if sections 332 and 337(a) apply. Furthermore, if an intercompany obligation is extinguished in a transaction to which section 351 applies and no amount of income, gain, deduction, or loss is recognized by the creditor or debtor, the transaction is generally not a triggering transaction.

Section 368(a)(1)(D) describes a D reorganization as a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders, is in control of the corporation to which the assets are transferred, but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

For purposes of qualifying as a D reorganization, §1.368-2(l)(2) provides that in cases in which no consideration is received or the value of the consideration received in the transaction is less than the fair market value of the transferor corporation's assets, the transferee corporation will be treated as issuing stock with a value equal to the excess of the fair market value of the transferor corporation's assets over the value of the consideration actually received in the transaction.

Section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance to the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to a reorganization. With respect to acquisitive D reorganizations, section 354(b)(1) provides that in order to receive non-recognition treatment under section 354(a)(1), the corporation to which the assets are transferred must acquire substantially all of the assets of the transferor, and the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 358(a)(1) and §1.358-(2)(a)(2)(i) generally provide that the basis of property permitted to be received under section 354 without the recognition of gain or loss shall be the same as that of the property exchanged.

In Rev. Rul. 78-330, 1978-2 C.B. 147 *modified by* Rev. Rul. 2007-8, 2007-1 C.B. 469, a parent corporation's cancellation of indebtedness of its wholly-owned subsidiary immediately before an acquisitive reorganization under section 368(a)(1)(D), in order to avoid the application of section 357(c), was respected. The cancellation of indebtedness was treated as a contribution to the capital of the debtor-subsidiary.

In general, under §1.61-12(a), if a shareholder gratuitously forgives a debt owed to the shareholder by the corporation, the forgiveness is treated as a contribution to the capital of the corporation to the extent of the principal of the debt. Under section 1016(a)(1), a shareholder who makes a contribution to the capital of the corporation is entitled to increase the shareholder's basis in shares of the corporation by the amount of the shareholder's basis in the contributed property. *See Commissioner v. Fink*, 483 U.S. 89 (1987). Section 108(e)(6) provides that for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, section 118 shall not apply, but such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

Section 165(a) allows as a deduction, any loss sustained during the taxable year that is not compensated for by insurance or otherwise. Under section 165(g), if any security that is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(3) provides that any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset but may be deducted under section 165(a) as an ordinary loss. For this purpose, a corporation is treated as affiliated only if the taxpayer directly owns stock in the corporation meeting the vote and value requirements of section 1504(a)(2), and more than 90 percent of the aggregate gross receipts of the corporation throughout its entire existence were from sources other than certain specific passive activities.

To obtain a worthless stock deduction under §1.165-1(b), the shareholder must show that: (1) the security had a basis; (2) the security was not worthless prior to the year in which worthlessness is being claimed; and, (3) that the security was worthless in the year claimed. Section 1.165-1(b) further provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

In *Boehm v. Comm'r*, 326 U.S. 287 (1945), the Supreme Court noted that, in determining whether a security is worthless, all the surrounding facts and circumstances will be examined. Generally, as set forth in *Morton v. Comm'r*, 38 B.T.A.1270, 1278-79 (1938), there is a two-part test for worthlessness. First, the stock must cease to have liquidating value (*i.e.*, present value, or the corporation must have an excess of liabilities over assets). Second, the stock must lack potential value (*i.e.*, future value, or an expectation of future asset value exceeding liabilities). The loss of present value may be readily determinable through a showing of insolvency. The absence of future value must be established by pointing to identifiable events that demonstrate the worthlessness of the stock or terminates any future value expectation.

In addition to the conditions required by section 165(g) for a shareholder to claim a worthless stock deduction, §1.1502-80(c) contains an additional requirement if the deduction is with respect to stock of a subsidiary held by a member of a consolidated group. Under that section, a loss on the worthlessness of subsidiary stock may not be claimed until the subsidiary has disposed of, abandoned, or destroyed all of its assets, or the subsidiary for any reason ceases to be a member of the group.

Section 332 provides that no gain or loss is recognized by a corporate shareholder upon receipt of property in complete liquidation of a subsidiary. For this purpose, a subsidiary is a corporation whose stock is owned by another corporation (or corporations in the case of a consolidated group) that meets the 80% vote-and-value requirements of section 1504(a)(2). Under §1.332-7, if section 332(a) is applicable to the receipt of the subsidiary's property in complete liquidation, then no gain or loss shall be recognized to the subsidiary upon the transfer of its properties even though some of the properties are transferred in satisfaction of the subsidiary's indebtedness to its parent. To qualify under section 332, the distribution must be in complete cancellation or redemption of all of the subsidiary's stock, and the transfer of all property must occur within the taxable year. Alternatively, the distribution will qualify if it is one of a series of distributions in complete cancellation or redemption of all of the subsidiary's stock in accordance with a plan under which the transfer of all property is completed within 3 years from the close of the taxable year in which the first distribution occurs.

Under Rev. Rul. 61-191, 1961-2 C.B. 251, a de facto liquidation occurs for purposes of determining carrybacks when a corporation disposes of all or most of its operating assets, terminates its business activities, and becomes a mere shell with no real corporate substance, purpose, or compelling reason for continuing its existence. In addition, in *Olmsted v. Comm'r*, 48 T.C.M. 594 (1984), the Tax Court generally looks to three factors to determine if a corporation has de facto liquidated: (1) a manifest intent to liquidate; (2) a continuing purpose to terminate corporate affairs and dissolve; and (3) corporate activities directed and confined to that purpose.

Under §1.6012-2(a)(2) a corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not it may thereafter be treated under State law as continuing as a corporation for certain limited purposes.

Under §301.7701-3(a), an eligible entity with a single owner is disregarded as an entity separate from its owner unless it elects to be classified as an association taxable as a corporation. If an eligible entity classified as an association elects to be a disregarded entity, under §301.7701-3(g)(1)(iii), it is deemed to have distributed all of its assets and liabilities to its single owner and the election has the same consequences for Federal income tax purposes as an actual liquidation or dissolution. Rev. Rul. 2003-125, 2003-2 C.B. 1243.

Under Rev. Rul. 69-630, 1969-2 C.B. 112, a bargain sale between related corporations was adjusted under the authority provided in section 482, so as to clearly reflect the income of the entities where the sale had as one of its principal purposes the avoidance of Federal income tax and resulted in a significant shifting of income. Thus, a bargain sale may be treated in part as a deemed distribution, contribution, or combination thereof.

Section 1.1502-80(a) provides that the Internal Revenue Code, or other law, shall be applicable to the consolidated group to the extent the regulations do not exclude its application.

Rev. Rul. 81-88, 1981-1 C.B. 585, *amp. by* Rev. Rul. 85-64, 1985-1 C.B. 365, provides that in determining the amount of an overpayment of income tax from a net operating loss carryback that may be refunded or credited, the taxable income of the first carryback year should not be reduced by the amount of an unclaimed deduction that is barred by the expiration of the period of limitations. If an adjustment for a barred deduction in the first carryback year results in a net operating loss for that year, that net operating loss may be carried forward and applied as an adjustment decreasing the taxable income of the next open carryback year prior to applying the net operating loss carryback.

In *Barenholtz v. U.S.*, 784 F.2d 375, 380-81 (Fed. Cir. 1986), the court upheld the Service's ability to re-compute the individual taxpayer's liability for past years that were closed by the period of limitation in order to correctly determine the taxpayer's liability for an open year. The Federal Circuit stated, "It is well settled that the IRS and the courts may re-compute taxable income in a closed year in order to determine tax liability in an open year."

ANALYSIS

P's purchase of S's stock for $10 creates an initial cost basis in the S stock of $10. After S sells Unwanted Asset to an unrelated person for $5, S recognizes no gain or loss on the sale because S had a $5 basis in Unwanted Asset. S's distribution of the $5 received from the third party sale to P is treated as a distribution of property under section 301. Because S and P are members of the same consolidated group immediately after the distribution, the distribution is an intercompany distribution under §1.1502-13(f)(2)(i). As an intercompany distribution, the $5 is not included in P's gross income under §1.1502-13(f)(2)(ii), but results in a $5 reduction to P's basis in its S stock under §1.1502-32(b)(2)(iv). Therefore, following the distribution, P has a basis of $5 ($10 – $5) in the S stock, S owns Wanted Intangible (basis $0, value $15), and S has an outstanding debt owed to P of $10.

Situation 1 (Wanted Intangible not distributed):

In Situation 1, S's election to be disregarded as an entity separate from its owner is treated as a distribution of all its assets (Wanted Intangible) and liabilities to P in liquidation of S. *See* §301.7701-3(g)(1)(iii). At the time of the election, the fair market value of Wanted Intangible ($15) exceeds the amount of S's liabilities ($10). Therefore, under Rev. Rul. 2003-125 and section 332, no gain or loss is recognized by P on the receipt of S's property in complete cancellation of its S stock and S is no longer a member of the consolidated group. P's basis in S's stock is eliminated and P may not claim a worthless stock deduction with respect to its S stock.

Situation 2 (Wanted Intangible distributed):

In Situation 2, after S's distribution of its only asset (Wanted Intangible), S is left as a mere shell without assets. Thus, under Rev. Rul. 61-191, S must be treated at the time of the distribution as having distributed the Wanted Intangible to P in complete liquidation of S. The distribution of Wanted Intangible worth $15 is deemed to fully satisfy the $10 liability owed to P and to be in cancellation of S's stock. Consequently, under section 332, no gain or loss is recognized by P on the receipt of S's property in cancellation of all its S stock. Furthermore, under §1.332-7, S recognizes no gain or loss on the transfer. P's basis in S's stock is eliminated and for Federal income tax purposes S is treated as ceasing to exist. *See* §1.6012-2(a)(2). The subsequent election by S, in Step 2, to be disregarded as an entity separate from its owner has no federal income tax consequences.

Situation 3 (Wanted Intangible transferred to another member without consideration or disclosure on tax return):

In Situation 3, S's transfer of its only asset, Wanted Intangible (basis $0, value $15), to S1 is treated as a reorganization under section 368(a)(1)(D). Under Rev. Rul. 78-330, the $10 liability S owed to P is treated as if it were canceled before the reorganization, and the amount of the extinguished liability ($10) is treated as contributed by P to the capital of S. The cancellation of S's $10 debt is treated by S, under section 108(e)(6), as if S satisfied the indebtedness for $10 and does not result in the recognition of income. As a result of P's $10 contribution to the capital of S, P's $5 basis in the S stock is increased by $10 to $15.

Because S1 issued no consideration to S in exchange for its receipt of Wanted Intangible (S's only asset), under §1.368-2(l)(2), S is treated as transferring Wanted Intangible to S1 in exchange for $15 of deemed S1 stock and distributing the deemed S1 stock to P in exchange for its S stock. Under section 358(a)(1) and §1.358-2(a)(2)(i), P's basis in the S1 stock deemed received is $15, the same as the $15 basis of the S stock exchanged in the reorganization. Under §1.358-2T(a)(2)(iii), P is then treated as surrendering all of its shares in S1, including the S1 shares it held immediately prior to the transaction and the S1 shares it is deemed to have received in the transaction, in a reorganization within the meaning of section 368(a)(1)(E), in exchange for the S1 shares P actually holds immediately after the transaction, with P's basis in those shares determined under the rules of §§1.358-2 and -2T. Under section 354, P does not recognize gain or loss on the deemed exchange of its S stock for S1 stock and the S stock is treated as having been canceled.

After the cancellation of S's liability by P, the transfer of Wanted Intangible by S, and the deemed distribution of S1 stock to P in exchange for the stock of S, S is left as a mere shell without assets. Whether or not S's charter is formally canceled under State law, S ceases to exist for federal income tax purposes. *See* Rev. Rul. 61-191, and §1.6012-2(a)(2). The subsequent election by S, in Step 2, to be disregarded as an entity separate from its owner has no federal income tax consequences.

Situation 4 (Asset 1 contributed to S, then Wanted Intangible transferred within group without consideration or disclosure, and S sold in Year 5 when no amortization deductions or income inclusion had ever been reported):

In Situation 4, Step 1, P's contribution of Asset 1 (basis $10, value $10) to S results in a contribution to the capital of S. P's $5 basis in S is increased by $10 to $15.

S's transfer of Wanted Intangible (basis $0, value $15) to S1 in exchange for no consideration, in Step 2, is not an arm's length transaction. Under Rev. Rul. 69-630, a transfer of property between related corporations will be appropriately adjusted under the authority provided in section 482, so as to clearly reflect the income of the parties. Accordingly, Wanted Intangible with a fair market value of $15 will be treated as distributed by S to P, its owning member, and then contributed by P to S1.

The deemed distribution by S to P requires S to recognize $15 of gain under section 311(b). However, the distribution is an intercompany transaction under §1.1502-13(b)(1), and therefore S's $15 gain is not taken into account at the time of the distribution. Under §1.1502-32(b)(3)(i), S's intercompany gain does not result in an increase to P's basis in S's stock prior to the time the gain is taken into account. Also, because the distribution is an intercompany distribution, the $15 distribution received by P is not included in P's gross income under §1.1502-13(f)(2)(ii), but does result in a $15 decrease in P's basis in S's stock under §1.1502-32(b)(2)(iv). P's initial $10 purchase price basis in S is reduced by the $5 cash distribution to P, increased by $10 due to P's contribution of Asset 1 to S, and reduced by $15, the fair market value of Wanted Intangible deemed distributed to P, resulting in a $0 basis in S's stock. Under section 301(d), P takes a $15 basis in Wanted Intangible (its fair market value on the date of distribution). Under section 362(a), S1 takes a $15 basis in Wanted Intangible on P's deemed contribution and P's $5 basis in S1's stock is increased by $15 to $20.

Under §1.1502-13 and section 197, when S1 receives Wanted Intangible with a fair market value basis of $15 from P in the deemed contribution, S1 can amortize its basis in Wanted Intangible over its 15-year amortizable life and as S1 claims a deduction, S includes in income a corresponding amount of its $15 intercompany item resulting from its section 311(b) gain. However, notwithstanding the intercompany transaction regulations, the facts in Situation 4 indicate that the P group fails to show on its return any amount of deduction by S1 or inclusion of income by S. Also, the facts indicate in Step 3 that P sells the stock of S to an unrelated person on January 1, Year 7, for $15, after the statute of limitations has run for Years 2 and 3. As a result of S's ceasing to be a member of the P group, the portion of S's intercompany item resulting from its section 311(b) gain that has not been taken into account is accelerated under §1.1502-13(d).

Section 1.1502-32 governs adjustments to the basis of a subsidiary's stock owned by other members of a consolidated group; taxable income taken into account by a subsidiary increases stock basis and deductions decrease stock basis. The consolidated return regulations, however, do not directly address the effect on stock basis and the amount of gain or loss on the disposition of a subsidiary's stock in an open year for amounts not properly reported in closed years. Thus, the question in this case of whether S's unreported income from the distribution of Wanted Intangible, and S1's unclaimed amortization deductions for closed years should be taken into account in determining P's basis in its stock of S and S1 for purposes of determining P's gain or loss on the disposition of such stock in an open year is not directly addressed by the consolidated return regulations. Section 1.1502-80(a)(1) provides, however, that the Internal Revenue Code, or other law, applies to the group to the extent the regulations do not exclude its application.

Section 6501 provides the period within which the Internal Revenue Service may timely assess a tax liability. Generally, when a return is filed, tax with respect to that return must be assessed within 3 years from the later of the date the return was filed or the original due date of the return. The plain language of section 6501(a) prohibits only the "assessment" of taxes after the period of limitation has run. It does not prohibit the Internal Revenue Service from using information from closed periods to determine or assess the proper amount of tax in an open year.

Rev. Rul. 81-88 and *Barenholtz v. U.S.*, 784 F.2d at 380-81, both confirm the general propositions that: (1) it is accepted practice to take into account otherwise barred deductions or inclusions in order to assess taxes or to determine the correct tax liability in an open year; and (2) the Service is not precluded from making adjustments to arrive at the correct taxable income in closed years in order to properly determine a taxpayer's liability in open years.

Since adjustments to basis are necessary in determining either the correct basis of a member or gain or loss on a transaction in an open year, S's unreported intercompany items for Years 2 through 7 relating to its section 311(b) gain should be taken into account in determining P's basis in its S stock and consequently P's gain or loss on the sale of S in Year 7. In addition, if any of P's shares of S stock are loss shares, S's unreported intercompany items should be taken into account for purposes of applying §1.1502-36, including for purposes of determining S's net positive adjustment under §1.1502-36(c)(3). Also, S1's unclaimed depreciation deductions for Years 2 through 7 should be taken into account in determining P's basis in its S1 stock in Year 7. Accordingly, S1 will be treated as if S1 deducted $1 each year between Years 2 and 7 and S will be treated as if S included in its income $1 of its intercompany item resulting from its section 311(b) gain each year between Years 2 and 6, and the remaining portion of its intercompany item in Year 7. Consequently: (1) S1's $15 basis in Wanted Intangible on January 1, Year 7, is reduced by S1's unclaimed amortization for Years 2 through 7 ($5) to $10; (2) P's $20 basis in its S1 stock on January 1, Year 7, is reduced by S1's unclaimed amortization for Years 2 through 7 ($5) resulting in a basis of $15 in S1; and (3) Under §1.1502-32(b)(2)(i), P's basis in its S stock will be increased by $1 each year for Years 2 through 7 ($5), resulting in a total basis in S in Year 7 of $5. Upon P's sale of S's stock, S will cease to be a member of the consolidated group and must take into account the $10 of gain under section 311(b) that remains after taking into account the amounts that should have been included in prior years.

If you have any additional questions about this matter, please contact Leah M. Thompson at (202) 622-7750 or Lawrence M. Axelrod at (202) 622-7700.

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