April 17, 2012

A Secret No More: Final Treasury Regulations Amend the Controlled Group Deferred Loss "Supersecret Rule"

Nearly a year after issuing proposed regulations that aimed to modify the so-called "supersecret rule" of Treas. Reg. § 1.267(f)-1(c)(1)(iv) (the Proposed Regulations), Treasury and the Internal Revenue Service (the IRS) issued final regulations amending that rule on April 13, 2012 (the Final Regulations). In brief, the supersecret rule generally defers losses from intercompany sales of stock within a controlled group *even after the target company is dissolved in a taxable liquidation*. The Proposed Regulations would have modified the supersecret rule by (i) adopting a new aggregation rule similar to, but ultimately more expansive than, the rule found in Treas. Reg. § 1.1502-34, (ii) extending the rule's applicability to scenarios in which split ownership of the target company exists before the intercompany sale, and (iii) providing relief to the extent of offsetting gain. (For our prior Legal Alert on the Proposed Regulations, click here.) The Final Regulations retain the rules of the Proposed Regulations, but make one revision to clarify the interaction of section 267(f) with the principles of Treas. Reg. § 1.1502-13. The Final Regulations also make one modification to ensure that taxpayers cannot circumvent the purposes of the Proposed Regulations through issuances of target corporation stock to controlled group members.

Background

Section 267(a)(1) generally provides that no deduction is allowed for any loss on the sale or exchange of property between certain related persons. An exception to this general rule applies in the case of a sale or exchange of loss property between corporations that are members of the same controlled group. *See* § 267(f)(2); *see also* § 267(f)(1) (providing that, for this purpose, the term "controlled group" has the meaning given to such term by section 1563(a), except that (i) "more than 50 percent" must be substituted for "at least 80 percent" each place that it appears in section 1563(a), and (ii) the determination must be made without regard to sections 1563(a)(4) and 1563(e)(3)(C)). In such case, the loss is deferred (rather than disallowed) until (i) the property is transferred outside of the controlled group and there would be recognition of the loss under consolidated return principles, or (ii) such other time as may be prescribed in Treasury regulations.

The Treasury regulations promulgated under section 267(f) govern the manner in which consolidated return principles apply to controlled groups. Those Treasury regulations generally provide that the timing principles of Treas. Reg. § 1.1502-13(c)(2) apply to sales or exchanges of property at a loss between members of the same controlled group. *See* Treas. Reg. §§ 1.267(f)-1(a)(2), 1.267(f)-1(c)(1). However, those Treasury regulations also provide that the attribute redetermination rules of Treas. Reg. § 1.1502-13(c)(1) generally do *not* apply to such transactions. *See* Treas. Reg. § 1.267(f)-1(c)(2). For example, if a member of a consolidated group (S) holds land for investment and sells that land at a loss to another member of its consolidated group (B), and B develops that land and sells developed lots to unrelated customers, S's intercompany loss will be taken into account when B sells the property to the unrelated person. Furthermore, S's loss will be recharacterized as an ordinary loss, even though S's loss otherwise would be a capital loss given its separate-entity status as holding the property for investment. If B and S were members of a controlled group, but not a consolidated group, S's loss also would be taken into account when B sells the parcel to an unrelated person, but S's loss would retain its character as a capital loss.

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The attribute redetermination rules of Treas. Reg. § 1.1502-13(c)(1) may have the effect of eliminating an intercompany loss with respect to a corporation's stock. For example, assume that S, a subsidiary in a consolidated group, owns 100% of the stock of T, a solvent corporation. S sells 30% of T's stock to B, the common parent of the consolidated group that includes S, at a loss. In a subsequent, unrelated transaction (and before any change in the value of the T stock), T liquidates. Under these facts, the attribute redetermination rules of Treas. Reg. § 1.1502-13(c)(1) recharacterize S's intercompany loss to produce the same results to the consolidated group as a whole as if S and B were divisions of a single corporation. Moreover, pursuant to the rule of Treas. Reg. § 1.1502-34, S and B's ownership of the stock of T is aggregated so that, under these facts, the subsequent liquidation of T would qualify as a tax-free liquidation under section 332. Thus, the subsequent liquidation of T would cause S's intercompany loss to be treated as a noncapital, nondeductible amount. The characterization of S's intercompany loss as a noncapital, nondeductible amount would cause a concomitant reduction in the basis of the stock of S under the investment adjustment rules of Treas. Reg. § 1.1502-32.

Although the attribute redetermination rules of Treas. Reg. § 1.1502-13(c)(1) generally do not apply to sales or exchanges of property at a loss between members of the same controlled group, Treas. Reg. § 1.267(f)-1(c)(1)(iv) contains a special rule, *i.e.*, the supersecret rule, with respect to a loss that would have been redetermined to be a noncapital, nondeductible amount if the consolidated return attribute redetermination rules did apply. Specifically, Treas. Reg. § 1.267(f)-1(c)(1)(iv) generally provides that, if an intercompany loss between members of a consolidated group would have been redetermined to be a noncapital, nondeductible amount, but is not redetermined because the sale or exchange occurred between members of a controlled group, the loss will be deferred until S and B are no longer in a controlled group relationship. Thus, if B was the parent of a controlled group that included S, rather than a consolidated group, under the facts of the example set forth in the preceding paragraph, the IRS likely would assert that S's loss on the sale of the T stock would continue to be deferred until S and B (and their successors) were no longer in a controlled group relationship, notwithstanding the fact that the liquidation of T would have been taxable under section 331. *See, e.g.*, Chief Counsel Advice 201025046 (Mar. 10, 2010); Chief Counsel Advice 200931043 (Apr. 13, 2009).

The Proposed Regulations

The Proposed Regulations would have modified Treas. Reg. § 1.267(f)-1(c)(1)(iv) by (i) adopting a new aggregation rule similar to, but ultimately more expansive than, the rule found in Treas. Reg. § 1.1502-34, (ii) extending the rule's applicability to scenarios in which split ownership of the target company exists before the intercompany sale, and (iii) providing relief to the extent of offsetting gain.

With respect to the first and second proposed modifications, the Proposed Regulations provided that, for purposes of determining whether a loss would have been redetermined to be a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13, the following categories of stock ownership had to be taken into account: stock owned by (i) the selling member, (ii) the buying member, (iii) all members of the seller's consolidated group, and (iv) any member of a controlled group of which the seller is a member that was acquired from a member of the seller's consolidated group (the Controlled Group Aggregation Rule). For example, assume that S1 and S2, both members of a consolidated group, each owns 50% of the stock of T. If the basis of the T stock is greater than its value, a liquidation of T generally would result in nonrecognition of the loss through the application of Treas. Reg. § 1.1502-34 and section 332. In an attempt to avoid the nonrecognition of the loss, either S1 or S2 may sell more than 20% of T's stock to a controlled group member that is not also a member of the same consolidated group as S1 and S2 in a transaction that is treated as a sale or exchange for federal income tax purposes. Thereafter, T is liquidated under section 331 in an attempt to recognize a loss on 100% of T's stock. Treasury and the IRS believe that, in such situations, as reflected by the Controlled Group Aggregation Rule, the loss from the prior stock sale should be deferred until the buying and selling members are no longer in a controlled group relationship.

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Treasury and the IRS also proposed to modify Treas. Reg. § 1.267(f)-1(c)(1)(iv) so as to allow an intercompany loss to be taken into account to the extent that the buying member recognized a corresponding gain (the Corresponding Gain Rule). (Alternatively, an intercompany loss is allowed to be taken into account when the selling member and the buying member cease to be in a controlled group relationship.) For example, if S sells 30% of T's stock to B at a loss (in a transaction that is treated as a sale between those two controlled group members for federal income tax purposes), and T's stock appreciates between the time of the intercompany sale and a subsequent event that results in B's recognition of gain (*i.e.*, T's liquidation), B would recognize a gain under section 331 at that time, but it had been suggested that S's loss from the prior stock sale would remain deferred in its entirety. In order to remove this perceived uncertainty, the Corresponding Gain Rule allowed S's loss to be recognized to the extent of the amount of corresponding gain recognized by B upon T's liquidation.

The Final Regulations

In light of questions received with respect to the necessity of the Corresponding Gain Rule, Treasury and the IRS decided to remove that rule from the Final Regulations. In particular, Treasury and the IRS concluded that the relevant consolidated return principles allow S's loss to be taken into account to the extent of B's corresponding gain, so the Corresponding Gain Rule essentially was redundant. Notably, however, an example has been added to Treas. Reg. § 1.267(f)-1(j) to illustrate the interaction of the Final Regulations with the consolidated return principles relevant to such a situation. *See* Treas. Reg. § 1.267(f)-1(j), Ex. 9.

In addition to this clarification, the Final Regulations amend the Controlled Group Aggregation Rule by providing that stock issued to a member of a controlled group by a target corporation also must be taken into account for purposes of determining whether a loss would have been redetermined to be a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13. For example, assume FP is a foreign corporation that owns all of the stock of FS, a foreign subsidiary, and all of the stock of P, a domestic corporation. P owns all of the stock of T. In Year 1, FS contributes cash to T in exchange for newly issued stock of T that constitutes 40% of T's outstanding stock. In Year 2, when the value of the T stock owned by P is less than the basis of that stock in P's hands, P sells all of its T stock to FP. In Year 3, in a transaction unrelated to the issuance of the T stock in Year 1, T converts under state law to a limited liability company that is treated as a partnership for federal tax purposes. Under the Final Regulations, the T stock issued by T to FS is taken into account for purposes of determining whether, upon the conversion of T, P's deferred loss would be treated as a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13. *See* Treas. Reg. § 1.267(f)-1(j), Ex. 10.

Finally, in the preamble to the Final Regulations, Treasury and the IRS discussed comments that had questioned the approach of the Proposed Regulations. Those comments and the responses of Treasury and the IRS are summarized below.

- First, it was suggested that the Final Regulations should incorporate a model that allows a loss to be taken into account based on the arm's-length principles contained in section 482 and the Treasury regulations promulgated thereunder. Treasury and the IRS did not agree with this suggestion because, in a transaction described in these Treasury regulations, it is assumed that the parties are acting at arm's length.

- It also was asserted that it was unclear whether the Proposed Regulations were intended to direct taxpayers to an analysis similar to that of Treas. Reg. § 1.1502-34 in determining whether a loss should be redetermined to be a noncapital, nondeductible amount. After considering this suggestion, Treasury and the IRS concluded that the rules in the Proposed Regulations were clear in that they expressly listed the corporations the stock holdings of which had to be taken into

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account. Furthermore, Treasury and the IRS believe that the Proposed Regulations were "appropriately broader" than the stock aggregation rule of Treas. Reg. § 1.1502-34 in order to account for, among other considerations, the fact that the definition of a controlled group is broader than the definition of a consolidated group.

- Finally, in addressing a question as to whether the Proposed Regulations were consistent with the holdings in *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), and other applicable case law, Treasury and the IRS stated that they believe that the Proposed Regulations and the Final Regulations are consistent with those cases. In support of this conclusion, Treasury and the IRS explained that these rules are intended to address the timing for taking into account a loss on a sale of property between members of a controlled group, and do not relate to whether a liquidation otherwise results in the recognition of a loss.

The Final Regulations apply to a loss that continues to be deferred pursuant to the supersecret rule if the event that would cause the loss to be redetermined as a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13 occurs on or after April 16, 2012, *i.e.*, the date of the publication of the Final Regulations in the Federal Register.

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