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LEGAL ALERT

March 4, 2011

Many Happy (Consolidated) Returns or 'Til "DIT" Do Us Part? Final Treasury Regulations Address Intercompany Items of Gain on Member Stock

On March 3, 2011, the Internal Revenue Service and Treasury issued final Treasury regulations that amend Treasury Regulation § 1.1502-13 with respect to the treatment of certain intercompany items of gain from transactions involving stock of members of a consolidated group (the Final Regulations). The Final Regulations are effective on March 4, 2011, *i.e.*, the date of their publication in the Federal Register. As we discuss in greater detail below, the Final Regulations contain several notable changes (and an important addition) in comparison to the previous temporary Treasury regulations issued in March 2008 as Temporary Treasury Regulation § 1.1502-13T(c)(6)(ii)(C) (the Prior Temporary Regulations). However, the overall approach of the Final Regulations does not diverge significantly from the approach of the Prior Temporary Regulations.

Background

Treasury Regulation § 1.1502-13 provides the rules for taking into account items of income, gain, deduction, and loss of members of a consolidated group from "intercompany transactions." In general, an intercompany transaction is defined as a transaction between corporations that are members of the same consolidated group immediately after the transaction. Intercompany transactions include, among other things, sales of property or other transfers of property, such as exchanges or contributions, whether or not gain or loss is recognized. In general, the items of income, gain, deduction, and loss of the selling member (S) from an intercompany transaction are S's "intercompany items." The items of income, gain, deduction, and loss of the buying member (B) from an intercompany transaction, or from property acquired in an intercompany transaction, are B's "corresponding items."

Treasury Regulation § 1.1502-13 prescribes a regime of matching and acceleration rules applicable to all intercompany transactions. The matching rule of Treasury Regulation § 1.1502-13(c) is the principal rule for redetermining the timing and attributes of S's intercompany items and B's corresponding items. In general, under the matching rule, the timing of inclusion of gain on a sale of property by S to B (or a similar realization transaction between S and B) is linked to B's recovery of its basis in the property, and S and B's characterization of the sale (or other transaction) is subject to redetermination in order to treat S and B as divisions of a single corporation.

A simple example illustrates these principles. Assume that corporations P, M, and T are all members of a consolidated group, with P wholly owning M, and M wholly owning T. M distributes all of its T stock to P in a transaction to which section 301 applies. If the value of the T stock was $100 at the time of the distribution and M had a $40 basis in the T stock at that time, M, as the selling member, would recognize (but not immediately take into account) a $60 intercompany item of gain attributable to the T stock. Moreover, P, as the buying member, would take a $100 basis in the T stock on account of the distribution. M generally would take into account its $60 intercompany item of gain under the intercompany transaction rules if, among other events, M or T left the consolidated group.

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Framework of the Final Regulations

Under the Final Regulations, an intercompany item of gain attributable to shares of a member's stock (*e.g.*, M's $60 intercompany item of gain with respect to the stock of T in the preceding example) can be permanently excluded from gross income following certain stock basis elimination transactions (*e.g.*, tax-free spin-offs and liquidations), notwithstanding the general rule that otherwise would apply to cause such an intercompany item of gain to be included in income. Specifically, the new general rule of Treasury Regulation § 1.1502-13(c)(6)(ii)(C)(1) provides that an intercompany item of gain with respect to a member's stock (often referred to as a "stock DIT") that was created by reason of an "intercompany transfer" of the stock, and that otherwise would not be taken into account upon a subsequent elimination of the stock's basis but for the transfer, will be redetermined to be excluded from gross income if:

1. B or S becomes a "successor" (as defined in Treasury Regulation § 1.1502-13(j)(2); *e.g.*, the transferee of assets in a transaction to which section 381(a) applies) to the other party (either B or S), or a third member becomes a successor to both B and S (Factor 1);

2. Immediately before the intercompany item of gain would be taken into account, the successor member holds the member's stock with respect to which the intercompany item of gain was realized (Factor 2);

3. The successor member's basis in the member's stock that reflects the intercompany item of gain that is taken into account is eliminated without the recognition of gain or loss (and such eliminated basis is not further reflected in the basis of any "successor asset") (Factor 3);

4. The effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group's consolidated return (Factor 4); and

5. The group has not derived, and no taxpayer will derive, any federal income tax benefit from the intercompany transaction that gave rise to the intercompany item of gain or the redetermination of the intercompany item of gain (including any adjustment to basis in member stock under Treasury Regulation § 1.1502-32) (Factor 5). For this purpose, the redetermination of the intercompany item of gain is not itself considered a federal income tax benefit.

The Final Regulations take the further step of providing that any amount excluded from gross income under Treasury Regulation § 1.1502-13(c)(6)(ii)(C)(1) will not be taken into account as earnings and profits of any member and will not be treated as tax-exempt income under the investment adjustment rules of Treasury Regulation § 1.1502-32.

Changes from the Prior Temporary Regulations

Although several notable changes have been made to the general rule, and, as discussed above, important ancillary consequences (*i.e.*, the effect of the excluded gain on earnings and profits and the treatment of the excluded gain under the investment adjustment rules) have been described in the Final Regulations, the general rule of the Final Regulations mirrors the general rule of the Prior Temporary Regulations in many respects. We highlight the primary differences below.

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With respect to Factors 1 and 2, the Service and Treasury explain in the preamble to the Final Regulations that they have reconsidered the requirement of the Prior Temporary Regulations that, immediately before the intercompany item of gain otherwise would be taken into account, the "common parent" of the consolidated group (P) must be the member that holds the member stock with respect to which the intercompany item of gain was realized, and that the gain must be P's intercompany item. As justification for this change from the Prior Temporary Regulations, the Service and Treasury reasoned that, given the other requirements of the Final Regulations—namely that (i) the group has not and will not derive any federal income tax benefit from the intercompany transaction; and (ii) the excluded gain will not be treated as tax-exempt income for purposes of the investment adjustment rules—it is appropriate to provide relief where a member other than the common parent holds the subject stock. This change to Factors 1 and 2 is a welcome one, insofar as it is an expansion of the Prior Temporary Regulations. Under the Prior Temporary Regulations, the intended tax benefit could be realized in many instances only by "rolling up" an entire group (or a chain of members within a group) into the common parent. That impediment now appears to be extinguished.

The scope of Factor 5 also has been broadened in the Final Regulations. Specifically, that requirement now looks not only to the group for purposes of determining whether any federal income tax benefit has been derived from the intercompany transaction that gave rise to the relevant intercompany item of gain, but also to whether *any other taxpayer* will derive a federal income tax benefit from that intercompany transaction. The preamble to the Final Regulations does not explain this change.

Amendments to the "Commissioner's Discretionary Rule"

Prior to the amendments made by the Final Regulations, the "Commissioner's Discretionary Rule," *i.e.*, Treasury Regulation § 1.1502-13(c)(6)(ii)(D), provided that S's intercompany item of income or gain could be redetermined to be excluded from gross income if the Commissioner of Internal Revenue determined that treating S's intercompany item as excluded from gross income was consistent with the purposes of Treasury Regulation § 1.1502-13 and other applicable provisions of the Internal Revenue Code and Treasury regulations. The preamble to the Prior Temporary Regulations requested comments on whether the Commissioner's Discretionary Rule should be retained. That preamble also stated that the Service and Treasury were considering whether to eliminate the Commissioner's Discretionary Rule.

As described in the preamble to the Final Regulations, the Service and Treasury believe that there may be circumstances where application of such discretion is warranted. Thus, for example, the Final Regulations do not provide automatic relief for transactions involving property other than member stock (such as the stock of non-members), but relief may be available after review by the Service under the Commissioner's Discretionary Rule. Accordingly, the Final Regulations retain the Commissioner's Discretionary Rule in a form revised to describe the conditions to be satisfied for that discretion to be exercised, and to indicate that relief is available only through a private letter ruling.

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