

April 25, 2011

The Secret Is Out! Proposed Treasury Regulations Shed New Light on the Controlled Group Deferred Loss “Supersecret Rule,” Including Its Application to CFCs

On April 20, 2011, Treasury and the IRS issued proposed Treasury regulations (the Proposed Regulations) that would modify the so-called “supersecret rule” of Treas. Reg. § 1.267(f)-1(c)(1)(iv), a provision that has come to have an increasingly important role in international restructurings involving members of controlled groups, including CFCs. 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 modify the supersecret rule by (i) adopting a new aggregation rule similar to, but not as expansive as, 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. In so doing, the Proposed Regulations adhere to positions taken by the IRS in recent informal guidance—namely, Chief Counsel Advice (CCA) 200931043 (Apr. 13, 2009) and CCA 201025046 (Mar. 12, 2010). (Hence, the “supersecret rule” reference.)

Background

Section 267(a)(1) provides that no deduction is allowed for any loss on the sale or exchange of property between certain related persons. Section 267(f)(2) contains an exception for a loss on the sale or exchange of property between members of a controlled group. 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 section 1563(a)(4) and (e)(3)(C). In the case of a sale or an exchange of loss property between members of a controlled group, the loss is deferred rather than disallowed. Under section 267(f)(2)(B), the loss is deferred 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 under section 267(f) provide that the timing principles for intercompany sales or exchanges between members of a consolidated group, *i.e.*, the rules of Treas. Reg. § 1.1502-13(c)(2), apply to sales or exchanges of property at a loss between members of a controlled group. The attribute redetermination rules applicable to transactions between members of a consolidated group, however, do not apply to sales or exchanges between members of a controlled group. For example, if a member of a consolidated group (S) holds land for investment and sells the land at a loss to another member of its consolidated group (B), and B develops the 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.

The attribute redetermination rule applicable to intercompany transactions between consolidated group members 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

© 2011 Sutherland Asbill & Brennan LLP. All Rights Reserved.

This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

corporation. S sells 30% of T's stock at a loss to B, the common parent of the consolidated group that includes S. In a subsequent, unrelated transaction (and before any change in the value of the T stock), T liquidates. The attribute redetermination rule of Treas. Reg. § 1.1502-13(c)(1) recharacterizes 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. Under these facts, the subsequent liquidation of T, tax-free under section 332, 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 rule generally does not apply to sales or exchanges between members of a controlled group, Treas. Reg. § 1.267(f)-1(c)(1)(iv) contains a special rule with respect to losses that would have been redetermined to be a noncapital, nondeductible amount if the consolidated return attribute redetermination rule did apply. Specifically, under Treas. Reg. § 1.267(f)-1(c)(1)(iv), if an intercompany loss between members of a consolidated group would have been redetermined to be a noncapital, nondeductible amount as a result of the attribute redetermination rule applicable to consolidated groups, 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 the facts in the example in the preceding paragraph were the same, except that B was the parent of a controlled group that included S, rather than a consolidated group, under the principles of section 267(f), Treasury and the IRS believe that S's loss on the sale or exchange of T stock should be deferred until S and B (and their successors) are no longer in a controlled group relationship.

CCA 200931043 and CCA 201025046 – Prelude to the Proposed Regulations

In CCA 200931043 and CCA 201025046, the IRS considered whether, upon the taxable liquidation of a domestic subsidiary (Sub), another member (M) of the consolidated group of which Sub had been a member could take into account the loss that M had realized (the Sub Loss) from its sale of a portion of the stock of Sub to another member (CM) of the controlled group that included M and Sub. (In CCA 200931043, CM was an indirect, wholly owned REIT subsidiary of M, while in CCA 201025046, CM was an indirect, wholly owned foreign subsidiary of M.) In both instances, the IRS concluded that, upon the liquidation of Sub, M could not take into account the Sub Loss. In so concluding, the IRS reasoned that the Treasury regulations under section 267(f)(2) were promulgated to prevent members of a controlled group from taking into account a loss or deduction solely as a result of a transfer of property between a selling member and a buying member. In each situation, M and CM remained members of the same controlled group following the liquidation of Sub. Therefore, in the view of the IRS, the Sub Loss continues to be deferred pursuant to Treas. Reg. § 1.267(f)-1(c)(1)(iv) until M and CM are no longer in a controlled group relationship.

The Proposed Regulations

Consistent with the conclusions reached by the IRS in CCA 200931043 and CCA 201025046, the Proposed Regulations provide that, for purposes of determining whether a loss would be determined to be a noncapital, nondeductible amount under the principles of Treas. Reg. § 1.1502-13, stock held by the selling member, stock held by the buying member, stock held by all members of the seller's consolidated group, and stock held by 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 must be taken into account. 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 nonconsolidated, controlled group member in a transaction that is treated as a sale or exchange for federal income tax purposes. Thereafter, T is liquidated in an attempt to recognize a loss on 100% of T's stock. Treasury and the IRS believe that, in these situations, and as reflected in the Proposed Regulations, the loss should be deferred until the buying and selling members are no longer in a controlled group relationship.

In a controlled group setting, taxpayers have noted that Treas. Reg. § 1.267(f)-1(c)(1)(iv) does not allow S to take into account any amount of the intercompany loss when B recognizes a corresponding gain. For example, if S sells 30% of T's stock to B at a loss (in a transaction that is treated as a sale or an exchange 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 S's loss would remain deferred in its entirety. Accordingly, Treasury and the IRS have proposed to modify Treas. Reg. § 1.267(f)-1(c)(1)(iv) so as to allow S's intercompany loss to be taken into account to the extent that B recognizes a corresponding gain. (Alternatively, S's intercompany loss is taken into account when S and B cease to be in a controlled group relationship.) Thus, in the example, under the Proposed Regulations, S's loss will be recognized to the extent of the amount of corresponding gain recognized by B upon T's liquidation.

The Proposed Regulations will apply to loss redetermination events that occur after the date that these Treasury regulations are published as final Treasury regulations in the Federal Register. Comments on the Proposed Regulations should be submitted by July 20, 2011.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Reginald J. Clark	404.853.8032	reggie.clark@sutherland.com
Michael R. Miles	202.383.0204	michael.miles@sutherland.com
Carol P. Tello	202.383.0769	carol.tello@sutherland.com
William R. Pauls	202.383.0264	william.pauls@sutherland.com