OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: STEVEN J. HANKIN
CHIEF, CORPORATE BRANCH
FIELD SERVICE DIVISION CC:DOM:FS

SUBJECT: Loss Deferral under I.R.C. § 267

This Field Service Advice ("FSA") responds to your memorandum dated August 25, 1998, supplementing an FSA issued July 25, 1997. Two additional FSA's were issued on October 7, 1997 and June 23, 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 =
S1 =
S2 =
S3 =

F1 =
F2 =

X =
Y =

$a =
$b =

$c	=
$d	=
$e	=
$f	=
$g	=
A$h	=
A$i	=
A$j	=
A$k	=
A$m	=
$n	=
A$o	=
A$p	=
A$q	=
A$r	=
$s	=
$t	=
$u	=
$v	=
aa	=
bb	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Year 1	=
Year 2	=
Country X	=

ISSUES:

1) Whether the P group correctly applied the basis shifting rules of I.R.C. § 267(f) in determining S3's loss on the sale of the F2 stock to X?

2) Whether the Service can assert the application of I.R.C. § 269 to S3's acquisition of the F2 stock.

CONCLUSIONS:

1) The P group correctly applied the basis shifting rules of I.R.C. § 267(f) in determining S3's loss on the sale of the F2 stock to X.

2) The Service cannot assert the application of I.R.C. § 269 because the control requirement is not satisfied.

FACTS:

During the year at issue, P was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. P owned all of the stock of S1, which owned all of the stock of S2, which owned all of the stock of S3. S1, S2 and S3 were all members of the P consolidated group.

S3 owned all of the stock of F1, which owned all of the stock of F2. F1 and F2 are each Country X corporations.

On Date 2, the following steps took place:

1) S1 contributed $c to the capital of S2, which contributed this money to the capital of S3, which borrowed $d (from S1) and used $e[1] to purchase A$h.

2) S3 contributed A$i (of the A$h it received from S2) to the capital of F1 in exchange for aa shares of A$1.00 par value F1 stock. This exchange qualified as tax-free under I.R.C. § 351 and increased S3's basis in F1 by A$i or $a.

3) F1 contributed the A$i, plus A$j of its own funds (for a total contribution of A$k), to the capital of F2 in exchange for bb shares of Class B A$1 convertible redeemable preference shares. This exchange qualified as tax-free under I.R.C. § 351 and increased F1's basis in F2 by A$k.

4) F1 sold F2 to S3 for A$m ($n) and realized a loss of A$o, which was deferred under I.R.C. § 267. However, you believe that this deferred loss became part of S3's basis in F2, pursuant to Temp. Treas. Reg. § 1.267(f)-1T(c)(6) & (7), when S3 sold F1 to X on Date 4 (see below).

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[1] We note that this amount of $e is less than the total amount of $f that S3 received or borrowed ($c + $d). The difference of $g ($f - $e) is not accounted for, although it may have represented the cost of purchasing the Country X dollars.

5) S3 contributed A$p (the difference between the A$h it received from S2 and the A$i it previously contributed to F2, through F1) to the capital of F2. Thus, S3 directly and indirectly contributed the entire A$h it received from S2 to the capital of F2.

On Date 4, S3 sold the stock of F1 to X for $s. P claimed a long term capital loss of $b on its consolidated return for the year ending Date 5, of which $t was deducted. The remainder ($u) was carried back to the Year 1 tax year and fully utilized.

In Year 2, S3 sold F2 to Y and again realized a loss of approximately $v attributable, in part, to the basis adjustment reflecting F1's deferred loss on the sale of F2, which increased S3's basis in F1 by such amount under I.R.C. § 267(f). This loss was utilized on P's consolidated return.

You have asked whether the P group correctly applied I.R.C. § 267.

I.R.C. § 267:

LAW AND ANALYSIS

Law:

I.R.C. § 267(a)(1) provides that no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of I.R.C. § 267(b).

I.R.C. § 267(b)(3) provides that the persons referred to in I.R.C. § 267(a) are two corporations which are members of the same controlled group (as defined in I.R.C. § 267(f)).

I.R.C. § 267(f)(1) provides that for purposes of this section, with exceptions not relevant here, the term "controlled group" has the meaning given to such term by I.R.C. § 1563(a).

I.R.C. § 267(f)(2) provides that in the case of any loss from the sale or exchange of property which is between members of the same controlled group and to which I.R.C. § 267(a)(1) applies, I.R.C. § 267(a)(1) shall not apply, but such loss shall be deferred until the property is transferred outside such controlled group and there would be a recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.

Treas. Reg. § 1.267(f)-1T(a)(3) provides that Treas. Reg. § 1.267(f)-1T applies to a loss on the sale of property between two members of a controlled group that do not join in filing a consolidated return for the taxable year the loss is incurred.

Treas. Reg. § 1.267(f)-1T(b)(1) provides that the term "group" means "controlled group". The term "controlled group" is defined in I.R.C. § 267(f)(1). Thus, excluded members referred to in I.R.C. § 1563(b), such as foreign corporations, are not excluded from a group.

Treas. Reg. § 1.267(f)-1T(b)(2) provides that the term "member" means a corporation included in a controlled group.

Treas. Reg. § 1.267(f)-1T(c)(1) provides that, except as otherwise provided in this section, the rules for deferred intercompany transactions in Treas. Reg. § 1.1502-13 apply under I.R.C. § 267(f)(2) to the deferral and restoration of loss on the sale of property directly or indirectly between the selling member and the purchasing member as if

> (i) the taxable year in which the sale occurred were a consolidated return year (as defined in Treas. Reg. § 1.1502-1(d)) and
>
> (ii) all references to a "group" or an "affiliated group" were to a controlled group.

Treas. Reg. § 1.267(f)-1T(c)(6) provides that if a selling member of property for which loss has been deferred ceases to be a member when the property is still owned by another member, then, for purposes of this section, Treas. Reg. § 1.1502-13(f)(1)(iii) shall not apply to restore that deferred loss and that loss shall never be restored to the selling member.

Treas. Reg. § 1.267(f)-1T(c)(7)(i) provides that if Treas. Reg. § 1.267(f)-1T(c)(6) precludes a restoration for property, then on the date the selling member ceases to be a member, the owning member's basis in the property shall be increased by the amount of the selling member's unrestored deferred loss at the time it ceased to be a member.

Treas. Reg. § 1.267(f)-1T(c)(7)(iii) provides that the owning member's holding period for the property shall be increased by the selling member's holding period.

Analysis:

F1's loss on the sale of the F2 stock to S3 was properly deferred under I.R.C. § 267(f)(2). That provision provides an exception to the normal rule of I.R.C. § 267(a)(1), which disallows a loss resulting from a sale of property between related persons. Instead, under I.R.C. § 267(f)(2) such a loss is deferred if the sale occurs between members of a controlled group and if I.R.C. § 267(a)(1) would otherwise apply. Under Temp. Treas. Reg. § 1.267-1T(b)(1), a controlled group includes foreign affiliated corporations. Thus, F1 and F2 are considered members of the P controlled group for purposes of applying the deferral rules of I.R.C. § 267(f).

Under the normal deferral rules of Treas. Reg. § 1.267(f)-1T(c)(1), the deferred intercompany transaction rules of Treas. Reg. § 1.1502-13 (as in effect prior to July 12, 1995, i.e., the effective date of new Treas. Reg. § 1.1502-13) apply to the deferral and restoration of loss on the sale of property between members of a controlled group.

Under these rules, the loss incurred by F1 upon the sale of the F2 stock to S3, which was deferred, would normally be restored to F1 when it left the group on Date 4 (when it was sold by S3 to X). Treas. Reg. § 1.1502-13(f)(1)(iii). However, Temp. Treas. Reg. § 1.267(f)-1T(c)(6) provides that this restoration rule shall not apply. Instead, S3's basis in the stock of F2 is increased by the amount of the deferred loss that was not restored to FI. Temp. Treas. Reg. § 1.267(f)-1T(c)(7)(i). Therefore, such loss would be claimed by the P group when S3 sold the F2 stock to Y. In other words, the P group properly applied the deferral and restoration rules of I.R.C. § 267.

I.R.C. § 269:

LAW AND ANALYSIS:

Law:

Section 269(a)(1) provides that if any person acquires, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

Analysis:

In this case, S3 directly acquired control of F2, by purchasing all of its stock. Therefore, the first requirement of I.R.C. § 269(a)(1) appears to be satisfied. We note, however, prior to the sale, S3 indirectly owned all of the F2 stock (through F1).

The legislative history of the predecessor of I.R.C. § 269 states as follows with respect to the acquisition test:

> If a controlled or affiliated group existed on [the effective date of the provision], transfers thereafter within the group could not amount to the acquisition of such control by the parent or its controlling interest. Control once acquired could not again be acquired, unless the group were in some way broken. A mere shift in the form of control - from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect - can not, therefore, amount to the acquisition of control within the meaning of [the provision].

Sen. Rep. No. 627, 78th Cong., 1st Sess., pp. 60-61 (1943), 1944 C.B. 971, 1017.

Therefore, S3's purchase of the F2 stock can not meet the definition of control within the meaning of I.R.C. § 269 since S3 indirectly controlled F2 prior to the sale. In addition, the legislative history further discusses transfers within a controlled group, as follows:

> If instead of shifting the stock of a subsidiary nearer the parent as in a [I.R.C. § 332] liquidation, it is transferred farther down the chain of subsidiaries [,] it is clear that these subsidiaries farther down the chain (but not the parent or the subsidiaries up the chain) do acquire control of the shifted subsidiary.

Id. at 1944 C.B. 1018.

Since the shift in this case is up the chain and not down the chain, the legislative history is clear that the I.R.C. § 269 control requirement cannot be satisfied in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Step Transaction

As noted above, the $a that was dropped through F1 to F2 on Date 2 had the effect of increasing S3's basis in F1 and F1's basis in F2. This $a is recovered by P as part of a $b loss on the sale of F1 on Date 4 and again recovered by P on the sale of F2 in Year 2 (because of I.R.C. § 267(f)) as part of a $v loss. Thus, you contend that P recovered twice its $a investment in its Country X subsidiaries. First, when it sold F1 to X and second when it sold F2 to Y. Therefore, you contend that this double recovery of a single economic investment is abusive.

By contrast, you believe that if the Service were to recast the $a contribution as a contribution from S3 directly to F2 (after F1 sold F2 to S3), the abuse is eliminated. F1's basis in F2 is reduced by $a, which reduces F1's loss on the sale of F2 to S3 by $a. Thus, S3's basis in F2 upon the sale of F1 (due to I.R.C. § 267(f)) is not increased by $b but instead only by $a. S3's basis in F2 is increased by $a due to the recast (an $a equity subscription by S3 in F2) and S3 (and the P group) recovers the $a investment in Year 2 when they sell F2 outside the group.

We continue to adhere to the position stated in our previous FSA that there is no basis for applying the step transaction doctrine to ignore the capital contributions by S3 to F1 and by F1 to F2.

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). The step transaction doctrine allows the Service to argue that certain economically meaningless steps of a transaction can be collapsed or ignored.

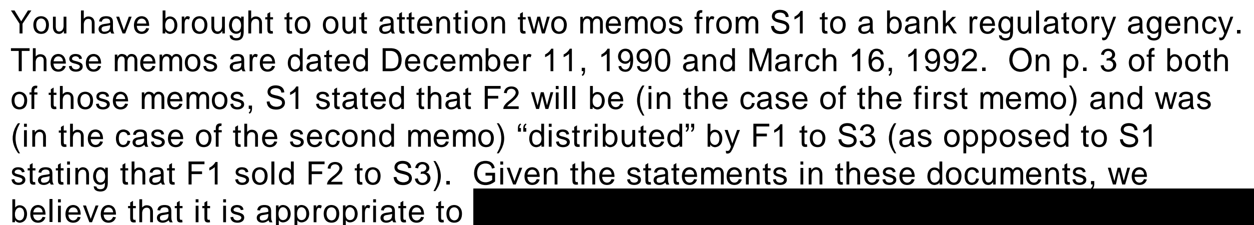
In this case, as noted in the previous FSA, you have not suggested any steps, let alone any economically meaningless ones, that can be collapsed or ignored. Rather, you have simply suggested that certain steps (the capital contribution from F1 to F2 of the money F1 received from S3) be reordered (by treating that contribution as occurring from S3 to F2 after F1 transferred the F2 stock to S3, see the next paragraph). However, as noted therein, the Tax Court rejected a similar approach in the case of Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989). Therefore, we do not believe such an approach would be any more successful here.

Normally, a capital contribution, by definition, has economic substance because the shareholder is transferring money to its corporation (and, thus, the shareholder no longer directly controls such money). Generally, a payment by a shareholder of a corporation's obligation which the shareholder guaranteed is treated as a capital contribution. See Treas. Reg. § 1.166-9(c). In this case, S3 had an obligation under bank regulatory provisions to maintain certain reserve requirements for F2. Thus, S3 made a contribution down the chain to meet those requirements.

However, you believe that this contribution should not be respected because S3 was not required, under these regulatory provisions, to contribute money to F1. Rather, S3 was only required to contribute money to F2. However, we believe that S3's obligation to F2 was in effect an obligation to transfer money down the corporate chain to F2. This is particularly the case in view of the fact that S3's obligation to F2 presumably only arose as a result of its indirect ownership of F2 (in which S3 owned F1 which owned F2). Moreover, if there had been no planned sale of F2, S3 would not have been able to satisfy its obligation except by contributing money down the chain (unless the Service were to argue that S3 made a nonshareholder capital contribution to F2, which we do not consider to be a compelling characterization of the contribution). Therefore, we believe that the transfer of money down the chain should be respected.

Sale v. Distribution of the F2 stock

You have brought to out attention two memos from S1 to a bank regulatory agency. These memos are dated December 11, 1990 and March 16, 1992. On p. 3 of both of those memos, S1 stated that F2 will be (in the case of the first memo) and was (in the case of the second memo) "distributed" by F1 to S3 (as opposed to S1 stating that F1 sold F2 to S3). Given the statements in these documents, we believe that it is appropriate to



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If the transfer is indeed a distribution, then by definition it would not be a sale. In that case, I.R.C. § 267 would not apply. Moreover, S3's basis in the stock of F2 would not be increased, as described above, under that section. Rather, S3's basis in the F2 stock would depend upon whether the distribution was taxable or tax-free to S3.

If the distribution were taxable, then under I.R.C. § 301(d), S3's basis in the F2 stock would be its fair market value as of the date of the distribution. I.R.C. § 301(b)(3). In that case, S3 would recognize no gain or loss upon the subsequent

sale of the F2 stock. Thus, S3 would only recognize a loss upon the sale of the F1 stock.

On the other hand, if the distribution were tax-free under I.R.C. § 355, then S3's basis in the stock of F1 (after taking into account the capital contribution from S3) would be allocated between F1 and F2 according to the relative fair market value of each entity. Treas. Reg. § 1.358-2(a)(2). [redacted]. In any event, after S3 had sold the stock of both F1 and F2, it would have the same total loss as described in the previous paragraph.