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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JOHN GUARNIERI
SPECIAL TRIAL ATTORNEY CC:LM:MCT:SLPHI

FROM: Associate Chief Counsel (Corporate) CC:CORP

SUBJECT: Bankruptcy of a Member of a Consolidated Group

This Chief Counsel Advice responds to your memorandum dated May 11, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp A =

Corp B =

Corp C =

Corp D =

Corp E =

Corp F =

Corp G =

Partnership =

Taxable Year 1 =

Taxable Year 2 =

Taxable Year 3 =

Taxable Year 4 =

U =

V =

W =

X =

Y =

Z =

Business T =

ISSUES

1. Whether the bankruptcy of a member of a consolidated group causes its partnership items to convert to non-partnership items for non-partner members of the group that have an interest in the items as a result of having been included in the group's consolidated return.

2. Whether a corporation ("downstream corporation") that receives substantially all of the former common parent corporation's assets in a downstream merger becomes the agent for the group for the tax years prior to the merger.

> 2A. What is the nature and scope of the downstream corporation's power as agent.

3. Whether the downstream corporation will be considered to have received substantially all of the assets of the former parent, for purposes of Treas. Reg. § 1.1502-75(d)(2)(ii), if a number of the assets of the former parent were conveyed to a shareholder of a few years before the downstream merger.

4. Whether the filing of a bankruptcy petition by the downstream corporation stays the running of the statute of limitations against all members of the old group that are not part of the bankruptcy.

> 4A. In the event that the automatic stay does not suspend the statute of limitations for the non-bankrupt subsidiaries, does the downstream corporation have the authority to enter into a "Sutton Agreement" for the tax years prior to the merger.

CONCLUSIONS

1. The bankruptcy of a corporation holding a separate interest in a partnership will convert its partnership items to nonpartnership items. After these items convert to nonpartnership items, the other members of the consolidated filing group who are

severally liable for these items will no longer have their tax liability determined by reference to these items as "partnership items." Thus, the other members of the consolidated group will no longer be considered "partners" under § 6231(a)(2)(B) with respect to the bankrupt corporation's separately held items. The above rules apply to the present case as follows:

Corp G and Corp B filed petitions in bankruptcy. Thus, the separately held partnership items of each in Partnership converted to nonpartnership items. This also converts these same items for any member of the consolidated filing group whose income tax liability is determined by taking these items into account.

2 and 2A. Section 1.1502-75(d)(2)(ii) provides that a group remains in existence, even if its former common parent is no longer the common parent, if the members of the affiliated group succeed to and become the owners of substantially all of the assets of such former parent and there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent ceases to exist.

Under these facts, Corp G is the successor common parent of the group with full authority to act for the group for periods before and after the downstream merger.[1]

3. As mentioned above, section 1.1502-75(d)(2)(ii) provides that a group remains in existence, even though its former common parent is no longer the common parent, if the members of an affiliated group succeed to and become the owners of substantially all of the assets of such former parent. As there is no conclusive evidence that the disposition of the assets and the downstream merger are part of one integrated transaction, the group will be considered to have received substantially all of the assets of the former common parent, thereby satisfying the requirements of § 1.1502-75(d)(ii).

4. The assessment period for the tax liability of the debtor is suspended pursuant to § 6503(a)(1) if a timely notice of deficiency is issued during the bankruptcy case. The suspension of the assessment period will last as long as the period for filing the Tax Court petition is suspended plus 60 days. The Tax Court petition period will remain suspended until the automatic stay is no longer in effect, which in a Chapter 11 case will ordinarily occur when the bankruptcy case is dismissed or a discharge is granted as a result of the confirmation of the Chapter 11 plan. B.C. § 362(c)(2), 1141(d).

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[1] A question has been raised as to whether the consolidated group would be estopped from denying that the downstream corporation is the agent of the group for years prior to the merger because the downstream corporation represented that it was the agent of the group under Treas. Reg. § 1.1502-75(d)(2). Because we have concluded that Corp G is the common parent of the group and therefore authorized to act as its agent for all tax periods, we offer no opinion on this issue.

4A. The debtor became the common parent of the group (see issue 2 above), and was a member of the group during Taxable Year 1. Thus, the assessment period would be suspended for the nondebtor subsidiaries under § 6503(a)(2) to the same extent the assessment period is suspended for the debtor.

FACTS

In February of Taxable Year 1, Corp C and Corp B, formed a partnership with other unrelated companies. The Service determined that the partnership transaction was, in effect, a disguised sale of the assets of Corp C and Corp B, and issued a Final Partnership Administrative Adjustment (FPAA) to the partnership for Taxable Year 1. Corp C filed a petition with the Tax Court as the partner other than the tax matters partner in response to the FPAA. Corp C's motion for summary judgment filed in the partnership case was denied and an interlocutory appeal was filed with the Court of Appeals which dismissed the case for lack of appellate jurisdiction in Taxable Year 4.

Corp D, the parent of Corp B and Corp C, filed a consolidated tax return for Taxable Year 1. Corp B and Corp C were included, as affiliates, in the Taxable Year 1 consolidated return. In addition, U other affiliates were identified in the return. Of the total V members of the consolidated group, at least W members (potentially X members) that were part of the Taxable Year 1 group are still in existence today.

In Taxable Year 2, Corp D transferred Y subsidiaries to a newly formed corporation, Corp E, and then spun off Corp E to Corp D's CEO and a family partnership.

In early Taxable Year 3, several persons, alleged to have been injured by Business T products filed a lawsuit claiming that the Taxable Year 2 spinoff was a fraudulent conveyance. To the best of our knowledge, this suit is still pending before the United States District Court.

Also in Taxable Year 3, Corp D underwent another reorganization which took the form of several downstream mergers. Prior to the mergers in Taxable Year 3, Corp D owned Corp A , which in turn owned Corp F. Corp F owned Corp C, which in turn owned a number of subsidiaries, including Corp B and Corp G.

In October of Taxable Year 3, Corp D merged into Corp A in a downstream merger. On the same date, Corp A merged into Corp F in a downstream merger. Subsequently, Corp F merged into Corp C in downstream merger.

In November of Taxable Year 3, Corp C merged into Corp G in a downstream merger.

Prior to the downstream mergers described above, Corp D did not designate a new agent for the group as required by Treas. Reg. § 1.1502-77(d), nor have the remaining members of the group designated a new agent.

In January 5 of Taxable Year 4, Corp G filed a chapter 11 bankruptcy petition. None of Corp G's subsidiaries were included in the bankruptcy filing.

In March of Taxable Year 4, Corp G sent a letter to the Justice Department, wherein it stated that "Pursuant to the downstream merger in late Taxable Year 3, Corp G became the common parent corporation of the consolidated group under Treas. Reg. § 1.1502-75(d)(2)."

In August of Taxable Year 4 Corp B filed for bankruptcy.

LAW AND ANALYSIS

Issue 1

When a partner files a petition in bankruptcy, its partnership items are treated as nonpartnership items. I.R.C. §§ 6231(b)(1)(D), 6231(c)(1)(E) and Temp. Treas. Reg. § 301.6231(c)-7T(a). The items "become nonpartnership items" for the taxable year of the bankruptcy petition and all prior years. Id. This prevents a partner's bankruptcy from staying a TEFRA Tax Court proceeding for other partners 1502.77-00, 1502.98-00, 6229.07-00, 6503.06-00 in the same partnership. Computer Programs Lambda Ltd. v. Commissioner, 89 T.C. 198 (1987).[2]

Section 6231(a)(2)(B) defines a "partner" who will be bound by TEFRA partnership proceedings as including both partners in the partnership and "any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." Thus, § 301.6231(a)(2)-1T(a) provides that a spouse who files a joint return with an individual holding a separate interest in a partnership shall be treated as a "partner" by virtue of her joint liability for her spouse's partnership items. Similarly, a nonpartner corporation is treated as a "partner" for purposes of the TEFRA procedures if it files a consolidated return making it severally liable for partnership items of a member of the consolidated filing group.

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[2] 11 U.S.C. § 362(a)(8) stays proceedings "concerning the debtor." Once the bankrupt partner's items convert, the partner is no longer a party to the TEFRA proceeding pursuant to section 6226(d)(1)(A). Thus, the TEFRA proceeding will no longer "concern the debtor" within the meaning of the bankruptcy stay under 11 U.S.C. § 362(a)(8).

In Callaway v. Commissioner, 231 F.3d 106 (2d Cir. 2000), the U.S. Court of Appeals for the Second Circuit considered § 301.6231(a)(2)-1T in holding that a wife was not bound by the outcome of a unified partnership proceeding where her husband's partnership items converted to nonpartnership items during the proceeding. The partnership interest at issue in Callaway was the husband's separate property. The court reasoned that the wife was treated as a partner under the regulation only because she filed a joint return with a person who owned a partnership interest; therefore, her tax liability was determined in part by taking into account partnership items. Once the husband's partnership items converted to nonpartnership items, the wife's tax liability was no longer affected by any partnership items and there was no longer any reason for her to participate in or be bound by the partnership proceedings.[3]

In so holding, the Callaway court distinguished Dubin v. Commissioner, 99 T.C. 325 (1992). In Dubin, the Tax Court held that a wife was bound by the outcome of a unified partnership audit proceeding even though her husband's partnership items converted to nonpartnership items prior to the conclusion of the proceeding. In Dubin, unlike Callaway, the husband and wife owned the interest in the partnership as joint property. Therefore, each was treated as having a share of partnership items that could be affected by the partnership proceeding independently of the other's share.

The Service intends to follow the holding of Callaway in future cases. Consequently, the bankruptcy of a corporation holding a separate interest in a partnership will convert its partnership items to nonpartnership items. After these items convert to nonpartnership items, the other members of the consolidated filing group who are severally liable for these items will no longer have their tax liability determined by reference to these items as "partnership items." Thus, the other members of the consolidated group will no longer be considered "partners" under section 6231(a)(2)(B) with respect to the bankrupt corporation's separately held items. The above rules apply to the present case as follows:

Corp G and Corp B filed petitions in bankruptcy. Thus, their separately held partnership items in Partnership converted to nonpartnership items. This also converts these same items for any member of the consolidated filing group whose income tax liability is determined by taking these items into account.

Issues 2 and 2A

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[3] In the lower Tax Court opinion in Callaway , T.C. Memo 1998-99, the Tax Court held that the bankruptcy of the spouse who held a separate interest in the partnership did not convert the items of his spouse who was treated as a "partner" solely by virtue of her filing a joint return.

In October of Taxable Year 3, Corp D merged into Corp A in a downstream merger. On the same date, Corp A merged into Corp C in a downstream merger. In November of Taxable Year 3, Corp C merged into Corp G in a downstream merger. As a result of these transactions Corp G directly owned the stock of Corps B and F, and no other corporation owned more than 80 percent of the stock of Corp G.

Generally, § 1.1502-75(d)(1) provides that a group remains in existence for a tax year if the common parent remains as the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the year. Section 1.1502-75(d)(2) provides certain exceptions to the general rule that a group's continuation is dependent on the continued existence of the common parent.

Section 1.1502-75(d)(2)(ii) provides that a group shall be considered as remaining in existence notwithstanding that the common parent is no longer in existence if the members of the affiliated group succeed to and become the owners of substantially all of the assets of such former parent and there remains one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent ceases to exist.

In the case before us, after the downstream mergers, all of the old common parent's assets remained in the group, and there remained an affiliated group with a common parent which is an includible corporation and which was a member of the group prior to the date of the merger, Corp G. While the language of § 1.1502-75(d)(2)(ii) does not specifically state which corporation will be the group's successor common parent after a qualifying transaction, we believe that the language "connected through stock ownership with a common parent corporation" clearly means that the corporation that is at the top of the chain of affiliation after the transaction(s) is the group's new common parent. Accordingly, Corp G succeeded Corp D as the group's common parent.[4] In Southern Pacific Co v. Commissioner, 84 T.C. 395 (1985), the tax court held that the successor common parent in a reverse acquisition was the common parent for years both before and after the transaction. In our view, the same analysis should apply in the downstream merger context. Therefore, under the Southern Pacific rationale, Corp G is the agent of the group for both pre- and post-transaction years.

Issue 3

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[4] Actually, Corp G immediately succeeded Corp C as the group's common parent, which had in turn succeeded Corp A, which was the common parent after Corp D merged into it.

In Taxable Year 2, Z years prior to the downstream mergers, Corp D transferred Y subsidiaries to a newly formed corporation, Corp E, and then spun off Corp E to Corp D's CEO and a family partnership. In a lawsuit unrelated to these proceedings, claimants have alleged that the spinoff of Corp E was a fraudulent conveyance.

As discussed above, § 1.1502-75(d)(2)(ii) provides an exception to the general group continuation rule of § 1.1502-75(d)(1). To qualify under the exception, the group must succeed to substantially all of the assets of its former common parent. Although there is no guidance on the meaning of "substantially all" under § 1.1502-75(d)(ii), we believe that for purposes of determining the assets of Corp D, any assets disposed of in unrelated transactions will not be considered Corp D assets. On the other hand, assets disposed of as part of the same plan as the downstream merger would be considered part of Corp D's assets for the purposes of determining "substantially all" under § 1.1502-75(d)(2)(ii).

The disposition in question here, the spinoff in Taxable Year 1, occurred Z years prior to the downstream merger. Without more to link the spinoff with the downstream merger than merely the litigants' fraudulent conveyance claims in the unrelated dispute, we would not include the spun off assets as part of Corp D's assets for the purposes of § 1.1502-75(d)(2)(ii). Therefore, in our view the "substantially all" requirement is met.

<u>Issues 4 and 4A</u>

4. Whether the filing of a bankruptcy petition by Corp G (referred to below as the "debtor") suspends the running of the statute of limitations against all the affiliates that joined in the Taxable Year 1 consolidated tax return (the "nondebtor subsidiaries") even though they are not part of the bankruptcy.

4A. In the event that the automatic stay does not suspend the statute of limitations for the nondebtor subsidiaries, does the debtor have the authority to enter into a "Sutton Agreement" for the tax years prior to the merger?

A consolidated return was filed for Taxable Year 1 by the group, which consisted of V entities. In late Taxable Year 3, the debtor became the successor to the common parent that filed the Taxable Year 1 return through a series of downstream mergers. A spinoff previously occurred in Taxable Year 2 involving Y subsidiaries, ownership of which was transferred to an individual and a family corporation. In Taxable Year 4, the debtor filed a chapter 11 bankruptcy petition.

The filing of a bankruptcy petition does not by itself result in a suspension of the period for making an assessment. Section 6503(h) suspends this period if the Service is prohibited from making an assessment as a result of a case under Title 11. However, the automatic stay which goes into effect as of the filing of the bankruptcy petition does not prohibit the making of a tax assessment. B.C. § 362(b)(9)(D). The Bankruptcy Code was amended by the Bankruptcy Reform Act of 1994 to permit tax assessments. This amendment is effective for bankruptcy cases filed on or after the date of enactment, October 22, 1994. Prior to the 1994 amendments, tax assessments were prohibited by the automatic stay and, therefore, the IRC § 6501 period was suspended by IRC § 6503(h). Thus, IRC § 6503(h) does not suspend the IRC § 6501 period in the present case.

If a timely notice of deficiency is issued while the automatic stay is in effect, the IRC § 6501 period may be indirectly suspended as a result of bankruptcy. This is because the automatic stay bars the commencement or continuation of Tax Court proceedings concerning the debtor. B.C. § 362(a)(8). With the automatic stay preventing the taxpayer from petitioning the Tax Court, the taxpayer's period for filing a Tax Court petition is suspended pursuant to IRC § 6213(f)(1), and the Service is precluded from making an assessment pursuant to IRC § 6213(a) prior to the expiration of the period for filing a Tax Court petition. This has the effect of suspending the IRC § 6501 period pursuant to IRC § 6503(a)(1).

In summary, the assessment period for the tax liability of the debtor is suspended pursuant to IRC § 6503(a)(1) if a timely notice of deficiency is issued during the bankruptcy case. The suspension of the assessment period will last as long as the period for filing the Tax Court petition is suspended plus 60 days. The Tax Court petition period will remain suspended until the automatic stay is no longer in effect, which in a Chapter 11 case will ordinarily occur when the bankruptcy case is dismissed or a discharge is granted as a result of the confirmation of the Chapter 11 plan. B.C. §§ 362(c)(2), 1141(d).

The consideration as to whether § 6503(a)(2) applies turns on the status of the debtor under the consolidated return regulations. Since the debtor was a member of the group in Taxable Year 1 and became the group's common parent under § 1.1502-75(d)(2)(ii), it is the agent for the non- bankrupt subsidiaries with respect to the consolidated return for Taxable Year 1 and would thus be precluded under the automatic stay from filing a petition in the Tax Court. Therefore, as discussed above, the assessment period will be suspended for the nondebtor subsidiaries under § 6503(a)(2) to the same extent the assessment period is suspended for the debtor.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Please call if you have any further questions.

Associate Chief Counsel (Corporate)
By: GERALD FLEMING
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel
(Corporate)

CC: