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memorandum

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subject: Duplicated Loss in Transactions Not Subject to §1.1502-35T

This Chief Counsel Advice responds to your request for non-taxpayer specific advice dated January 21, 2001. In accordance with section 6110(k)(3), this Chief Counsel Advice may not be used or cited as precedent.

ISSUE

If an economic loss is reflected in the asset of a subsidiary and in the subsidiary's stock, can the consolidated group recognize a loss on the disposition of the subsidiary's stock, as well as the disposition of the loss asset?

CONCLUSION

No. If a member of a consolidated group recognizes a loss on the disposition of subsidiary stock after March 6, 2002, duplication of the underlying economic loss is prohibited by §1.1502-35T of the Income Tax Regulations. In the case of a loss recognized by a member on the disposition of subsidiary stock that is not subject to §1.1502-35T, if the stock loss is (or was) attributable to the same economic loss for which the group claimed (or claims) a deduction or loss, the duplicative loss shall be disallowed under the principles of §1.1502-32(e), the doctrine of Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934), as well as any other applicable arguments.

BACKGROUND

Under §1.1502-32 (the investment adjustment system), each member of a consolidated group adjusts its basis in subsidiary stock to reflect the subsidiary's items of income, gain, deduction and loss (the "subsidiary's items") that are taken into account by the group. The purpose of the investment adjustment system is to ensure the clear reflection of the group's income, including by preventing the group from bearing the tax burden, or enjoying the tax benefit, more than once for a subsidiary's items. See §1.1502-32(a)(1). To illustrate, assume P, the common parent of a consolidated group, forms S with $100 and S then earns $20. The P group will include S's $20 in the group's taxable income and P will increase its basis in S to $120 to reflect the $20 that the P group has taken into account. Thus, if P were then to sell its S stock, P would not be taxed again on the same $20 gain.

Section 1.1502-32 is concerned only with the application to subsidiary stock basis of items that have been taken into account by the group. Thus, if a group recognizes gain or loss on subsidiary stock before the subsidiary's underlying items have been taken into account, §1.1502-32 does not address the duplication. Consider the following example:

Example #1: Outside (stock) loss precedes inside (asset) loss

In Year 1, P, the common parent of a consolidated group, forms S with a contribution of $80 in exchange for all 80 shares of the S common stock (the "Year 1 shares"). In Year 2, P contributes land to S with a basis of $120 and a value of $20 in exchange for 20 additional shares of S common stock (the "Year 2 shares"). In Year 3, P sells the Year 2 shares to an unrelated party for $20, recognizing a $100 loss that offsets P's income on the return. The sale does not deconsolidate S. In Year 4, S sells the land for $20, recognizing a $100 loss that offsets P's income on the group's return. The group has thus obtained a $200 tax benefit from the single $100 economic loss.

As illustrated by the above example, loss duplication arises when unrecognized depreciation is disproportionately reflected in the basis of shares of subsidiary stock held by group members. Generally, though not always, this duplication arises when a group member transfers a loss asset (an asset with a basis that exceeds its value) to a subsidiary in exchange for subsidiary stock the basis of which is determined with reference to the transferor's basis in the property transferred. As a result, the economic loss reflected in the asset is also reflected in the subsidiary stock that the transferor member receives in exchange for the asset. As used in this memorandum, the term "loss duplication" refers either to the unrecognized asset loss, the unrecognized stock loss, or both, as the context requires.

If (as in Example #1) shares have been acquired in different transactions, the basis in certain shares may disproportionately reflect an unrecognized loss. Because §1.1502-32 allocates positive basis adjustments pro rata to all shares within a class, even if the subsidiary's items are taken into account before the group recognizes gain or loss on a sale of the subsidiary stock, §1.1502-32 will be unable to prevent the duplication of loss, as in the following example:

Example #2: Inside (asset) loss precedes outside (stock) loss

Assume the same facts as in Example 1, except that in Year 3 S sells the land for $20, recognizing a $100 loss that offsets P's income on the consolidated return. Under the investment adjustment rules of §1.1502-32, P's basis in the Year 1 shares is reduced to $0 ($80 starting basis less 80% of the $100 loss taken into account) and its basis in the Year 2 shares is reduced to $100 ($120 starting basis less 20% of the $100 loss). In Year 4, P sells the Year 2 shares to an unrelated party for $20 (the fair market value of 20% of S), recognizing an $80 loss. The group has thus obtained a $180 tax benefit from the single $100 economic loss.

As illustrated by the above example, the investment adjustment rules of §1.1502-32 alone do not prevent loss duplication in all cases. Moreover, as discussed more fully below, §1.1502-32 is not a comprehensive system for addressing all forms of duplication and so other rules and principles must also be taken into account.[1]

DISCUSSION

I. THE ILFELD DOCTRINE

A. Charles Ilfeld Co. v. Hernandez

The seminal case addressing the duplicative deduction of an economic loss is Charles Ilfeld Co. v. Hernandez. 292 U.S. 62 (1934). In Ilfeld, the Supreme Court considered whether the common parent of a consolidated group was entitled to a loss deduction with respect to its investment in two subsidiaries. Id. at 65. The subsidiaries had incurred operating losses over a number of years, which were used to offset the parent's income on the group's consolidated

[1] Note that the consolidated return system permits a limited amount of duplication. This duplication is the result of the fact that 100% of a subsidiary's items must be taken into account by the group, but only 80% of a subsidiary's stock must be owned by group members in order for the subsidiary to join in the group's return. For example, assume P, the parent of a consolidated group, owns 80% of the stock of S with a basis of $80. If S earns $10, the P group will report all $10 on its return and P will increase its basis in S stock by $8, the proportion of S's earnings attributable to those shares. If P then sells its S stock, it will recognize no further gain or loss on the stock because P's basis in the S stock ($88) is equal to the S stock's value ($88). On the other hand, if S had recognized a loss of $10, the P group would have reported the entire amount on its return, and P would have reduced its basis in its S stock by $8, the proportion of the loss attributable to those shares. Again, if P then had sold its S stock, P would have recognized no further gain or loss because P's basis in the S stock ($72) would have been equal to the S stock's value ($72). In both cases, however, the P group has actually taken into account more gain (or loss) than P actually realized on its investment in the S stock. This limited duplication, arising from the mechanical application of the Code, is not the subject of this memorandum, and should not be disallowed under the principles discussed herein.

return. Id. at 63. Subsequently, the subsidiaries sold all their assets, paid off debts, and then distributed the remaining proceeds to the parent in liquidation. Id.

Examining the consolidated return regulations then in effect, the Supreme Court reasoned that the distributions had occurred during the consolidated return period and thus constituted intercompany transactions for which no deduction was allowed. Id. at 67-68. The Court went on to consider the absence of any authority specifically allowing the claimed losses, stating that "[i]n the absence of a provision in the Act or regulations that fairly may be read to authorize it, the deduction claimed is not allowable." Id. at 66. The Court then observed:

> The allowance claimed would permit petitioner twice to use the subsidiaries' losses for the reduction of its taxable income. By means of the consolidated returns in earlier years it was enabled to deduct them. And now it claims for 1929 deductions for diminution of assets resulting from the same losses. If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers.

Id. at 68. Although the discussion of double deductions was, at most, an alternative basis for the decision, the Court affirmed the double deduction proscription almost immediately thereafter in McLaughlin v. Pac. Lumber Co., 293 U.S. 351 (1934).

A long line of cases continued to apply the Ilfeld doctrine in the consolidated return setting. In more recent years, however, the doctrine has generally not been asserted in this context because loss duplication was largely addressed by the consolidated return provisions.

Outside the consolidated return context, the Ilfeld doctrine thrived, most notably with the Supreme Court decision in United States v. Skelly Oil Co., 394 U.S. 678 (1969) (applying Ilfeld in a case arising under the claim of right doctrine). The Skelly Oil reformulation of the Ilfeld doctrine has attained the status of a general canon of statutory construction. See Transco Exploration Co. v. Commissioner, 949 F.2d 837, 840-41 (5^{th} Cir. 1992) ("Skelly and Charles Ilfeld offer an important canon of statutory construction: whenever possible, tax provisions should be interpreted so as to avoid the practical equivalent of double deductions"). Lower courts have applied the reformulation in a variety of cases extending beyond the context of corporations filing consolidated returns. See, e.g., United Telecommunications, Inc. v. Commissioner, 589 F.2d 1383 (10^{th} Cir. 1978) (interpreting Treasury regulations describing the computation of the investment tax credit so as to avoid a double deduction); S/V Drilling Partners v. Commissioner, 114 T.C. 83 (2000) (applying Ilfeld and Skelly Oil to deny a double nonconventional fuel source credit under section 29). Courts have even extended the doctrine beyond the realm of income taxes. See, e.g., Estate of Sachs v. Commissioner, 856 F.2d 1158 (9^{th} Cir. 1988) (denying estate tax deduction for refunded income tax payment under Ilfeld and Skelly Oil principles).

B. Continued Vitality of the Ilfeld Doctrine

Despite the long line of cases affirming the continued vitality of the Ilfeld doctrine, taxpayers have argued that the recent decision in Gitlitz v. Commissioner, 531 U.S. 206 (2001) has substantially undercut the Ilfeld doctrine. This argument fails to recognize that, although the Gitlitz court declined to apply the Ilfeld doctrine, the rationale for its decision is fully consistent with Ilfeld.

The primary issue before the Court in Gitlitz was whether the shareholders of an S corporation were permitted to increase their bases in their S corporation stock by the S corporation's discharge of indebtedness (DOI) that was excluded from gross income under sections 108(a) and 108(d)(7)(A).[2] The Court held not only that the shareholders were entitled to increase their basis in their stock, but also the basis increase occurred before the reduction of the S corporation's tax attributes required by section 108(b). Id. at 216-218. The Court reached both conclusions based on what it repeatedly described as a plain reading of the applicable statutory provisions. See 531 U.S. 206, 220 n.10. (citing specific statutory language in section 108 as amended by Congress in 1984 that the Court construed as allowing the benefits claimed by the taxpayer).[3]

As discussed above, Ilfeld is a doctrine of statutory construction that is properly applied only in instances where the duplicative tax benefit is not expressly authorized by statute or regulation. Because the Court in Gitlitz concluded that the tax benefits sought by the taxpayers were authorized under the Code, the Court did not need to reach the application of Ilfeld. Gitlitz thus comports with the Supreme Court's first pronouncement of the rule in Ilfeld that "[i]n the absence of a provision in the Act or regulations that fairly may be read to authorize it, the deduction claimed is not allowable," Ilfeld, 292 U.S. at 66, as well as Skelly Oil's reiteration that "the Code should not be interpreted to allow ... 'the practical equivalent of double deduction,' absent a clear declaration of intent by Congress." 394 U.S. at 684 (citations omitted).

C. Application of Ilfeld in the Consolidated Return Setting

1. Woods Investment, Wyman-Gordon,

[2] In Gitlitz, an S corporation realized DOI income, which was excluded from gross income under sections 108(a) and 108(d)(7)(A) because of the S corporation's insolvency. 531 U.S. at 210. The S corporation's shareholders increased their bases in their stock by their pro rata share of the corporation's DOI on the theory that the DOI was an "item of income" within the meaning of section 1367(a)(1)(A), and therefore subject to the pass-thru provisions of section 1366(a)(1)(A). Id. at 209. The shareholders also took the position that the pass-thru and basis increase occurred before the reduction of the S corporation's tax attributes (required by section 108(b) as the price for the section 108(a) income exclusion). Id. at 216-217. As a result, the shareholders claimed they were entitled to use losses and deductions from prior years that had been suspended under section 1366(d). Id. at 210.

[3] Congress reversed the result in Gitlitz by amending section 108(d)(7)(A) as part of The Job Creation and Worker Assistance Act of 2002, P.L. 107-147, 116 Stat. 21. That section provides that an S corporation's DOI that is excluded from income is not to be taken into account as an item of income by any shareholder, and thus does not increase any shareholder's basis in S corporation stock.

and CSI Hydrostatic Testers

A trio of Tax Court cases is sometimes characterized as evidence that the Ilfeld doctrine had grown increasingly inapplicable to taxpayers filing consolidated returns. While the Tax Court declined to apply the Ilfeld doctrine to disallow deductions in two of these three cases, it did so for reasons that are fully consistent with the legal standard set forth in Ilfeld, viz., that taxpayers are not entitled to a loss or deduction that is economically duplicative of a prior deduction unless a Code or regulatory provision explicitly authorizes the duplicative benefit.

In Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985), acq., 1986-2 C.B. 1, the common parent of a consolidated group challenged an IRS determination that the parent had improperly determined its basis in the stock of three subsidiaries for purposes of reporting gain on the sale of the subsidiaries' stock. During the period that the subsidiaries were members of the consolidated group, the subsidiaries had claimed accelerated depreciation deductions. Id. at 276. In computing the earnings and profits (E&P) of the subsidiaries (which, in turn, affected the parent's computation of its basis in such stock under former §1.1502-32), the parent applied section 312(k), reducing E&P only by the amount of straight-line depreciation rather than the accelerated depreciation actually taken. Id. at 278. Relying on Ilfeld and §1.1016-6(a) (requiring basis adjustments to eliminate double deductions), the Service argued that the taxpayer was required to reduce its basis in the subsidiaries' stock by the excess of accelerated over straight-line depreciation, in order to prevent the group from obtaining what amounted to a double deduction. Id. at 279.

The Woods Investment court found the Service's reliance on Ilfeld misplaced, reasoning that, in Ilfeld, there was no applicable regulation specifically allowing the deduction. 85 T.C. at 282. Instead, the Woods Investment court found that §1.1502-32 comprehensively addressed the problem before it and, thus, effectively authorized the double deduction by reason of §1.1502-32 in conjunction with section 312(k). Id. at 283.[4]

Shortly after deciding Woods Investment, the Tax Court again considered the application of the Ilfeld doctrine in Wyman-Gordon Co. v. Commissioner, 89 T.C. 207 (1987). The issue in Wyman-Gordon was whether DOI income that was excluded from an insolvent subsidiary's taxable income under section 108(a)(1) should nonetheless be taken into account for purposes of computing E&P and basis adjustments under former §1.1502-32. Id. at 215. If so, any excess loss account (ELA) in the subsidiary's stock would have been eliminated.[5] Answering this

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[4] Congress reversed the holding in Woods Investment by enacting section 1503(e)(1)(A) (providing that, solely for purposes of determining gain or loss on a disposition, a parent corporation's basis in the stock of a consolidated subsidiary is to be determined by computing E&P without regard to sections 312(k) and (n)) as part of The Revenue Act of 1987, P.L. 100-203, 101 Stat. 1330.

[5] In Wyman-Gordon, S2, a member of a consolidated group and the wholly-owned subsidiary of S1, incurred operating losses over several years, which offset income on the group's return. 89 T.C. at 210. The losses also resulted in a deficit in S2's E&P, causing S1 to have an ELA—the equivalent of a negative basis—with respect to its S2 stock. Id. at 211. Because S2 was insolvent at the time, it did not include the DOI in income under section 108(a)(1). Id. Former §1.1502-19 required a member that

question in the negative, the court cited the specific rules under § 1.1502-19 (generally requiring inclusion of an ELA in income upon a disposition of subsidiary stock) as well as the "strong policy" against double deductions in the consolidated return context as set forth in Ilfeld. 89 T.C. at 217-218. The court further noted the absence of an express statement in the regulations about how DOI income factored into the computation of E&P or the ELA. Id. at 218-219.

The Wyman-Gordon court distinguished Woods Investment with the observation that "[t]here exists no comparable statutory provision that requires inclusion of discharge of indebtedness income in earnings and profits in the situation before us ..." Wyman-Gordon, 89 T.C. at 219. Wyman-Gordon thus displays the court's willingness to preclude double deductions in the absence of clear statutory or regulatory authority permitting them.

The Tax Court revisited the Wyman-Gordon issue in CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398 (1994), aff'd per curiam 62 F.3d 136 (5th Cir. 1995), but by this time Congress had enacted section 312(l) as part of the Bankruptcy Tax Act of 1980, P. L. 96-589, 94 Stat. 3389, 3406. Under section 312(l), DOI income was required to be included in E&P for purposes of making investment adjustments under §1.1502-32.[6] Accordingly, the Tax Court found that the issue had become more closely aligned with that in Woods Investment, because the result was specifically provided for in the applicable Code and regulatory provisions. CSI Hydrostatic Testers, 103 T.C. at 410.

Thus, the Tax Court's approach in this trio of cases is consistent with the Supreme Court's pronouncement of the rule in Ilfeld that "[i]n the absence of a provision in the Act or regulations that fairly may be read to authorize it, the deduction claimed is not allowable," Ilfeld, 292 U.S. at 66, as well as the Skelly Oil reiteration that "the Code should not be interpreted to allow … 'the practical equivalent of double deduction,' absent a clear declaration of intent by Congress." 394 U.S. at 684 (citations omitted). Moreover, the Tax Court continues to affirm the vitality of Ilfeld and Skelly Oil as authority for precluding duplicative tax deductions. See, e.g., Alling v. Commissioner, 102 T.C. 323, 332-333 (1994) (prohibiting taxpayers from offsetting straddle losses from closed years against gains in open years as this would amount to a double deduction precluded by Ilfeld); S/V Drilling Partners v. Commissioner, 114 T.C. 83, 89-90 (2000) (citing Ilfeld/Skelly Oil as authority for denying double nonconventional fuel source credit under section 29).

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disposed or was treated as disposing of subsidiary stock (including the case in which the subsidiary realized DOI that was excluded from gross income) to include the balance of any ELA in income immediately before the disposition. Although the DOI was excluded from income, the taxpayer argued that it was nonetheless entitled to take into account the DOI for purposes of computing S2's E&P and S1's basis in the S2 stock under former §1.1502-32, resulting in the reduction and elimination of the ELA. Id. at 215.

[6] The Tax Court explained: "Although the statutory language of section 312(l) is stated in the negative, the legislative history makes it clear that [DOI] income, including amounts excluded from taxable income due to the debtor's insolvency, will increase earnings and profits to the extent a taxpayer's basis in depreciable assets is not reduced." 103 T.C. at 405 (citation omitted).

2. Rite Aid

Addressing loss duplication in instances not within the scope of § 1.1502-32 was one of the two main functions of § 1.1502-20 (the loss disallowance rule, or LDR). In Rite Aid Corp. v. United States, 255 F.3d 1357 (2001), the Federal Circuit invalidated the duplicated loss component of the LDR, which raises the question of whether the application of the Ilfeld doctrine would inappropriately rely on common law principles to accomplish something the Federal Circuit ruled was beyond the Secretary's regulatory authority. The answer is that it does not. In Rite Aid, the Federal Circuit held that the duplicated loss component of the LDR was an improper exercise of regulatory authority because the court found that the operation of the rule could--and on the facts of the case did--prevent a selling group from obtaining any tax benefit from an economic loss. In other words, the case was not about disallowing duplicated loss, but rather about disallowing all loss. Accordingly, the application of the Ilfeld doctrine as set forth in this memorandum does not run afoul of the holding in Rite Aid.

II. LOSS DUPLICATION IS NOT AUTHORIZED BY THE CODE OR REGULATIONS

A. Section 1.1502-32 is Not the Exclusive Means for Addressing Loss Duplication in a Consolidated Group

The holding in Woods Investment does not preclude applying the Ilfeld doctrine to prevent the duplication addressed in this memorandum because §1.1502-32 was not promulgated as the sole means of addressing loss duplication issues in the consolidated return context and, more specifically, the general rule in §1.1502-32 was not promulgated to address loss duplication arising in the cases at issue here. Thus, the general rule in §1.1502-32 does not constitute an authorization of such duplication.

First, it is clear that the IRS and Treasury have not considered §1.1502-32 a comprehensive system to address the duplication of items within a consolidated group. Section 1.1502-32(e)(1) contains an anti-avoidance rule that specifically operates to overrule the general operation of §1.1502-32 in transactions such as Example #2, supra, p. 3. This rule is necessary because §1.1502-32 allocates items based on the premise that each share of stock (at least within the same class) is entitled to a proportionate share of the subsidiary's earnings. Problems arise, however, if unrecognized gain or loss is disproportionately reflected in subsidiary stock basis. Section 1.1502-32(e)(1) addresses this problem by providing that adjustments will be made to further the regulation's purposes where taxpayers have acted with a principal purpose that is contrary to the purposes of §1.1502-32. Example 2, §1.1502-32(e)(2) makes it clear that adjustments may be allocated to shares of stock that disproportionately reflect unrecognized gain and, by extension, loss.

Furthermore, one of the principal purposes of §1.1502-20 was to address loss duplication that was not within the scope of §1.1502-32. When the Federal Circuit rejected the duplicated loss component of §1.1502-20, the gap between section 358 (which determines basis in section

351 exchanges) and the consolidated return provisions—believed to be closed by §1.1502-20—re-emerged. The IRS and Treasury responded swiftly to close the gap by issuing Notice 2002-18 (immediately upon expiration of the time for filing a petition for a writ of certiorari) announcing that new loss duplication regulations would be forthcoming, by proposing §1.1502-35T on October 23, 2002, and by promulgating §1.1502-35T on March 14, 2003 (making it generally applicable to stock transfers and deconsolidations on or after March 7, 2002).

Therefore, this is not a case of the Service failing to correct a technical defect in the interaction of its regulations with Code provisions, as was the case in both Woods Investment and CSI Hydrostatic Testers. Cf. Woods Inv., 85 T.C. at 281 ("we conclude that petitioner reached the result mandated by respondent's consolidated return regulations [§1.1502-32] and section 312(k) in computing its basis in the subsidiaries' stock"); CSI Hydrostatic Testers, 103 T.C. at 410 ("we conclude that our reasoning in both [Woods Inv.] and [Wyman-Gordon] makes clear that the enactment of section 312(l) requires COD income to be included in earnings and profits for purposes of the investment basis adjustment rules of [§]1.1502-32") (citations omitted). Rather, this case is similar to Ilfeld and Wyman-Gordon: no regulatory or statutory provision specifically permits the duplicative deduction and so the deduction is disallowed.

B. General Allowance Provisions do Not Overcome the Ilfeld Presumption Against Duplicative Tax Benefits

It is important to emphasize that Ilfeld and Skelly Oil establish a presumption against duplicative deductions or their equivalent. United Telecommunications, Inc. v. United States, 589 F.2d 1383, 1388 (10th Cir. 1978). To overcome this presumption, a taxpayer must point to a specific statutory authorization for the duplicative benefit. Id. ("the rule is that there must be a specific statutory or regulatory provision authorizing a double deduction in order for it to be permissible"); see also Skelly Oil, 394 U.S. at 684 ("the Code should not be interpreted to allow respondent 'the practical equivalent of double deduction,' absent a clear declaration of intent by Congress") (emphasis added) (citations omitted). Moreover, general allowance provisions such as sections 162 and 165 are insufficient to overcome the Ilfeld presumption. O'Brien v. Commissioner, 79 T.C. 776, 787 (1982), aff'd and remanded on other issues, 771 F.2d 476 (10th Cir. 1985) ("[p]etitioners are ... incorrect in arguing that two independent provisions allowing different credits constitute a specific statutory authorization permitting a double credit"); see also Rome I, Ltd. v. Commissioner, 96 T.C. 697, 704 (1991) ("double deductions (or their practical equivalent) are not allowed even when based on separate and distinct sections of the Code").

In this regard, the Supreme Court's decision in Skelly Oil, 394 U.S. 678 (1969) is instructive. In Skelly Oil, a producer of natural gas had included certain sales receipts in gross income in earlier years, and also included them in its "gross income from the property" for purposes of calculating depletion deductions under section 613. Id. at 679-80. When the taxpayer was required to refund a portion of the receipts in a later year, it claimed a deduction for the full amount on the grounds that the refunds constituted either losses under section 165 or business expenses under section 162. Id. at 680. The Supreme Court cited Ilfeld for the proposition that "the Code should not be interpreted to allow respondent 'the practical equivalent of double deduction,' absent a clear declaration of intent by Congress," Skelly Oil, 394 U.S. at

684 (citations omitted), and then stated that "[w]e cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received." Id. at 686. In holding that the taxpayer was required to reduce the deduction by the percentage depletion previously claimed, the Court declined to interpret either section 162 or 165 as requiring the duplicative benefit claimed by the taxpayer. See also Brenner v. Commissioner, 62 T.C. 878, 884-885 (1974) ("we do not think section 162(a) reflects any [Congressional] intent" to allow a double deduction).

Therefore, as general allowance provisions, sections 165 and 162 neither mandate nor authorize a taxpayer to claim two deductions with respect to one economic loss.

III. APPLICATION OF §1.1502-32(e)(1) AND ILFELD TO EXAMPLES #1 AND #2

For the reasons set forth above, both §1.1502-32(e) and the Ilfeld doctrine can and should be asserted to disallow the loss in Examples #1 and #2.

To begin, in situations similar to Example #2, §1.1502-32(e) should be asserted whenever possible. In such cases, the loss recognized upon the sale or disposition of the land would all be allocated to the Year 2 shares because the transaction was structured in a manner that evidences no purpose apart from producing a distortion of the group's income. The effect of this allocation is to prevent the duplication that would otherwise arise upon the sale of the Year 2 shares.

In addition, in transactions similar to those in both Example #1 and Example #2, Ilfeld principles should be asserted to prevent any duplication not prevented by §1.1502-32(e). It is important to note that the Ilfeld doctrine, unlike §1.1502-20 and §1.1502-35T, is not based on a policy determination that loss is more appropriately allowable with respect to a subsidiary's assets and operations than it is with respect to the subsidiary's stock. Rather, the Ilfeld doctrine is based on the policy determination that a taxpayer (here, the consolidated group) should not receive more than one tax benefit for an economic loss. Thus, the loss that is disallowed may be either (1) the stock loss or (2) the loss or deduction realized by the subsidiary directly, depending on which loss is recognized first, because that determines which loss "duplicates" a loss already taken. An Ilfeld argument should not be asserted to deny the first loss where the later, duplicative loss has not yet been claimed. See Textron, Inc. v. United States, 561 F.2d 1023, 1027 (1st Cir. 1977).[7]

[7] Moreover, Ilfeld applies to deny the second loss regardless of whether the loss claimed in the earlier year was proper. See Alling v. Commissioner, 102 T.C. 323 (1994). In Alling, the Tax Court applied Ilfeld and Skelly Oil to preclude the taxpayers from offsetting gains from commodity tax straddles with losses from the straddles that had been improperly deducted in years barred by the statute of limitations. Id. at 333. The Alling court specifically questioned the vitality of its earlier decision to the contrary in B.C. Cook & Sons, Inc. v. Commissioner, 59 T.C. 516 (1972) (permitting a taxpayer to take a theft loss for amounts previously and erroneously included in cost of goods sold). Alling, 102 T.C. at 333. See also Rev. Rul. 81-207, 1981-2 C.B. 57 (stating that the Service would not follow B.C. Cook & Sons as that case was inconsistent with the Tax Court's more recent decision in Unvert v. Commissioner, 72 T.C. 807, 814 (1979)).

Thus, in Example #1 (outside/stock loss precedes inside loss), because the loss on S's sale of the land duplicates P's prior stock loss, the inside loss is disallowed. In Example #2 (inside/asset loss precedes stock loss), because the stock loss duplicates S's loss on the disposition of the land (which loss was absorbed by the P group), the stock loss is disallowed.

Where the group claims a loss on the disposition of subsidiary stock and the subsidiary leaves the group as a result of such disposition with the underlying economic loss unrecognized (as was the case in Rite Aid), Ilfeld is not to be applied to disallow the stock loss because the group has not--and presumably will not--enjoy the tax benefit of the inside loss. However, if the subsidiary is re-consolidated with the group at a time when the subsidiary still holds the loss asset (or a successor asset) or has a net operating loss that was reflected in the stock loss, then Ilfeld should be asserted to disallow the second loss to the group at that later time.

If you have any questions or need assistance with the issues addressed in this memorandum, please contact Sean P. Duffley or Jay M. Singer, CC:CORP:4, 202-622-7530.