INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 02, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200613034**
Release Date: 3/31/2006

ndex (UIL) No.: 162.00-00
CASE-MIS No.: TAM-161900-04

Director
CTM:1 Field Operations West

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Corporation B =

Agency =

Year A =
Year B =
Year C =
Year D =
Year E =
Date 1 =
Date 2 =
Date 3 =

Date 4 =
Date 5 =
$x =
$y =
$z =
Corporation X =

Subsidiary 1 =

Subsidiary 2 =
Failed Thrift =

Acquiring =

Acquisition Agreement =

Assistance Agreement =

Tax Ruling =

Transfer Agreement =

Merger Agreement =

Tax Settlement Agreement =

a% =
b% =
Intercompany Note =

Binding Clause =

Modifications Clause =

Liquidity Account =

SR Accounts =

SRA I =

SRA II	=
SRA I Debit(s)	=
SRA I Credit(s)	=
SRA II Debit(s)	=
SRA II Credit(s)	=
Tax Benefits	=
Agency Payments	=

ISSUE:

Whether the tax benefit sharing amounts remitted to Agency in Years C, D, and E are deductible under § 162 of the Internal Revenue Code as ordinary and necessary business expenses.

CONCLUSION:

The tax benefit sharing amounts remitted to Agency in Years C, D, and E are not deductible under § 162 as ordinary and necessary business expenses.

FACTS:

Acquisition of Failed Thrift

Agency, an instrumentality of the United States Government, was appointed as receiver for Failed Thrift prior to Date 1. On or about Date 1, substantially all of the assets and liabilities of Failed Thrift were acquired by Acquiring in a transaction approved by Agency that, pursuant to the Tax Ruling, was treated as a reorganization within the meaning of §§ 368(a)(1)(G) and 368(a)(3)(D) ("Reorganization 1").[1] Acquiring included Corporation X which was the common parent of an affiliated group of corporations that filed a consolidated return. Acquiring succeeded to and took into account items described in § 381(c). Upon completion of Reorganization 1, Subsidiary 1 was treated as the successor to Failed Thrift.[2] The specific federal income tax effects of Reorganization 1 are detailed in the Tax Ruling and will not be repeated here.

As part of the acquisition of Failed Thrift, Corporation X, Subsidiary 1, Subsidiary 2 (as well as other members of the Corporation X consolidated group) entered into a number of agreements with Agency, including the Assistance Agreement. The Assistance Agreement set forth the financial and non-financial assistance obligations of Agency as well as certain accounting mechanisms for keeping track of the parties' cross-obligations and benefits arising under the various agreements. As required under the Acquisition Agreement, Subsidiary 2 issued the Intercompany Note to Subsidiary 1, which was guaranteed by Agency. Pursuant to the Assistance Agreement, the financial assistance obligations of Agency were to be performed in stages. As part of its contractual obligations, Agency was required to provide liquidity for Subsidiary 2. Agency's liquidity obligation was primarily handled through deposits made to the Liquidity Account.

Additionally, under the agreements with Agency (including the Assistance Agreement), Acquiring was required to establish and maintain a number of memorandum accounts, including the SR Accounts. The SR Accounts (i.e., SRA I and SRA II) were used to track the debits (SRA I Debits and SRA II Debits) and credits (SRA I Credits and SRA II Credits) as specified in the Assistance Agreement. The Assistance Agreement identified specific items that were to be treated as debits and credits to the SR Accounts.[3] One

[1] All references to the Internal Revenue Code and Federal Income Tax Regulations are to the provisions in force at the time of the relevant event or taxable year being discussed.

[2]

[3] Agency Payments took into account the debits and credits reflected in the SR Accounts in determining the amount of Agency's contributions to the Liquidity Account and/or Corporation X under the Assistance Agreement.

item specifically identified as an SRA I Credit under the Assistance Agreement was Tax Benefits. The SRA I Credit entries for any Tax Benefits generally reflected the parties' Tax Benefit Sharing ("TBS") allocation of a% of the Federal Net Tax Benefit (as provided under Section 9 of the Assistance Agreement) belonging to Agency.[4] That is, as part of the acquisition of Failed Thrift from Agency, Acquiring agreed to and contracted with Agency to allocate a% of the Federal Net Tax Benefit (as provided under Section 9 of the Assistance Agreement). Thus, prior to Reorganization 1, Acquiring and Agency agreed that Acquiring would obtain only b% of the Federal Net Tax Benefit (as provided under Section 9 of the Assistance Agreement) as a result of Acquiring's acquisition of Failed Thrift.

Certain federal income tax savings attributable to Acquiring's use of any loss carryovers of Failed Thrift and any tax losses or net operating losses ("NOLs") of Subsidiary 2 factored into the TBS computation. As Acquiring benefited from the Tax Benefits, Section 9 of the Assistance Agreement required that Corporation X make a payment equal to a% of such Tax Benefits to the Liquidity Account. As provided in that Assistance Agreement, after termination of the Assistance Agreement, the SR Accounts were to terminate and any subsequently determined Tax Benefits (as computed under Section 9 of the Assistance Agreement) were to be remitted directly by Corporation X to Agency.[5]

Acquiring obtained the Tax Ruling which addressed in part certain federal income tax consequences flowing from the TBS arrangement. The Tax Ruling provided that as long as Subsidiary 1 continued to qualify as a "domestic building and loan association", as defined in the Code, any assistance received or accrued by Acquiring (directly or indirectly through Subsidiary 2) from Agency would be excludible from gross income pursuant to § 597. The Tax Ruling also provided that should certain conditions occur, any subsequent (that is, "future") losses generated by Subsidiary 2 would no longer be available for use by Subsidiary 1. Prior to Year B, the Intercompany Note was paid in full and the conditions set forth in the Tax Ruling occurred.[6]

Reorganization 2

On Date 2, Corporation B (the common parent of Taxpayer) and Corporation X entered into the Merger Agreement. The terms of that agreement provided that Corporation X

[4] Section 9 also subjected certain other tax benefits to this arrangement. For purposes of this memorandum, our analysis of the parties' TBS arrangement applies both to the Federal Net Tax Benefit and to such other tax benefits as provided in Section 9 of the Assistance Agreement.

[5] The Assistance Agreement's Modification Clause provides that no amendment or modification of the agreement shall be binding unless executed in writing by the parties or their successors. The Assistance Agreement's Binding Clause provided that the terms and provisions of the agreement were binding upon and inure to the benefit of the parties, their respective transferees, successors, and assigns.

[6]

would merge into Corporation B and that all outstanding stock of Corporation X would be converted into the right to receive stock in Corporation B. The merger of Corporation X with and into Corporation B ("Reorganization 2"), occurred late in Year B, and constituted a reorganization within the meaning of § 368(a)(1)(A).

Section 6.6 of the Merger Agreement required Corporation X to use its "best efforts to obtain any necessary consents and modifications so that the [Agency] Agreements shall be assumed" by a subsidiary or subsidiaries as designated by Corporation B. Further, Section 6.6 required Corporation X to use its best efforts to resolve all material outstanding differences between Corporation X and Agency and to facilitate renegotiation of the Agency Agreements to simplify the remaining effective provisions of the Agreements. The Agency Agreements are defined in Section 4.23 of the Merger Agreement as "all of the currently applicable agreements between [Corporation X] and [Agency] arising from the [Year A] Acquisition."

Corporation X and Agency entered into the Tax Settlement Agreement, page 1 of which expressly states that Corporation X "is currently in negotiations with [Corporation B] with respect to [Reorganization 2]." The Tax Settlement Agreement expresses the parties' intent "to clarify and resolve certain interpretative disputes that have arisen with respect to certain provisions of section 9 of the Assistance Agreement". Section 4.3 of the Tax Settlement Agreement recites the parties' agreement "to negotiate in good faith to achieve a simplification of [Section 9 of the Assistance Agreement] that would take effect for taxable years ending after [Reorganization 2]".

The Modification Clause of the Tax Settlement Agreement provides that only those portions of Section 9 of the Assistance Agreement specifically addressed in the agreement are modified by the Tax Settlement Agreement and that the remainder of Section 9 remains unmodified in full force and effect. Further, the Modification Clause states that the agreement may not be modified or supplemented in any or all respects except in written agreement of all the parties. The Binding Clause of the Tax Settlement Agreement provides that the agreement is intended to bind each of the parties and their successors and assigns.

In anticipation of Reorganization 2, Corporation X, Subsidiary 1, Subsidiary 2 (and other affiliates of Corporation X) entered into the Transfer Agreement with Agency. That agreement provided among other things for the transfer to Agency of the stock of Subsidiary 2 and certain assets of Subsidiary 1. The Transfer Agreement also clarified that Subsidiary 1's remaining assets and liabilities, along with the tax attributes of Subsidiary 1 (*e.g.*, NOL carryovers), carried over with Subsidiary 1 after Reorganization 2. Additionally, Article 6 of the Transfer Agreement further modified Section 9 and certain other TBS provisions of the Assistance Agreement. Following execution of the Transfer Agreement, any debits or credits to the SR Accounts for TBS amounts were to be handled between the parties as payments in immediately available funds. After Reorganization 2, the tax losses or NOLs which triggered the TBS payments were located in Subsidiary 1, which survived Reorganization 2 as a subsidiary of Corporation B.[7]

In anticipation of the presubmission conference, Taxpayer stated that Corporation X remained responsible for performing the Section 9 TBS payment obligation up to the date of the Merger and that such obligation was assumed by Corporation B in Reorganization 2. See the presubmission memorandum, dated Date 4, at page 2 of 10. However section 6.01 of the Transfer Agreement states that "[f]rom and after the closing date of [Reorganization 2], such definitions [in Section 9 of the Assistance Agreement] shall be further amended to replace the phrase "[Corporation X]" with "[Subsidiary 1]" in each place in which it appears."

The Modification Clause in the Transfer Agreement states that no modification or waiver of the provisions of the agreement, nor any consent to any departure from the agreement, shall be effective unless it is in writing signed by all the parties. The Binding Clause in the Transfer Agreement provides that the agreement shall be binding upon and shall inure to the benefit of the parties and their respective successors and assigns.

The Tax Settlement Agreement and the Transfer Agreement modified the Assistance Agreement by requiring, among other things, a simplification of the TBS calculation and elimination of the SR Accounts (which were replaced by direct payments) with respect to the Section 9 items. However, other provisions of Section 9 concerning the calculation of TBS amounts and the obligation to make the Section 9 payments remained in full force and effect at the time of Reorganization 2. Consequently, to the extent that Taxpayer received certain federal income tax savings attributable to the tax benefits resulting from Reorganization 2 attributable to the original acquisition of Failed Thrift, the obligation under Section 9 of the Assistance Agreement continued in force. After Reorganization 2, however, pursuant to the Transfer Agreement it was Subsidiary 1 that was required to perform the TBS payment obligation called for under the agreements. That is, following Reorganization 2, Subsidiary 1 was obligated to remit a% of the Federal Net Tax Benefit (as determined under section 9 of the Assistance Agreement, as modified by the parties) to Agency. Further, following Reorganization 2, the TBS allocation between Agency and Subsidiary 1 remained, respectively, a% and b%.

Corporation B remitted a TBS payment to Agency in the amount of $x in Year C, in connection with the use of Subsidiary 1's NOL carryforward. Similarly, in each of Year D and Year E, Corporation B remitted a TBS payment to Agency in the amount of $y and $z, respectively. These TBS payments were attributable to Subsidiary 1's NOL carryforwards utilized in taxable years immediately preceding Year C and D, respectively.[8]

[7] Following the merger, on Date 3, Subsidiary 1 changed its name. The facts before us suggest that no events took place other than a mere name change. Thus, our analysis treats this event as a mere name change.

[8] Following Reorganization 2, no TBS payment was due to Agency prior to Year C.

Corporation B initially claimed that it "succeeded to [the Assistance Agreement] and the obligation to pay [Agency] for [Subsidiary 1's] NOLs … . " See the memorandum dated Date 4, at page 2 of 10, from Taxpayer submitted in connection with the presubmission conference.[9] However, Taxpayer now maintains that following Reorganization 2, Corporation B entered into an oral contract with Agency that replaces, in the entirety, all prior contracts and agreements between Agency and Corporation X (and certain other affiliates of Corporation X) dealing with the Section 9 TBS payments. Taxpayer claims that under the terms of this new agreement, Corporation B was responsible to make any TBS payments to Agency and that the manner for the TBS payment calculations changed from the manner specified in the earlier agreements between Agency and Acquiring. The sole evidence Taxpayer provides of the existence of the oral contract is Agency's acceptance of those TBS payments from Corporation B.

Taxpayer has not proffered specific details regarding this oral agreement with Agency. For example, Taxpayer has not stated the effective date of this agreement, nor who represented Agency in connection with this oral modification of those earlier written agreements. Taxpayer also has not offered any evidence that all of the prior written TBS-related agreements were extinguished.

Taxpayer asserts that Corporation B initially capitalized the TBS payments when those payments were made in Years C, D, and E. However, pursuant to affirmative claims filed with the examining agent, Taxpayer now seeks to treat those TBS payments as its currently deductible ordinary and necessary business expenses under § 162.

LAW AND ANALYSIS:

Section 162 and § 1.162-1(a) generally allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. _See_ _Commissioner v. Lincoln Savings and Loan Association_, 403 U.S. 345, 352 (1971). It is well-established that deductions are a matter of legislative grace and that the taxpayer bears the burden of proving entitlement to the deduction sought. _New Colonial Ice Co. v. Helvering_, 292 U.S. 435, 440 (1934); _INDOPCO, Inc. v. Commissioner_, 503 U.S. 79, 84 (1992).

The key issue in this case is whether the TBS payment obligations were an expense deductible under § 162. For Corporation X, as well as for Subsidiary 1 or any other member of the Corporation B group, they were not. For Corporation X and its successors, the treatment of TBS payments for federal income tax purposes flows from the doctrine of claim of right as expressed with respect to items of income. If items are received and held without being taken into income, a corollary to claim of right provides

[9] Taxpayer's position as discussed below is inconsistent with section 6.01 of the Transfer Agreement.

that disposal of these items would not, arguably, reduce income (for example, as a deduction under § 162).

Generally, for purposes of income recognition, "[I]f a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income … , even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932). However, if a taxpayer receives funds as an agent or trustee for a designated purpose, such funds are not taxable to such taxpayer. *Illinois Power Company v. Commissioner*, 82 T.C. 842, 897 (1984), *aff'd in part, rev'd in part*, 792 F.2d 683 (7th Cir. 1986). *See also Ford Dealers Advertising Fund, Inc. v. Commissioner*, 55 T.C. 761 (1971), *aff'd per curiam* 456 F.2d 255 (5th Cir. 1972); *New York State Assoc. of Real Estate Boards Group Insurance Fund v. Commissioner,* 54 T.C. 1325 (1970); *Angelus Funeral Home v. Commissioner*, 47 T.C. 391 (1967), *aff'd,* 407 F.2d 210 (9th Cir. 1969). Whether amounts constitute income when received depends upon the parties' rights and obligations at the time the payments are made. *Commissioner v. Indianapolis Power & Light Company*, 493 U.S. 203, 211 (1990). The underlying principle is that the taxpayer is allowed to exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money. *Illinois Power Company*, 792 F.2d at 689.

As a corollary to these income rules, if a taxpayer would not have dominion over amounts received by it such that income is reportable upon receipt, the taxpayer may not deduct any later disbursements of such funds. *See generally Commissioner v. Indianapolis Power & Light,* 493 U.S. at 212-4. Security deposits, and the determination of whether the deposits are income upon receipt (and thus whether later disbursements of the deposits are deductible), turn on the intentions and acts of the parties as ascertained from the agreements and related circumstances. *Rev. Rul. 72-519*, 1972-2 C.B. 32. *See also O'Meara v Commissioner*, 8 T.C. 622, 634-5 (1947) (a taxpayer may not take a loss in connection with an income item unless it has been previously taken up as income in the appropriate tax return). Thus, whether amounts are permitted as a deduction depends upon the parties' rights and obligations.

In connection with the acquisition of Failed Thrift, Agency and Corporation X entered into cross obligations to facilitate the acquisition. Under the Assistance Agreement, which spelled out certain rights and obligations of the parties, Agency was required to perform on its financial (for example, with respect to the Promissory Notes) and non-financial (for example, with respect to certain regulatory forbearance promises) obligations. Concomitantly, Corporation X was required to perform on its financial (for example, TBS payments) and non-financial (for example, with respect to certain management duties) obligations.

As part of the negotiated terms and conditions for the acquisition of Failed Thrift by Corporation X, the parties agreed to a tax sharing arrangement with respect to the

Federal Net Tax Benefit derived by Corporation X as provided in Section 9 of the Assistance Agreement. That is, Corporation X was not entitled to a% of the Federal Net Tax Benefit (within the meaning of Section 9 of the Assistance Agreement). Originally, the parties treated the TBS obligation as entries to the SR Accounts.

The total amount of financial assistance to be provided to Corporation X was not established as a sum certain when the Assistance Agreement was executed in Year A. Rather, it was expressed by the formulas used in maintaining the SR Accounts. Because of the netting of the SRA I Debits and the SRA I Credits, the TBS amounts that were credited to SRA I had the effect of reducing the amount of financial assistance that Agency was otherwise required to pay Corporation X.

As provided in section 9 of the Assistance Agreement, Corporation X was obligated to convey a% of the Federal Net Tax Benefits to Agency to the extent Corporation X used such tax benefits. Thus, pursuant to its agreement with Agency (and as given effect in the Tax Ruling), Corporation X did not acquire more than the right to retain b% of the Federal Net Tax Benefits. As a matter of contract, it had bargained away a% of such tax benefits as a condition of acquiring Failed Thrift from Agency. Under the Assistance Agreement, Corporation X never had the right to Agency's a% of the Federal Net Tax Benefits. Rather, all Corporation X ever owned with respect to the Federal Net Tax Benefits (as provided in Section 9 of the Assistance Agreement) was b% of such benefits.

Taxpayer argues that it is entitled to deduct the Federal Net Tax Benefits paid to Agency after the merger. Because Taxpayer has maintained inconsistent arguments with respect to the TBS payment obligation, we will set each argument separately and then address them in order.

<u>Taxpayer's Argument 1</u>

In its presubmission statement, Taxpayer states that Corporation B made Section 9 TBS payments to Agency because it assumed such obligation as a successor in interest to Corporation X. More specifically, Taxpayer states that in connection with Reorganization 2, Corporation X (and others) negotiated and entered into the Transfer Agreement. Taxpayer states that the Transfer Agreement set out the parties' agreement to modify and "replace" Section 9 of the Assistance Agreement. Taxpayer further states that "[Corporation B] succeeded to this agreement and the obligation to pay [Agency] for [Subsidiary 1's] NOLs" when Corporation B acquired the Corporation X group. Taxpayer states that Corporation B's payments to Agency were appropriate and helpful to Corporation B's business because, solely as a result of making these payments, Corporation B was permitted to utilize Subsidiary 1's NOLs to offset taxable income on its consolidated federal income tax return. See the presubmission memorandum dated Date 4 from Taxpayer.

<u>Taxpayer's Argument 2</u>

Taxpayer now states that its Section 9 TBS payments to Agency arise, not in Corporation B's capacity as a successor in interest to Corporation X's with respect to the Transfer Agreement obligations, but out of a separate agreement between Corporation B and Agency. In this discussion, Taxpayer states that Corporation B did not (and could not as a matter of law) assume Corporation X's or Subsidiary 1's obligations under Section 9 of the Assistance Agreement, as modified by the Transfer Agreement. Taxpayer states that because of the changes in the structure of the Corporation X group that resulted from the merger, Section 9 provisions, as amended, were rendered virtually meaningless. Thus, Corporation B entered into a new and oral agreement with Agency and that all prior TBS contracts were extinguished. See Taxpayer's Response to Audit Team's Request for Technical Advice, dated Date 5.

Response to Argument 1

Reorganization 2 was a state law merger, whereby Corporation X merged into Corporation B. Reorganization 2 qualified as a reorganization described in § 368(a)(1)(A). As a state law merger, all of Corporation X's assets, liabilities and contractual obligations as of the effective time of the merger became Corporation B's assets, liabilities and contractual obligations.[10] But for the Transfer Agreement, Corporation B would have succeeded to Corporation X's obligation to make the Section 9 TBS payments to Agency under state law.[11] However, with respect to Section 9 TBS payments, the Transfer Agreement specifically requires Subsidiary 1 to perform in place of Corporation X "from and after" the time of the merger. We interpret "from and after"

[10] The acquiring corporation in a state law merger becomes answerable for all the acquired corporation's obligations existing at the date of the merger, without enlargement, diminution or modification, regardless of whether such obligation is imposed by statute, by the charter, by contract, or otherwise. See 19 C.J.S. Corporations § 810.

[11] Had Corporation B succeeded to Corporation X's contractual obligation as a result of the merger, then section 381 would apply to determine Corporation B's tax treatment of such obligations. Section 381(a) states that the acquiring corporation shall succeed to and take into account, as of the close of the day of the transfer, the items described in section 381(c), including items in (c)(16), of the transferor. Since the Section 9 payment obligation under the assistance agreement was in full force and effect at the time of the Merger, and was held by Corporation X, such obligation would have become an obligation of Corporation B under section 381.

Section 381(c)(16) provides that if the acquiring corporation (Corporation B) in a § 368(a)(1)(A) reorganization assumes an obligation of the target corporation (Corporation X), and such obligation, if paid or accrued by the target corporation, would have been deductible to the target corporation, the acquiring corporation may deduct such item when it is paid or accrued by the acquiring corporation. This provision applies to an obligation that gives rise to a liability after the time of the merger. Under § 381(c)(16), upon payment of the obligation to Agency, Corporation B would be entitled to a deduction only if Corporation X would have been entitled to such deduction. Because Corporation X never held more than a right to retain b% of the Federal Net Tax Benefits, Corporation X would not have been entitled to deduct any TBS payments to Agency had it ever been required to remit such amounts directly to Agency. Thus, Corporation B would also not be able to deduct such TBS payments to Agency had it acquired that obligation from Corporation X.

to mean that Subsidiary 1 replaces Corporation X as the party to the agreement with the responsibility of performance under Section 9 as a contractual matter and thus, Corporation B did not succeed to such Corporation X performance requirements by operation of merger.

We also do not find language in the Transfer Agreement that supports Taxpayer's statement that the parties agreed to "replace" Section 9 of the Assistance Agreement. The Transfer Agreement does not say that. Rather, Section 4.05 of the Transfer Agreement sets out certain "modifications and clarifications with respect to the Assistance Agreement." Further, Article 6 of the Transfer Agreement states that "[p]rior to the closing date of the Merger, the term "Credited" as defined in Section 9(a) of the Assistance Agreement shall be ***amended*** to mean paid to [Agency] by PARENT COMPANY in immediately available funds." (Emphasis added.) The term "PARENT COMPANY" is not defined in the Transfer Agreement, but it is the term denoting Corporation X in the Assistance Agreement. In addition, Article 6 states that "From and after the closing date of the Merger, such definitions shall be further ***amended*** to replace the phrase 'PARENT COMPANY' with [Subsidiary 1] in each place in which [that phrase] appears." (Emphasis added.)

We find that the language of the Transfer Agreement does not show an intent to "replace" Section 9 of the Assistance Agreement. Rather, the term "replace" as used in the Transfer Agreement merely shifts to Subsidiary 1 a contract responsibility delegated to Corporation X under the Assistance Agreement, as amended. Replacing a party's name with another party's name in the relevant documents does not equate to an intention to "replace" the Assistance Agreement (as amended), itself. This is especially so where, as here, the obligation to be performed remains unchanged.

We also disagree with Taxpayer that Corporation B's payments to Agency compensate Agency for Subsidiary 1's NOLs. Subsidiary 1's NOLs survived Reorganization 2 as limited by the Code and regulations. Corporation B could not purchase NOLs from Agency. Rather, Corporation B's payments to Agency were in satisfaction of Subsidiary 1's own obligation under Section 9 of the Assistance Agreement (as amended).

Moreover, the ability of Subsidiary 1's NOLs to offset taxable income of the Taxpayer consolidated group would not differ whether Subsidiary 1 made the TBS payment to Agency directly or whether Corporation B undertook this obligation. Taxpayer has argued that its ability to use Subsidiary 1's NOLs resulted solely from Corporation B making these payments. However, Taxpayer's ability to utilize Subsidiary 1's NOLs to offset taxable income on its consolidated federal income tax return is determined by reference to the Code and regulations, not Corporation B's performance with respect to the TBS payments due Agency.

We also understand Taxpayer to say that the tax laws as in effect at the time of Reorganization 2 applied without regard to the special tax rules applicable to the acquisition of Failed Thrift. Reorganization 2 resulted in a change of ownership within the meaning of § 382. Reorganization 2 also resulted in the termination of the Corporation X consolidated group. Accordingly, Subsidiary 1's NOLs were subject to the SRLY regulations[12], as in effect at the time of Reorganization 2. Here again, it is the application of the Code and the regulations that determine to what extent Subsidiary 1's losses can be utilized to offset income. Taxpayer does not explain why solely as a result of Corporation B making Subsidiary 1's TBS payments Corporation B is permitted to utilize Subsidiary 1's NOLs to offset taxable income of Taxpayer.

<u>Response to Taxpayer's Second Argument</u>:

We conclude that the Transfer Agreement shifts the performance of Corporation X's Section 9 contractual obligation from Corporation X to Subsidiary 1. However, Corporation B is a successor under state merger law to all other provisions of the Assistance Agreement and all other contractual obligations of Corporation X at the time of the Merger.

Taxpayer seems to argue that Corporation B ultimately is not a successor to the Assistance Agreement, and that its payment of a% of the Federal Net Tax Benefits to Agency does not have its origins in the Assistance Agreement. Taxpayer further argues

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[12] Generally, the income of a consolidated group is determined by aggregating the income of all of the members and offsetting it against the losses of the members. However, in the instant case, where Subsidiary 1 incurred its losses in a taxable year in which it was not a member of Corporation B's consolidated group, the SRLY ("separate return limitation year") rules may limit the use of such losses by the Corporation B group. The SRLY regulations changed a number of times prior to the promulgation of final regulations which were adopted in June 1999. T.D. 8823, T.D. 8824, T.D. 8825, 64 Fed. Reg. 36091(7/2/99). Proposed regulations were published in January 1991. CO-078-90, 56 Fed. Reg. 4228, 2/4/91. Temporary and reproposed regulations were adopted in June 1996. CO-24-96, 61 Fed. Reg. 33393, 6/27/96.

A full discussion of the SRLY rules is beyond the scope of this advice. However, we note that the 1999 final regulations provide an "overlap" rule. Where an acquisition would have been subject to both the § 382 limitation and the SRLY limitation prior to the 1999 regulations, it would only be subject to § 382 as of the effective date of the regulations. The 1999 regulations, however, cannot be applied retroactively. Thus, for example, where P acquires S in 1996 in a transaction subject to SRLY and § 382, and S has no income to utilize its loss carryforwards, such losses continue to carryforward. As of the effective time of the 1999 regulations, S's losses that were formerly subject to SRLY are no longer subject to this limitation. Thus, in 1999, S may have an accumulation of losses (subject to § 382) that can be used to offset the income of the members of the P group.

Section 172 factors into the order in which losses are used. Thus, losses are generally absorbed in the order of the taxable years in which they arose. Losses carried from taxable years ending on the same date and similarly available to offset consolidated taxable income for the year are generally absorbed on a pro rata basis. Thus, it is possible that if Taxpayer has CNOL carryforwards and Subsidiary 1 has SRLYed carryforwards that arose in the same year. Taxpayer's and Subsidiary 1's loss carryforwards are both potentially available to offset Subsidiary 1's attributable portion of Taxpayer's consolidated income. In addition, other rules may factor into the order of the use of losses. For example, § 382(l)(2)(B) applies such that if losses are carried from the same taxable year, those losses subject to a § 382 limitation are absorbed before losses that are not subject to such limitation.

that Corporation B's TBS payments should be viewed, for federal tax purposes, as unrelated to the Assistance Agreement (or other agreements relating to that Assistance Agreement). This position, however, simply cannot be reconciled with the fact that Corporation B made TBS payments to Agency. If Corporation B were truly operating independently of the Assistance Agreement, it never would have made such payments. Rather, Taxpayer would have kept the entire amount of the Federal Net Tax Benefits resulting from the use of Subsidiary 1's NOLs.

Taxpayer states that the changes resulting from Reorganization 2 with respect the Corporation X group rendered meaningless the Section 9 calculations of the TBS payments as reflected in the prior agreements with Agency. Taxpayer asserts that because Corporation B entered into an oral agreement with Agency, and that Corporation B's payments to Agency arise out of this oral contract rather than the Assistance Agreement (as amended), the TBS payments qualify as ordinary and necessary deductions under § 162.

We understand that Taxpayer's argument, in effect, is that the complexity of its own structure renders unworkable the TBS payment calculations as set out in the written agreements in effect at the time of Reorganization 2. Our own review of the relevant agreements identified herein did nor disclose any provision that specifically provides for the calculation of the TBS payments required under those agreements if there was a termination of the Corporation X group or if Subsidiary 1's NOLs became subject to limitation under § 382 and/or the SRLY provisions. Nor, did our review disclose whether, in such case, Subsidiary 1's losses must be used in preference to another corporation's losses so as to maximize the amount of the TBS payments to Agency. However, the fact that additional clarification may have been necessary for Subsidiary 1 to calculate its Section 9 TBS payments after Reorganization 2 occurred does not negate the continuing application of the Assistance Agreement, as modified. Rather, the need to clarify the Section 9 calculations, in itself, evidences the continuing validity of that obligation. If neither Subsidiary 1, nor Corporation B (acting on Subsidiary 1's behalf), continued to make the Section 9 payments to Agency following Reorganization 2, Agency would have had the right to enforce the Assistance Agreement (as modified) against Subsidiary 1.

Further, the specific terms of the Assistance Agreement, as modified, are contrary to Taxpayer's assertion that the agreement can be extinguished by an oral contract. Indeed, under the Binding Clauses and the Modification Clauses in the relevant agreements it is patently clear that the parties to those agreements intended that successors (including assignees) would be bound and that any modifications of these agreements would be made in writing. Taxpayer has failed to show documentation that the Assistance Agreement, as amended, was extinguished. Taxpayer has also not furnished any evidence that Agency agrees with Taxpayer's characterizations. The fact that the Agency accepted the TBS payments in the amounts determined by Corporation B is not inconsistent with the stated intentions of the parties to the Transfer Agreement to simplify the Section 9 computations. Thus, the fact that Corporation B made the TBS payments to Agency does not extinguish the written agreements.

Nothing in the Assistance Agreement, as amended, prohibited Subsidiary 1 from having someone act on its behalf with respect to its obligation to remit TBS payments. In fact, Corporation B's capitalization[13] of its payments to Agency shows that Corporation B treated the payments at issue as made on behalf of Subsidiary 1. While not absolutely clear, Corporation B could have reached this result by, in effect, treating each payment as a (deemed) contribution to the capital of Subsidiary 1 (followed by a deemed payment by Subsidiary 1 to Agency. Accordingly, Corporation B would increase its basis in the Subsidiary 1 stock by the amount of the deemed payment to Subsidiary 1. Alternatively, Corporation B could have reached this same result if it treated Subsidiary 1 as obligated to reimburse Corporation B for making these TBS payments on Subsidiary 1's behalf and Subsidiary 1 does not reimburse Corporation B. Although this memorandum expresses no opinion as to whether the TBS payments can be properly capitalized, such treatment evidences the continuing validity of Subsidiary 1's contractual obligation to perform under the Assistance Agreement (as modified by the Transfer Agreement).

Taxpayer has also argued that Corporation B entered into a new contract with Agency because, after Reorganization 2, the amount of the TBS payments to Agency depended upon Taxpayer's utilization of Subsidiary 1's NOLs. Further, Taxpayer states that this utilization now depends on factors germane to Taxpayer's own income and losses, which were never a factor in the original agreements. However, this is not a meaningful distinction between Taxpayer's situation after Reorganization 2 and that of the Corporation X group prior to Reorganization 2. Each year, the amount of the Section 9 obligation was always subject to change because it was dependent on the amount of income against which the losses could be used.

Because the right to retain b% of the Net Federal Tax Benefit was all that was acquired by Corporation X there would have been no deduction under § 162 available to Corporation X with respect to any performance of the Section 9 TBS payment obligation. When the performance obligation under the Assistance Agreement with respect to the TBS payments shifted to Subsidiary 1 "from and after" Reorganization 2, there was no material change in the proportional ownership interests of the Federal Net Tax Benefits as between Agency and Subsidiary 1. The fact that Corporation B made the payments to Agency does not convert the character of those payments from nondeductible to deductible.

The use of Subsidiary 1's losses under the Code or regulations does not depend on whether Corporation B or Subsidiary 1 makes the payments to Agency. Taxpayer

[13] We understand that Taxpayer originally capitalized these payments. Subsidiary 1 is an indirect subsidiary of Taxpayer. The factual record does not state how Taxpayer capitalized these payments. For the purposes of this discussion, we presume Taxpayer capitalized its TBS payments in its (indirect ownership of the) stock of Subsidiary 1.

implies that the shifting of the payment obligation from Subsidiary 1 to Corporation B increased Taxpayer's ability to use the losses, thereby providing a direct benefit to Corporation B's business operations. However, any additional benefit derived by Corporation B was incidental at best.

For the reasons set forth above, we conclude that in making TBS payments to Agency, Corporation B fulfilled an obligation of its subsidiary, Subsidiary 1, that was formerly the obligation of Corporation X under the Assistance Agreement (as modified by the parties in writing). Further, for the same reasons that the TBS payments were not deductible by Corporation X prior Reorganization 2, these payments would not be deductible by Subsidiary 1 or any other member of the Corporation B group. Therefore, the TBS payments made to Agency in Years C, D, and E are not deductible under § 162.

CAVEAT(S):

No opinion is expressed as to the proper treatment of the TBS payments by Taxpayer, including Corporation B and Subsidiary 1, under any other provision of the Code.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.