Unwelcome Result of All-Cash D Regs in Consolidation Can Be Avoided, Official Says

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A Treasury official on January 5 said taxpayers may be able to avoid an unwelcome result of the final all-cash D regs that has drawn criticism from practitioners.

Donald Bakke, attorney-adviser in Treasury's Office of Tax Legislative Counsel, said taxpayers may be able to prevent gain duplication by issuing an amount of transferee corporation stock -- in addition to cash -- and not distributing the issued shares up the chain of ownership. Bakke spoke at a BNA Tax Management luncheon sponsored by Buchanan Ingersoll & Rooney PC.

Practitioners have criticized the final all-cash D regs for the way they apply the nominal share construct in consolidation to trigger an excess loss account (ELA) resulting in deferred intercompany gain.

Practitioners at the luncheon considered an example in which the parent company (P) of a consolidated group owns the stock of two first-tier subsidiaries, A and B, and subsidiary A owns the stock of a target company (T). T transfers all its assets (worth $100) to B for $100 cash and then liquidates. Under the final all-cash D regs, T is deemed to receive a nominal share of B, resulting in the deemed distribution and duplicated gain. (For prior coverage, see *Doc 2009-27768* or *2009 TNT 241-1*. For the final regs (T.D. 9475), see *Doc 2009-27671* or *2009 TNT 241-7*.)

Using the example, Bakke said the duplicated gain could be avoided if "for good business reasons" T instead transferred $100 of assets to B for $99 cash and $1 worth of B stock, which can be distributed in liquidation to A. He said such a technique would generally be respected.

He told Tax Analysts that if taxpayers "don't like the result that the all-cash D reg provides in consolidation, they might consider otherwise issuing a 'small' amount of transferee stock," which A would hold onto so as not to trigger the ELA.

Andrew M. Eisenberg, a partner with Jones Day, agreed, saying he thinks most taxpayers will probably do as Bakke suggested.

Candace Ridgway, a partner at Jones Day and a panelist at the luncheon, asked whether you could get the same treatment if instead of issuing a new share of stock, P simply dropped an existing share of B stock down to A to absorb the ELA.

"I think that's a possibility," Bakke said. He added that there are other reasons you might want to drop stock of B down to A other than to avoid the unwelcome result of the all-cash D regs.

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But Robert H. Wellen, a partner at Ivins, Phillips & Barker, wondered whether such a technique would be respected. He said if Treasury thinks the stock drop doesn't offend any policy, perhaps there should be a revenue ruling or some other kind of guidance giving the planning techniques a green light.

Wellen described the techniques as "kind of avoiding the system," albeit in "a benign way."

"When you're talking about a construct that has no economic substance itself whatsoever, then how do you work in whether a transaction that you're doing to get around it has economic substance or not?" Ridgway asked. "The whole thing in the first place doesn't have economic substance."

Allocating Basis to a Real Share

Benjamin Willis of PricewaterhouseCoopers questioned whether, in a lower-tier context outside consolidation, the reg could be read to allow taxpayers to attach the basis of the nominal share onto a real share before the nominal share is deemed distributed up and around the chain. If possible, the real share could then be sold to recognize the loss, and taxpayers would avoid losing the nominal share's basis, which would be zero, when it is deemed distributed.

"The reg tells you to designate something," said Michael J. Wilder, a partner at McDermott Will & Emery. "It doesn't tell you when to designate it." Therefore, the designation could occur before the deemed distribution, he said.

While Bakke acknowledged that the regs' language isn't limited to corporation shares actually held by the shareholder, William Alexander, IRS associate chief counsel (corporate), said the IRS didn't intend for practitioners to read the regs as Willis and Wilder do and suggested that the Service may consider clarifying the language.

Treatment Among Family Members

Practitioners pointed out that the ability to designate basis to a share varies when the owners of the target and acquiring companies are family members.

Alexander explained that the basis on the nominal share can be moved among family members by treating it as a gift. "You would presume that the nominal share was issued in effect to the target owner and then was gifted to the owner of the acquiring company who actually owns the stock," he said. "That would move the basis."

Scott Levine, a partner at Jones Day, told Tax Analysts that he questioned whether a nominal share with a significant basis can really be considered something with no value for tax purposes. If gifted, the share could result in the recipient having the right to take a future loss, reducing the recipient's tax liability.