Office of Chief Counsel
Internal Revenue Service

memorandum

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KCPeterson

date: AUG 31 1999

to: Jesse Martinez, Internal Revenue Service Agent,
Laguna Niguel CE 1117

from: Ken Peterson, Attorney, Laguna Niguel, District Counsel
June Y. Bass, Assistant District Counsel

subject: [redacted]
Discharge of Indebtedness
Parent's recognition of subsidiary's excess loss account

DISCLOSURE STATEMENT

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Issues

1. Can a taxpayer, who excludes income from discharge of indebtedness under I.R.C. § 108(a), reduce the basis of the assets transferred to it the day after the debt was discharged?

2. Will a subsidiary's discharge of indebtedness cause the parent company to recognize the subsidiary's excess loss account?

Conclusions

1. A taxpayer who excludes income from discharge of indebtedness under I.R.C. § 108(a) can reduce the basis of all assets held by it on the first day of the tax year subsequent to the discharge including assets transferred to it the day after the discharge. However, the basis of these assets can only be reduced to the extent the aggregate of the bases of the property held by the taxpayer immediately after the discharge exceeds the aggregate of the liabilities of the taxpayer immediately after the discharge.

2. A subsidiary's discharge of indebtedness will cause the parent company to recognize the subsidiary's excess loss account if the amount discharged was excluded from gross income and the subsidiary did not reduce tax attributes.

Facts[1]

[redacted], a parent entity, created [redacted] a subsidiary. The purpose in forming the entity was the construction of various [redacted] plants. The [redacted] plants were to convert [redacted] into electricity, which would be sold to electric utility companies. The construction was financed by a loan from [redacted]. Upon completion of the construction, the loan was converted into a term loan in the amount of $[redacted].

The plants never produced the energy expected due to [redacted]. [redacted] incurred operating losses for various years. In fact, within [redacted] years [redacted] was in default on its payments to [redacted]. [redacted] never recovered and, in [redacted] it came to an agreement with [redacted] whereby the plants would be sold and the proceeds would go to [redacted] in satisfaction of the remaining debt. The sale of the plants and the application of the proceeds to the debt were completed on [redacted]. At that point in time the principal and interest outstanding on the loan totaled $[redacted]. The proceeds from the sale totaled approximately $[redacted]. [redacted] applied the $[redacted] to the $[redacted] of debt and [redacted] forgave the difference of

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[1] The facts set forth in this opinion were obtained from our telephone conversations as well as your memorandum seeking District Counsel's advice and the attachments thereto. We have made no independent investigation of the facts in this case. Our legal conclusions are contingent on the accuracy of the information provided. Thus, Counsel reserves the right to change our conclusions if the actual facts are different than the facts represented to us in your request for advice. Accordingly, you should not rely on this memorandum, and you should seek further advice from Counsel, if you uncover any information inconsistent with the facts recited herein.

$[redacted]. Because the taxpayer was insolvent, the taxpayer excluded the $[redacted] from income under I.R.C. § 108(a).

On [redacted], immediately after the discharge, there were no assets with basis (or any other tax attributes as described in I.R.C. § 108(b), other than net operating losses). The day after the discharge, on [redacted], [redacted] began transferring assets into [redacted]. These assets consisted of approximately $[redacted] of land and $[redacted] of depreciable buildings. [redacted] acquired these assets from other entities which were controlled by [redacted], the controlling shareholder of [redacted].

[redacted] did not make an election to first reduce the basis of depreciable property on its original tax return as allowed by I.R.C. § 108(b)(5), nor did [redacted] file an amended return to make such an election.

On its return subsequent to the year of discharge, [redacted] reduced the basis in the assets transferred to [redacted] the day after the discharge. [redacted] claims that the discharge does not require it to recognize [redacted]'s excess loss account because [redacted] reduced the basis of these assets.

Discussion

1. Can the taxpayer who excluded income from the discharge of indebtedness under I.R.C. § 108(a) reduce the basis of the assets transferred to it the day after the debt was discharged?

According to I.R.C. § 108(a), an insolvent taxpayer does not have to recognize income from discharge of indebtedness. However, a taxpayer who does not recognize income under I.R.C. § 108(a) must reduce tax attributes in accordance with I.R.C. § 108(b), if possible.

Here, [redacted] did not recognize income under I.R.C. § 108(a) because it was insolvent when it was discharged from indebtedness. [redacted] was then required to attempt to reduce tax attributes under I.R.C. § 108(b). [redacted] began by reducing its net operating loss, a tax attribute described under I.R.C. § 108(b)(2)(A). The net operating loss was totally absorbed because the income from discharge of indebtedness was much greater than [redacted]'s net operating loss. [redacted] was then required to attempt to reduce tax attributes under the other subsections of I.R.C. § 108(b). [redacted] could not reduce the tax attributes described under I.R.C. §§ 108(b)(2)(B), (C), (D), (F), or (G) because [redacted] did not have any of these tax attributes ([redacted] did not have general business credits, minimum tax credits, capital loss carryovers, passive activity losses and credit carryovers, or foreign tax credit carryovers.)

Nor could [redacted] reduce the basis of depreciable property under I.R.C. § 108(b)(5). According to I.R.C. § 108(b)(5) a taxpayer may elect to first reduce its basis in depreciable property prior to reducing the other tax attributes described in I.R.C. § 108(b). A taxpayer normally makes this election on his income tax return for the taxable year in which the discharge occurs. Treas. Reg. 301.9100-13T. The taxpayer may make the election on an amended return if it establishes reasonable cause for failing to file the election with its original return. Id.

Here, [redacted] did not make an election to first reduce the basis of depreciable property on its original tax return. [redacted] has not shown reasonable cause for failing to make such an election, and [redacted] has not filed an amended return stating that it intends to make such an election. Thus, [redacted] is unable to reduce the basis of its depreciable property under I.R.C. § 108(b)(5).

Thus, the only tax attribute left that [redacted] could have potentially reduced was its basis in its assets under I.R.C. § 108(b)(2)(E). According to I.R.C. § 1017, a basis reduction under I.R.C. § 108(b)(2)(E) occurs to assets held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. However, the basis reduction cannot exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge. I.R.C. § 1017 (b)(2).

Here, because [redacted] transferred assets to [redacted] prior to year-end, [redacted] had assets with a basis as of the first day of the following tax year. However, because [redacted] did not transfer the assets to [redacted] until the day following the discharge, [redacted], the aggregate bases of the assets held by [redacted] on [redacted], immediately after the discharge, was zero. Thus, the basis reduction cannot exceed zero. Therefore, the taxpayer is unable to reduce tax attributes under I.R.C. § 108(b)(2)(E).

Hence, because [redacted] cannot further reduce tax attributes under any subsection of 108(b), [redacted] cannot reduce the basis in the property it received the day after the discharge of its indebtedness.

2. Will [redacted]'s discharge of indebtedness cause [redacted], the parent company, to recognize [redacted]'s excess loss account?

The Code and Regulations attempt to treat corporations filing a consolidated return as a single entity. See Treas. Reg. 1.1502-32(a)(1). In order to do this, the Regulations allow a parent to

have a negative basis in its subsidiary. Treas. Reg. 1.1502-19(a)(2). This negative basis is kept track of in an excess loss account. Id. If a parent disposes of a subsidiary's stock, the parent must recognize the related excess loss account as income. Treas. Reg. 1.1502-19(b)(1). Certain events are considered dispositions which trigger the recognition of the excess loss account as income. Treas. Reg. 1.1502-19(c).

A parent is treated as having disposed of a subsidiary's stock if the subsidiary's stock becomes worthless. Treas. Reg. 1.1502-19(c)(iii). A subsidiary's stock is worthless if an indebtedness of the subsidiary is discharged, the amount discharged is excluded from gross income, and the amount discharged is not applied to reduce tax attributes. I.R.C. § 1.1502-19(c)(iii)(B); I.R.C. § 1.1502-32(b)(3)(ii)(C).

Here, the indebtedness of [redacted] was discharged, the amount discharged was not included in gross income, and [redacted] was unable to reduce tax attributes (as discussed above). Thus, [redacted] must recognize the subsidiary's excess loss account as income to the extent that it was unable to reduce tax attributes.

Recommendation

[redacted] cannot reduce the basis of the assets transferred to it the day after the discharge and must recognize [redacted]'s excess loss account. We recommend that you adjust [redacted]'s taxable income accordingly.

This advice has been coordinated with Grid Glyer from the Field Service branch of the Office of Chief Counsel. We are closing our file on this matter; however, should you have any questions, please call the undersigned attorney.

KENNETH C. PETERSON
Attorney