Selling Your Child at a Loss?

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When a parent sells its subsidiary at a loss, can it deduct it? Shorn of complexity, that was the issue presented in CCA 201025046 (Mar. 12, 2010). Parent had acquired all of the stock of Sub One in a stock for stock reorganization. Thereafter, Sub One was a wholly owned sub of Parent and a member of Parent's consolidated group. Sub One had a single class of common stock. Parent had a built-in loss in the stock of Sub One.

Parent also owned all the stock of Sub Two and it was also a member of the U.S. consolidated group. Sub Two conducted business in the United States as well as internationally through wholly owned affiliates, including Foreign Sub One (a directly owned sub) and Foreign Sub Two (an indirect, wholly owned sub). The transaction was devised to simplify the company's organizational structure and to centralize management of its intangible assets. Parent therefore took the following steps:

1. Parent bought certain assets from Sub One.
2. Foreign Sub One subscribed to ordinary shares of Foreign Sub Two stock, and immediately paid for them using borrowed funds.
3. Parent sold shares of common stock in Sub One to Foreign Sub Two in exchange for shares of cumulative redeemable preferred stock.
4. Sub One's board adopted a plan of complete liquidation, approved by the Sub One shareholders (Parent and Foreign Sub Two).
5. Sub One then distributed all of its assets to Parent and Foreign Sub Two in redemption and cancellation of the shares.
6. Sub One was formally dissolved.

The question was whether Parent's exchange of its stock in Sub One for Foreign Sub Two's preferred shares triggered a loss to Parent. Parent's stock in Sub One was nonqualified preferred stock under Internal Revenue Code Section ("Code Sec.") 351(g). Taxpayer conceded that such a loss would be deferred under Code Sec. 267(f). Nonetheless, Parent claimed it could take the loss into account when Sub One liquidated. Furthermore, Parent reported a loss on the transfer of its remaining Sub One stock to Sub One in the liquidation.

A Bridge Too Far

The related-party rules are a constant companion in parent-subsidiary relationships. Code Sec. 267(f)(2) defers losses from a sale of property between members of a controlled group until the property goes outside the group. [*See* Reg. §1.267(f)-1(a)(1).] However, the regulations also state that if S's loss would be redetermined to be a noncapital nondeductible amount under Reg. §1.1502-13 (but is not redetermined because of paragraph (c)(2)), then the loss continues to be deferred. In essence, the regulations under Code Sec. 267 require a hypothetical analysis of the transaction under Reg. §1.1502-13. If the hypothetical treatment results in the item being redetermined to be a noncapital nondeductible item, it must continue to be deferred.

The matching rules of Reg. §1.1502-13(c) attribute the intercompany item and corresponding item to be redetermined to produce the effect of a transaction between divisions in a single company. Using this matching concept, Parent's intercompany item is the loss on the intercompany sale of the Sub One stock. Foreign Sub Two's corresponding item is the amount that Foreign Sub Two recognizes as a result of Sub One's liquidation. That means Foreign Sub Two would not recognize a gain or loss.

Assuming that Foreign Sub Two and Parent were divisions of a single company, Foreign Sub Two would not increase its basis in the Sub One stock upon receipt. Foreign Sub Two would be treated as realizing a loss, although it would not be recognized. In addition, although there was no single 80-percent shareholder in calculating the recomputed corresponding item, the intercompany stock sale would be treated as the movement of that asset within the single corporation, not as a sale between two entities. Ultimately, the chief counsel advice concludes that Parent's loss must be deferred until Parent and Foreign Sub are no longer in a controlled group relationship. [*See* Reg. §1.267(f)-1(c)(1)(iv).]