WHERE DO YOU KEEP YOUR *M&A TAX REPORT*?

If you do not have an *M&A Tax Report* binder, or if the one you have is full, please write or call and we will be happy to send you one **at no charge!**

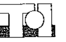
TAX INSTITUTE
235 Montgomery Street #972
San Francisco, CA 94104
e-mail: info@taxinstitute.com
(800) 852-5515 Fax (415) 834-1888

Restoration of Triggered Gain From Deferred Intercompany Transaction

by Robert W. Wood • San Francisco

A recent case case decided by the Court of Federal Claims confronts what to many of us is a Byzantine set of rules: the consolidated return rules. The transaction in question involved a Section 338 election, and may be worthy of note by many in the corporate tax field—even if you don't make it your business to understand the consolidated return mechanics.

Continued on Page 5



TRIGGERED GAIN

Continued from Page 4

In *Eckerd Corp., et al. v. United States*, No. 95-733T (Fed. Cl., May 6, 1997), the parent corporation of an affiliated group made a deemed sale of the group's assets under Section 338 to an unrelated corporation. The question in the case was whether the parent corporation would have to restore to income the deferred gain that had previously been generated by the deferred intercompany transaction. The Jack Eckerd Corp. ("Oldco") was the common parent of a total of 34 affiliated subsidiary corporations. Before April 30, 1986, some subsidiaries sold warehoused inventory to other members of the group for eventual resale to customers. On April 30, 1986, Eckerd Holdings, Inc. (an unrelated corporation) purchased 100% of the stock of the group for a total of $1.2 billion. The group then merged into Eckerd Holdings, which changed its name to the Jack Eckerd Corp. ("Newco").

Oldco filed a consolidated return for the group (as a final return) for the short year beginning August 1985 and ending April 30, 1986. That return reported deferred gains of $15.4 million from the previous inventory sale between members of the old group. On the same day that Oldco filed its final return, Newco filed an election under Section 338(g) of the Code to treat the purchase of the stock of the group as an asset purchase.

ALSO AVAILABLE FROM TAX INSTITUTE:

TAXATION OF INTANGIBLE ASSETS, by Mark A. Muntean

TAXATION OF COMPENSATION AND BENEFITS, by David J. Cartano

TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS, by Robert W. Wood

TAX GUIDE FOR CHURCH & CLERGY, by Mark A. Muntean

THE HOME OFFICE TAX GUIDE, by Robert W. Wood

For more information, call or write today:

TAX INSTITUTE
235 Montgomery Street #972
San Francisco, CA 94104
e-mail: info@taxinstitute.com
(800) 852-5515 Fax (415) 834-1888

No Pain, No Gain

Eckerd Corp. then filed a refund claim, arguing that it erroneously reported the gain from the intercompany inventory sale. The IRS denied the claim and Eckerd filed a refund suit. The IRS argued that the deferred gain from the inventory sale, as a "deferred intercompany transaction," had to be recognized when the old group sold its assets. The IRS advanced two principal arguments for this treatment.

First, under Section 1.1502-13(f)(1)(i) of the Regulations, the inventory was disposed of outside the group. Secondly, said the IRS, under Section 1.1502-13(f)(1)(iii), both the selling and purchasing members of the old group had ceased to be members of that group. That should trigger the deferred intercompany gain. In response to these two arguments, Eckerd argued that the nonrecognition provisions of Section 337 applied by virtue of the election under Section 338(g), thus shielding the prior deferred intercompany transaction from any gain recognition.

Unfortunately for Eckerd, the Court of Federal Claims held for the government, finding that Section 338 required the old target group to be treated as having sold all of its assets in a single transaction to which Section 337 applied. According to the court, the reference to Section 337 in Section 338 simply means that the target is deemed to sell all of its assets. However, the court said that nothing in Section 338 even suggests that the Section 337 nonrecognition provision would apply to the prior deferred transaction.

Furthermore, the court rejected the argument advanced by Eckerd that the Service was seeking to tax the deemed asset sale itself in violation of Section 338. The court agreed with the IRS that the deemed sale triggered two of the restoration provisions contained in Reg. §1.1502-13(f)(1). According to the court, a consequence of the deemed asset sale was a tax on the prior intercompany transaction. It was not, said the court, a tax on the deemed asset sale itself. The court found the IRS position to be supported by *Winer v. Commissioner*, 371 F.2d 684 (1st Cir. 1967).

Continued on Page 6

TRIGGERED GAIN

Continued from Page 5

Finally, Eckerd also argued that Section 1.1502-13(f)(2)(ii)(b) was of assistance. The court rejected Eckerd's reliance on that provision, too, reasoning that in the Regulation, unlike in Eckerd's situation, the former parent was the selling member in the deferred intercompany transaction, and currently owned the subject property.

Conclusion

Ultimately, the *Eckerd* case seems to stand for the never pleasant but oft-repeated proposition that relief provisions are to be strictly construed. Likewise, it seems to suggest that the consolidated return rules are almost a fiefdom unto themselves. The consolidated return notion that certain deferred intercompany transactions can be put to one side and the gain will not have to be recognized has a rather short set of conditions. But, once the gain is triggered, it has to be recognized. ■