OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

ATTN:

FROM: ARTURO ESTRADA
ACTING BRANCH CHIEF CC:DOM:FS:CORP

SUBJECT: SRLY FRAGMENTATION

This Field Service Advice responds to your memorandum dated March 3, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =
B =
C =
a =
b =
c =
d =
date 1 =
date 2 =
date 3 =

date 4 =

date 5 =

date 6 =

year 7 =

year 8 =

e =

ISSUE 1: Whether the taxpayer in the instant case meets the SRLY exception under Treas. Reg. § 1.1502-1(f)(2)(ii).

CONCLUSION 1: The taxpayer in the instant case does not meet the SRLY exception under Treas. Reg. § 1.1502-1(f)(2)(ii).

ISSUE 2: Whether Service position is that the member-by-member SRLY fragmentation rules under Treas. Reg. § 1.1502-21(c) apply for the tax year at issue.

CONCLUSION 2: Service position is that the member-by-member SRLY fragmentation rules under Treas. Reg. § 1.1502-21(c) apply for the tax year at issue.

ISSUE 3: What litigation hazards exist in taking the position that the member-by-member SRLY fragmentation rules under Treas. Reg. § 1.1502-21(c) apply for the tax year at issue?

CONCLUSION 3: [redacted]

FACTS: C was a publicly traded corporation focusing on a, b, and c. Late in year 7, A targeted C as a hostile takeover candidate and proceeded to acquire d shares of C stock on the open market. On Date 1, A made an unsolicited tender offer to C shareholders of $e/share.

By date 2, A had acquired sufficient shares of C to gain 80% control of C. After the acquisition, A sold C's non-core businesses and foreign c in order to reduce the substantial debt A had incurred in the process of purchasing C stock. A then changed its name to B.

Prior to date 2, C was a parent corporation of a consolidated group ("C group").

After the buyout and at the close of business on date 2, the ownership of the C group changed. B acquired more than 80% control of C and, thus, of the C group. The C group's tax year terminated on date 2.

The members of the C group incurred capital losses and general business credits prior to entering the B Group that became carryovers to the former C group members in the B group. In filing its consolidated return for year 8, the taxpayer used a SRLY subgroup approach in which it used the former C group members' carryovers on the return to the extent of the total income reported by the former C group members in the B group. It did not use any of the former C group members' carryovers against any other income of the B group.

DISCUSSION

You ask our advice on the Service's position on the SRLY rules applicable to the year at issue, and the litigation hazards that exist in taking that position.

LAW AND ANALYSIS

Relevant Code Provisions and Case Law

Treas. Reg. § 1.1502-1(e) provides that the term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

Treas. Reg. § 1.1502-1(f)(1) provides that, except as otherwise provided, the term "separate return limitation year" means any separate return year of a member or of a predecessor of such member.

Treas. Reg. § 1.1502-1(f)(2)(ii) provides the term "separate return limitation year" shall not include a separate return year of any corporation which was a member of the group for each day of such year, provided that an election under section 1562(a) (relating to the privilege to elect multiple surtax exemptions) was never effective (or is no longer effective as a result of a termination of such election) for such year.

Treas. Reg. § 1.1502-21(b)(1) is concerned with the use of net operating losses on a consolidated return. That regulation permits a consolidated group to use net operating losses sustained by any members of the group in "separate return years" if the losses could be carried over pursuant to section 172. As a general rule, net operating losses reported on a separate return can be carried over and used on a consolidated return. An exception to this rule is found in Treas. Reg. § 1.1502-21(c). This section provides that the net operating loss of a member of an affiliated group arising in a "separate return limitation year" which may be included in the consolidated net operating loss deduction of the group shall not exceed the amount

of the consolidated taxable income contributed by the loss sustaining member for the taxable year at issue.

In *Wolter Construction v. Commissioner.,* 634 F.2d 1029 (6th Cir. 1980), the court held that losses incurred by a corporation which is unrelated at the time of its losses to its subsequent affiliates, before it becomes a member of an affiliated group filing a consolidated return, can only be carried forward and used on the consolidated return to the extent that the corporation that incurred the losses has current income reflected on the consolidated return.

Analysis

Under the SRLY fragmentation rules of Treas. Reg. § 1.1502-21(c), a subsidiary can only use its own carryforwards to offset its own income.

The taxpayer argues that the member-by-member SRLY fragmentation rules under Treas. Reg. § 1.1502-21(c) do not apply in the instant case.

Treas. Reg. § 1.1502-1(f)(2)(ii) provides the term "separate return limitation year" shall not include a separate return year of any corporation which was a member of the group for each day of such year provided that an election under section 1562(a) (relating to the privilege to elect multiple surtax exemptions) was never effective (or is no longer effective as a result of a termination of such election) for such year.

The taxpayer states that the phrase "such year" under Treas. Reg. § 1.1502-1(f)(2)(ii) refers to the year 7 loss year. The taxpayer argues that the word "group" refers to the acquired C "group." The taxpayer then asserts that, since the loss member was a member of the C "group" for every day of year 7 (and a multiple surtax exemption was not in effect for year 7), the exception to the SRLY rule in Treas. Reg. § 1.1502-1(f)(2)(ii) applies in the instant case.

We believe the word "group" under the exceptions to the SRLY rules under Treas. Reg. § 1.1502-1(f)(2)(ii) clearly refers to the B group, and since members of the C group were not members of the B affiliated group in the loss year (year 7), the exception doesn't apply.

Treas. Reg. § 1.1502-1(e) defines a separate return year as a year . . . for which a corporation joins in the filing of a consolidated return by "another" group. Treas. Reg. § 1.1502-1(f)(2)(ii) speaks of "the" group. If Treas. Reg. § 1.1502-1(f)(2)(ii) was intended to apply to the previous group, the regulation clearly would have said "another" group as it did in Treas. Reg. § 1.1502-1(e). Also, in the same context, Treas. Reg. § 1.1502-21(c) states, "In the case of a net operating loss of a member of the group arising in a separate return limitation year . . . the amount which may be

included . . . in the consolidated net operating loss carryovers . . . to a consolidated return year of the group . . . ." (emphasis added)

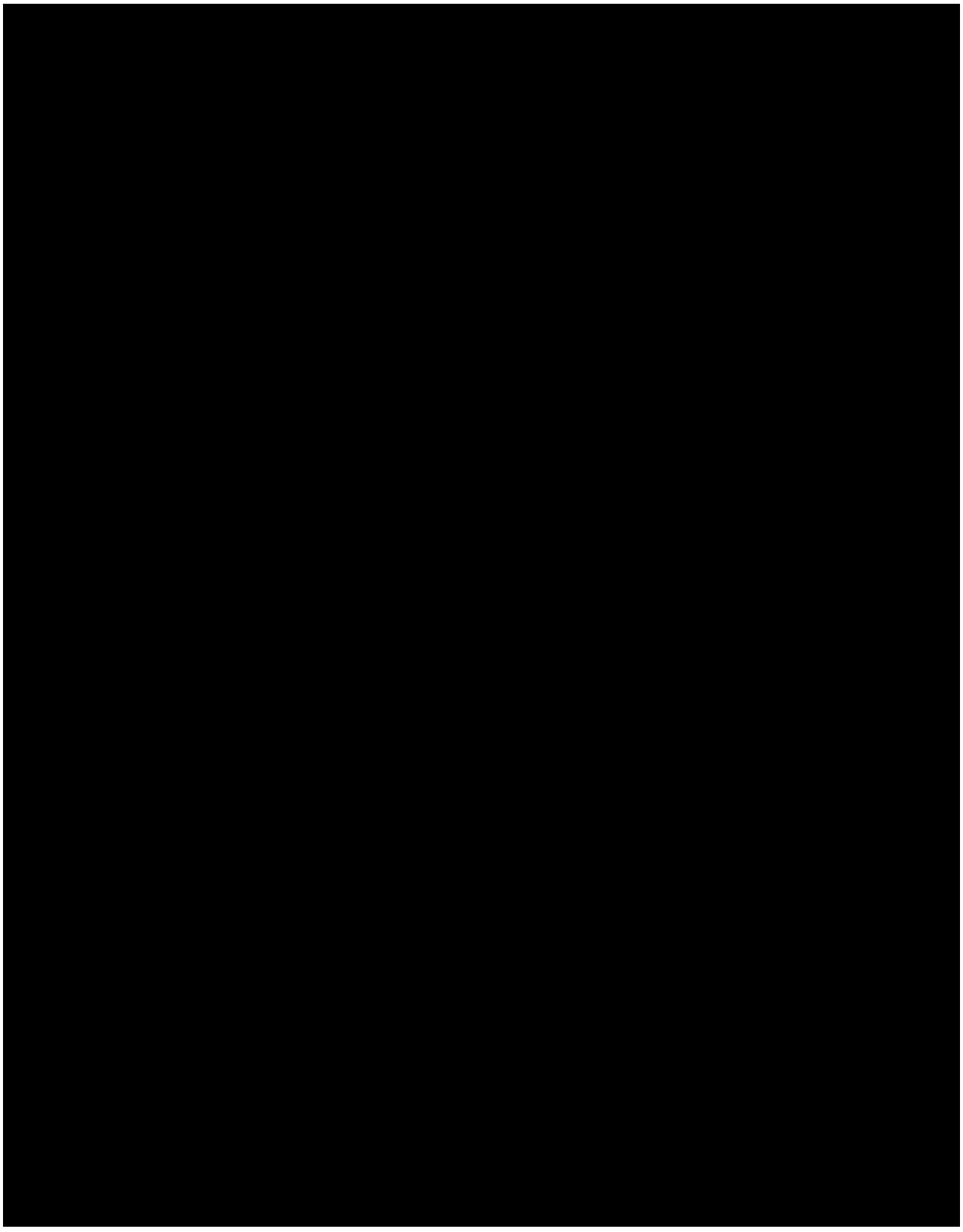
The exception in Treas. Reg. § 1.1502-1(f)(2)(ii) addresses a situation in which a corporation was, in the year the loss was incurred, a member of the same affiliated group to which it wants to carry the loss, but the group, although affiliated, did not file a consolidated return in the year of the loss.

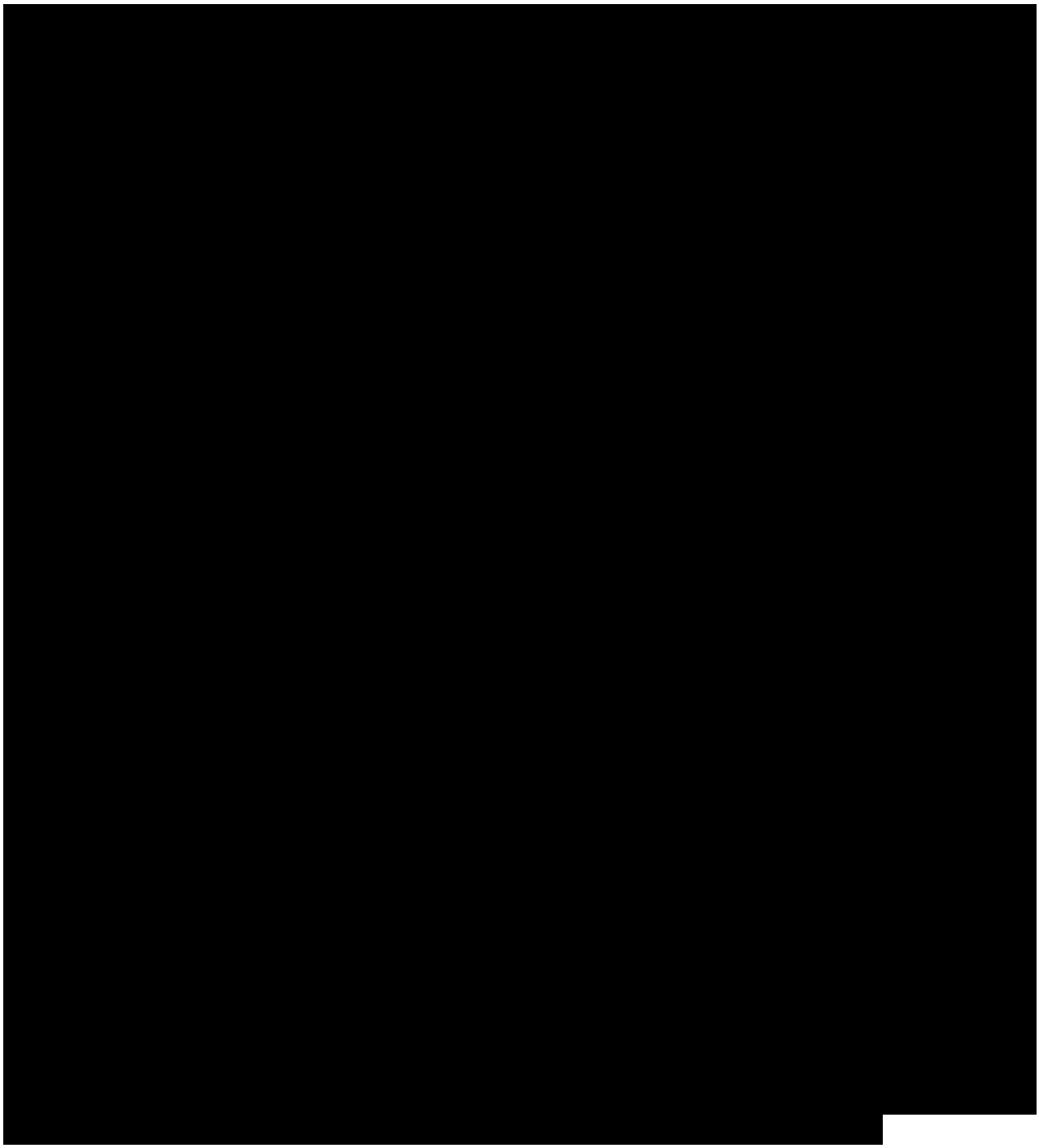
A plain reading of the regulations defines *the* group as the group whose consolidated return is at issue. That would be the B group, and the acquired corporation (C) was not a member of the B group for the year in which the loss arose. Therefore, the exception to the SRLY rules under Treas. Reg. § 1.1502-(1)(f)(2)(ii) does not apply in the instant case. In *Wolter Construction v. Commissioner,* 634 F.2d 1029 (6th Cir. 1980), the court held that losses incurred by a corporation which is unrelated at the time of its losses to its subsequent affiliates . . . can only be carried forward and used on the consolidated return to the extent the corporation that incurred the losses has current income reflected on the consolidated return. In the instant case, our subsidiary (C) was unrelated at the time of its losses to its subsequent affiliate B. *Wolter* clearly is consistent with the interpretation that *the* group is the group whose consolidated return is at issue.

Additionally, the tax year at issue in the instant case is year 8. For this year, Treas. Reg. § 1.1502-21(c) provides member-by-member SRLY fragmentation rules. Accordingly, Service position is that the member-by-member SRLY fragmentation rules under Treas. Reg. § 1.1502-21(c) apply in the instant case to the C group capital losses and general business credits carried over to the B group. The SRLY subgroup rules, which the taxpayer erroneously adopted in filing its return in the instant case, apply only to consolidated return years ending on or after 1/29/91.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]





If you have any further questions, please call 622-7930.

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By: _____
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cc: Assistant Regional Counsel (TL)
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