

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-117349-98

CC:DOM:CORP:B2

National Director of Appeals
Chief, Appeals Office

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

P =

S1 =

S2 =

S3 =

Thrift 1 =

Thrift 2 =

Thrift 3 =

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Date A =

Date B =

Date C =

Date D =

Date E =

Date F =

Date G =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

\$w =

\$x =

\$y =

\$z =

ISSUES:

Whether, for purposes of computing an I.R.C. § 165(g)¹ worthless stock deduction in Year 3, P properly adjusted its basis in the stock of S1 pursuant to § 1.1502-32 of the Income Tax Regulations to account for (1) the accrued but

¹ All references to sections of the Internal Revenue Code and the Income Tax Regulations are references to the Code and Regulations in effect for the taxable year in issue.

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uncollected interest (“ABUI”) charged to the Special Reserve Account (the “SRA”) by S1's lower-tier subsidiary S3, and subsequently paid to S3 by the Federal Savings and Loan Insurance Corporation (“FSLIC”), and (2) the interest accrued and paid to S3 on the overstated portion of the Net Worth Note (the “Note”) issued by FSLIC to S3.

CONCLUSION:

(1) P is not required to reduce its basis in the S1 stock because S3 properly charged the SRA for ABUI and accrued FSLIC assistance in the same amount in Year 2.

(2) Based on the information available in Year 1, Year 2, and Year 3, interest attributable to the overstatement in the Note was properly accrued and entered into S3's earnings and profits (“E&P”) for purposes of determining P's basis in the S1 stock.

FACTS:

The information submitted indicates that, during the period in question, P was the common parent of an affiliated group filing consolidated tax returns (“P group”) on a calendar year basis using the accrual method of accounting. P owned all of the outstanding stock of S1. S1 owned all of the outstanding stock of S2. In Year 1, S2 created a wholly-owned subsidiary, S3, organized as a Federal savings bank, to acquire the assets and liabilities of three insolvent financial institutions (Thrift 1, Thrift 2, and Thrift 3, or the Thrifts) that were under FSLIC supervision. On Date A, FSLIC entered into an assistance agreement (the “Assistance Agreement”) with S1, S2, and S3.

I. The FSLIC Assistance Agreement

Pursuant to the Assistance Agreement, on the effective date of the acquisitions (“effective date”) FSLIC agreed to provide S3 an interest-bearing promissory note equal to the aggregate negative capital of the Thrifts immediately prior to the effective date (the “Note”). The Note was to be calculated based upon information contained in the latest regulatory reports submitted by the Thrifts to the Federal Home Loan Bank Board. After the effective date, FSLIC was to conduct an audit of the Thrifts using information available prior to the effective date.

Under the Assistance Agreement, FSLIC also agreed to reimburse S3 for losses on certain assets acquired from the Thrifts. The mechanism for reimbursement was the establishment of a book account, the SRA. If S3, with FSLIC's concurrence, determined that a particular asset was uncollectible, a charge (debit) was made to the SRA. The SRA balance was then submitted by S3 to FSLIC on a quarterly report. FSLIC had the option to pay the net debit balance to S3, or to carry over the balance or portion thereof. ABUI, which represented interest that had been accrued by the Thrifts prior to the effective date but not yet collected, was among the assets that could be charged to the SRA.

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II. The Private Letter Ruling

A private letter ruling dated Date B (TR-31-3268-88) ("PLR") held that each of the acquisitions of the assets and liabilities of each of the Thrifts qualified as a reorganization under § 368(a)(1)(G), and that S3 had a carryover basis in the assets received under § 362(b). The PLR further provided that all FSLIC assistance paid or accrued would be excludable from income under § 597. Pursuant to § 381(c)(2), S3 would succeed to and take into account the E&P of the Thrifts as of the effective date. Payments of interest to S3 on the Note and all other payments by FSLIC pursuant to the Assistance Agreement would generate E&P to S3 after the acquisitions; any increase to S3's E&P as a result of such interest payments and other assistance payments would cause a positive adjustment with respect to the subsidiary stock owned by S2 and S1.

The PLR also provided that the Note would be treated as an asset of the Thrifts prior to the acquisitions and, accordingly, the Note would be included in the Thrifts' E&P before the acquisitions. Inclusion of the Note in the Thrifts' E&P therefore would not cause a positive adjustment with respect to the subsidiary stock owned by S2 and S1.

III. P's Tax Treatment of FSLIC Assistance

On Date C, S3 acquired substantially all the assets and liabilities of Thrift 1 and Thrift 2. On Date D, S3 acquired substantially all the assets and liabilities of Thrift 3. Also on Date D, FSLIC determined that \$w of ABUI should be written off as uncollectible. This write-off lowered the value of the ABUI receivable transferred to S3, causing a corresponding increase in the negative capital of the Thrifts. Because the negative capital of the Thrifts immediately prior to the effective date was used to calculate the amount of the Note, the \$x Note issued by FSLIC to S3 was overstated by \$w as described below.

In Year 2, S3, with the written concurrence of FSLIC, determined that \$y of ABUI was uncollectible. S3 charged off \$y on its books and claimed a Federal income tax deduction for this amount. S3 reduced its E&P, causing S2, S1, and P to make corresponding reductions to their bases in their subsidiary stock under § 1.1502-32. S3 then debited the SRA for \$y, and FSLIC paid this amount in Year 2. Although this amount was excluded from taxable income under § 597, S3's accrual of the tax-exempt income caused an increase in S3's E&P, causing S2, S1 and P to make corresponding increases to their bases in their subsidiary stock under § 1.1502-32.

On Date E of Year 3, the Office of Thrift Supervision placed S1 in receivership, appointing the Resolution Trust Corporation ("RTC") as receiver. On the P group's Year 3 consolidated return, P claimed an ordinary loss from the worthlessness of the S1 stock. It has been stipulated that S1 and its subsidiaries were disaffiliated from the

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P group on Date F.²

FSLIC's Year 1 write-off of the \$w of ABUI was not discovered until a compliance audit report (the Report) prepared by an outside accounting firm for the Federal Deposit Insurance Corporation (as successor to FSLIC) was issued in Year 4. The Report noted that the Year 1 write-off was inconsistent with the terms of the Assistance Agreement, and stated that the write-off had caused an overstatement in the Note of \$w. The Report recommended that the overstatement be corrected through a credit to the SRA for the same amount. The Report also concluded that because the ABUI in retrospect proved uncollectible, the taxpayer's Year 2 debit to the SRA was proper. On Date G, the \$w overstatement in the Note was recouped by the FDIC through a credit to the SRA against other amounts of assistance owed to S3.

In Year 5, an internal RTC memorandum determined that the Report had not addressed the issue of related interest on the overstatement. The memorandum recommended that interest totalling approximately \$z attributable to the \$w overstatement be recovered. This interest was recouped by the FDIC later in Year 5 through a credit to the SRA.

LAW AND ANALYSIS:

ISSUE ONE: Whether P properly adjusted its basis in the stock of S1 to account for ABUI charged to the SRA by S3 and subsequently paid by FSLIC.

Section 165 provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. The basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in § 1011 for determining the loss from the sale or other disposition of property.

Section 1.312-6(b) of the Income Tax Regulations provides, in part, that among the items entering the computation of corporate earnings and profits for a particular period are all income exempted by statute as well as all items includible in gross income under § 61 of the Code.

Section 1.1502-32(a) of the regulations provides, in part, that as of the end of each consolidated return year, each member owning stock in a subsidiary shall adjust the basis of such stock in the manner prescribed in this section. If a subsidiary owns stock in any other subsidiary, the adjustment with respect to the stock of the higher tier

² The analysis in this technical advice memorandum is predicated on the occurrence of a disaffiliation of S1 from the P group on Date F. No opinion is expressed as to the merits of such determination.

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subsidiary shall not be made until after the adjustment is made with respect to the stock of the lower tier subsidiary. In the case of a disposition of stock of a subsidiary before the end of the taxable year, the adjustment with respect to such stock shall be made as of the date of disposition. Section 1.1502-32(a) further provides that the amount of such adjustment shall be the difference between the positive adjustment and the negative adjustment. Such difference is referred to as the “net positive adjustment” or the “net negative adjustment”, as the case may be.

Section 1.1502-32(b) of the regulations provides, in part, that with respect to a share of stock which is not limited and preferred as to dividends, the positive adjustment for such share of stock includes an allocable part of the undistributed earnings and profits of the subsidiary for the taxable year, and the negative adjustment for such share includes an allocable part of the deficit in the earnings and profits of the subsidiary for the taxable year.

Section 1.1502-32(d) of the regulations generally provides that the earnings and profits of a member are to be determined by reference to § 1.1502-33 of the regulations.

Section 1.1502-33(c)(4)(ii) of the regulations provides, in part, that there shall be reflected in the E&P of each member for a taxable year an amount equal to any increase or decrease for such taxable year pursuant to § 1.1502-32(e)(1) and (2) in such member’s basis for its stock in a subsidiary.

Section 1.1502-32(e)(1) of the regulations generally provides that a member owning stock in a subsidiary shall apply its net negative adjustment to reduce its basis for such stock, and § 1.1502-32(e)(2) generally provides that a member owning stock in a subsidiary shall apply its net positive adjustment to increase its basis for such stock.

The examining agent contends that for purposes of calculating the Year 3 worthless stock deduction, P should be required to reduce its basis in the S1 stock by \$w. Examination argues that the Year 2 payment of FSLIC assistance through the SRA caused an overstatement in P’s basis in the S1 stock. Examination argues that the Year 2 assistance payment was erroneous because \$w of the \$y in ABUI charged to the SRA as uncollectible previously had been written off by FSLIC in Year 1 and factored into the calculation of the Note.

The taxpayer argues that P properly adjusted its basis in the stock of S1 to account for the ABUI charged to the SRA by S3 in Year 2. Taxpayer argues that the Year 2 charge to the SRA was independent of the determination of the Thrifts’ negative capital and the calculation of the Note; *i.e.*, regardless of the amount of the Note, S3 would have charged the SRA for \$w because this represented the amount of ABUI that ultimately proved uncollectible. The taxpayer further argues that because the SRA charge was proper, S3 correctly accrued FSLIC assistance and increased its E&P by

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the same amount, resulting in a corresponding increase in P's basis in the stock of S1.

Discussion

The purpose behind the investment adjustment rules set forth in § 1.1502-32 is to prevent the duplication of gain or loss and the taking of deductions that do not reflect an economic loss within the consolidated group. Section 1.1502-32(a) accomplishes this goal by requiring annual adjustments by a member owning stock in a subsidiary equal to the net positive adjustment or the net negative adjustment, as applicable. The primary positive adjustment is the member's allocable part of the undistributed E&P of the subsidiary for the taxable year. § 1.1502-32(b)(1)(i). The primary negative adjustment is the member's allocable part of the deficit in E&P of the subsidiary for the taxable year. § 1.1502-32(b)(2)(i). Under the tiering provision of § 1.1502-33(c)(4)(ii), if a member increases its basis in the stock of a subsidiary pursuant to § 1.1502-32(e)(2) or decreases its basis in the subsidiary stock pursuant to § 1.1502-32(e)(1), that member must correspondingly increase or decrease its own E&P. This in turn triggers an increase or decrease in the stock basis of a higher-tier member under § 1.1502-32(b).

In the instant case, the Assistance Agreement provided that ABUI was among the assets acquired by S3 from the Thrifts for which reimbursement could be claimed from FSLIC in the event S3 was unable to collect thereon. In Year 2, S3, with the written concurrence of FSLIC, determined that \$y of ABUI was uncollectible. Accordingly, S3 charged off \$y on its books and claimed a Federal income tax deduction for this amount. Also in Year 2, S3 debited the SRA for the same amount and subsequently received a payment of \$y from FSLIC. The submission indicates that at the time of the Year 2 SRA charge and the related accrual of FSLIC assistance, S3 was unaware that \$w of the ABUI had been written off by FSLIC in Year 1.³

Pursuant to the PLR, S3's accrual of assistance from the SRA debit was excludable from income under § 597. Also under the PLR, FSLIC's payment generated E&P to S3, a result that is consistent with § 1.312-6(b) of the regulations.⁴

³ The overstatement was not discovered until the Year 4 Report was prepared for the FDIC by an outside accounting firm. The Report noted that the Year 1 write-off was inconsistent with the terms of the Assistance Agreement and resulted in the Note being overstated by \$w. The Report recommended that the overstatement be corrected through a credit to the SRA for the same amount. The Report also concluded that because the ABUI in retrospect proved uncollectible, the taxpayer's Year 2 SRA debit was proper.

⁴ The PLR held that the Note was to be treated as an asset of the Thrifts prior to the transaction. The PLR further held that although the Note would enter into

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The Year 2 Federal income tax deduction of \$w based on S3's charge-off of the ABUI as uncollectible had the effect of decreasing S3's E&P. S3's accrual of the FSLIC assistance increased its E&P by the same amount. Thus, there was neither a net positive nor a net negative impact upon S3's E&P for purposes of determining the annual investment adjustment of P with respect to its S1 stock. Consequently, P is not required to reduce its basis in the S1 stock.

ISSUE TWO: Whether P properly adjusted its basis in the stock of S1 to account for interest accrued and paid to S3 on the overstated portion of the Note issued by FSLIC to S3.

Section 61(a)(4) provides that interest is included in gross income.

Section 451 provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period.

Section 1.451-1(a) of the regulations provides, in part, that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Section 1.451-1(a) further provides that when an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. In general, the principles of the accrual method of accounting apply in the calculation of the earnings and profits of taxpayers using the accrual method of accounting for income. See § 1.461-1(a)(2)(i).

Taxpayer asserts that S3 received the interest that accrued on the overstated portion of the Note under a claim of right, relying on the doctrine set forth in North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). Taxpayer further asserts that the interest, although tax-exempt under § 597, caused an increase in S3's E&P, ultimately increasing P's basis in its S1 stock under § 1.1502-32 for purposes of calculating the Year 3 worthless stock deduction.

Examination states that the claim of right doctrine does not apply, and concludes

the Thrifts' E&P before the acquisitions, such inclusion in E&P would not cause a positive adjustment with respect to the stock of S2 or S1. In other words, because the Note was treated as an asset of the Thrifts prior to the transfers to S3, any E&P consequences arising from such inclusion would inure to the prior owners of the Thrifts and not to S3 or the P group.

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that the taxpayer should be required to reduce its basis in the S1 stock.

Discussion

Gross income under § 61 includes income from whatever source derived, unless otherwise excluded by law. When a taxpayer receives an amount in one year, which receipt is found in a subsequent year to have been mistaken, the taxpayer must report the amount as gross income for the year of receipt. United States v. Lewis, 340 U.S. 590, 591-92 (1951). A taxpayer has gross income when the taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to disposition, even though it may still be claimed that the taxpayer is not entitled to retain the money and even though the taxpayer may be required to restore its equivalent. James v. United States, 366 U.S. 213, 219 (1961); North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932).

In the instant case, S3 received a Note in the principal amount of \$x from FSLIC in Year 1. S3 accrued and received interest payments from FSLIC in Year 1, Year 2, and Year 3, based on the Note. Pursuant to the PLR, the interest payments were excludable under § 597 and generated E&P to S3, ultimately causing a positive adjustment with respect to P's basis in its S1 stock under § 1.1502-32. In a subsequent year, after the disaffiliation of S1 and S3 from the P group, it was determined that the Note had been overstated at issuance. In Year 5, the RTC recovered the \$z in interest on the overstated portion of the Note through a credit against other assistance owed to S3.

Although subsequent events revealed that a portion of the interest was attributable to a miscalculation in the amount of the Note, S3 received the interest payments in Year 1, Year 2, and Year 3, without a consensual recognition to repay and without restriction under the terms of the Note. We conclude that, but for the application of § 597, the interest would have been includible in gross income in the years received. Therefore, P properly accounted for the interest through adjustments to its basis in the S1 stock.

The same conclusion is reached applying the general principles of the accrual method of accounting. Section 1.451-1(a) provides, in part, that income is includible in income when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever is earliest. Rev. Rul. 79-266, 1979-2 C.B. 203. Under § 1.451-1(a), adjustments as to the amount of an otherwise proper income accrual are usually taken into account in the year the amount is finally determined.

In the instant case, FSLIC overstated the face amount of the Note. As a result,

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both FSLIC and S3 overstated the interest due on the Note to S3 each quarter in Year 1, Year 2, and Year 3. Absent a determination in Year 4 that the Note was overstated, S3 would have kept the amount of interest it had previously accrued. Thus, the all events test was satisfied and S3 properly took the interest into account in determining its E&P. Accordingly, P is not required to reduce its basis in the S1 stock in Year 3.

CAVEATS:

This technical advice memorandum expresses no opinion about the tax treatment of the above transactions under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions above that are not specifically covered by the above technical advice memorandum.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.