

Part III—Administrative, Procedural, and Miscellaneous Guidance Regarding Affiliation

Notice 2004-37

SECTION 1. PURPOSE

This Notice announces those circumstances under which a consolidated group that owns stock of an includible corporation will be treated as satisfying the value requirement of § 1504(a)(2)(B) of the Internal Revenue Code for certain purposes. It also announces the intention of the Internal Revenue Service and the Treasury Department to propose regulations pursuant to § 1504(a)(5)(C) providing that the value requirement will be treated as satisfied if the affiliated group, in reliance on a good faith determination of value, treated such requirement as satisfied. In addition, pursuant to § 1504(a)(5)(D), the proposed regulations will disregard an inadvertent ceasing to satisfy the value requirement by reason of changes in relative values of different classes of stock. This Notice describes the issues that the Service and the Treasury Department are studying and invites comments on those issues.

SECTION 2. BACKGROUND

Section 1504(a)(1) provides that an affiliated group means one or more chains of includible corporations connected through stock ownership with a common parent which is an includible corporation, but only if (A) the common parent owns directly stock meeting the requirements of § 1504(a)(2) in at least one of the includible corporations and (B) stock meeting the requirements of § 1504(a)(2) in each of the includible corporations (other than the common parent) is owned directly by one or more of the other includible corporations. Section 1504(a)(2) imposes two requirements. First, pursuant to § 1504(a)(2)(A), the stock must possess at least 80 percent of the total voting power of the stock of the corporation. Second, pursuant to § 1504(a)(2)(B), the stock must have a value equal to at least 80 percent of the total value of the stock of the corporation (the value requirement).

Section 1504(a)(5)(C) directs the Secretary to prescribe regulations that provide that the value requirement will be treated as met if the affiliated group, in reliance on a good faith determination of value, treated it as met (the good faith exception). Section 1504(a)(5)(D) directs the Secretary to prescribe regulations that disregard an inadvertent ceasing to meet the value requirement by reason of changes in relative values of different classes of stock (the inadvertence exception). The legislative history of § 1504 reflects that the inadvertence exception should be available only if the changes in relative value are “not large” and are not “intentionally generated.” H.R. Rep. No. 98-861 at 834, 1984-3 C.B. (vol. 2) 87 (1984). Section 1504(a)(5)(C) and (D), therefore, contemplate that affiliation could be treated as continuing, notwithstanding that the value requirement is not satisfied.

The Service and Treasury Department intend to promulgate regulations implementing the provisions of § 1504(a)(5)(C) and (D). This document outlines those circumstances under which the Service will provide relief from the failure to satisfy the value requirement until temporary or final regulations are promulgated or until this Notice is revised. It is possible that the standards adopted in such regulations will vary from and, in certain circumstances, be narrower than the interim relief provided in this document.

SECTION 3. INTERIM RELIEF

.01 Scope. Until temporary or final regulations implementing § 1504(a)(5)(C) and (D) are promulgated, or until this Notice is revised, the Service will not challenge a consolidated group's position on a consolidated return that the stock ownership of a "qualifying corporation" satisfies the value requirement for purposes of applying any "value provision" if the consolidated group (including a consolidated group that arises or continues to exist by reason of the relief provided in this Notice) satisfies the requirements of either section 3.02 or section 3.03. For purposes of the preceding sentence, a "qualifying corporation" is an includible corporation (within the meaning of § 1504(b) or (c)). In addition, a "value provision" is any provision of the Code and the regulations promulgated thereunder for which ownership of stock, as defined in § 1504, representing 80 percent (or any lesser threshold percentage) of the total value of the stock of the qualifying corporation is relevant. A "value provision" is also any provision of the Code and the regulations promulgated that refers to "affiliated group" as such term is defined in § 1504.

This Notice does not require a taxpayer to treat the value requirement as satisfied with respect to a corporation for purposes of any value provision if the requirements of the value provision are not in fact satisfied. This Notice does not permit a taxpayer to treat the value requirement as satisfied with respect to a corporation for purposes of some but not all value provisions (see section 3.04(7)).

Finally, the relief provided in this Notice extends only to the taxpayer that satisfies the requirements of section 3.02 or section 3.03. For example, assume a consolidated group's ownership of the stock of a qualifying corporation does not satisfy the value requirement and, consistent with the terms of this Notice (because it is entitled to either the good faith or inadvertence exception), the consolidated group takes the position on its consolidated return that its ownership of the stock of the qualifying corporation satisfies the value requirement. If the group sells all of its stock of the qualifying corporation, unless the purchaser of the stock independently satisfies the requirements of section 3.02, an election under § 338(h)(10) may not be made in respect of the stock of the qualifying corporation.

.02 Good Faith Exception. The requirement of this section 3.02 will be satisfied if the consolidated group made a good faith determination that the value requirement was

satisfied. The requirement of this section 3.02 will cease to be treated as satisfied immediately before the occurrence of a designated event described in section 3.04, unless the consolidated group makes a good faith determination that, immediately after such designated event, the value requirement is satisfied. If, at any time prior to the occurrence of a designated event, the consolidated group knows or should know that the good faith determination that the value requirement was satisfied was incorrect, the requirement of this section 3.02 nonetheless will continue to be treated as satisfied until immediately before the occurrence of a designated event described in section 3.04.

.03 Inadvertence exception. The requirement of this section 3.03 will be satisfied if (a) the consolidated group's ownership of stock of the corporation does not satisfy the value requirement as a result of a change in the relative values of different classes of stock and such change is not attributable to the occurrence of a designated event described in section 3.04, and (b) immediately before such change in relative values, the consolidated group's ownership of stock of the corporation satisfied the value requirement. The requirement of this section 3.03 will cease to be treated as satisfied immediately before the occurrence of a designated event described in section 3.04.

.04 Designated Events. The following events are designated events:

(1) The corporation issues stock to a person that is not a member of the consolidated group.

(2) The corporation redeems stock owned by a member of the consolidated group, other than in complete liquidation of the corporation.

(3) A member of the consolidated group (directly or indirectly) transfers stock of the corporation to a person that is not a member of the consolidated group.

(4) The corporation after May 6, 2004 distributes with respect to its stock money or other property to a member of the consolidated group or a person related (within the meaning of § 267(b) or § 707(b)) to a member of the consolidated group. However, a transaction that is not in form a distribution with respect to a corporation's stock (for example, a distribution deemed to occur by reason of the application of § 482) is a designated event only if (a) the corporation accounts for it on its books and records as a transaction with respect to its stock, (b) it involves the transfer of money or other property (including stock of the corporation) by the corporation to a person in satisfaction of the indebtedness of another member of the consolidated group or a person related thereto, or (c) it involves the forgiveness by the corporation of indebtedness of a member of the consolidated group or a person related (within the meaning of § 267(b) or § 707(b)) to a member of the consolidated group.

(5) The consolidated group claims a worthless stock deduction with respect to any of the stock of the corporation. In this case, the designated event shall be treated as

occurring on the later of the last date on which members of the group own stock that actually satisfies the value requirement or the first day of the taxable year for which the deduction is claimed.

- (6) The corporation engages in a recapitalization described in § 368(a)(1)(E).
- (7) The consolidated group takes a position on its consolidated Federal income tax return that the value requirement is not satisfied for purposes of applying any value provision. In this case, unless the position taken reflects the occurrence of another designated event, the designated event shall be treated as occurring on the later of the last date on which members of the group own stock that actually satisfies the value requirement or the first day of the taxable year for which the position is taken. However, if a consolidated group took such a position before May 6, 2004 and the group would otherwise be eligible for relief under this Notice, a designated event will not result from taking such inconsistent position if the group amends the relevant return or returns to take a position consistent with satisfaction of the value requirement for purposes of applying every applicable value provision.

SECTION 4. REQUEST FOR COMMENTS

The following paragraphs describe the issues the Service and Treasury Department are considering in connection with promulgating regulations implementing the good faith and inadvertence exceptions. The Service and Treasury Department request comments on these issues as well as any other issues that are relevant to regulations implementing these exceptions.

.01 Scope. The interim relief set forth in this Notice applies only to corporations that are members of a consolidated group (including corporations that are members of a consolidated group by virtue of being entitled to the interim relief set forth in this Notice). The Service and Treasury Department request comments regarding whether the good faith and inadvertence exceptions should, by regulation, permit a corporation that is not a member of a consolidated group to treat its ownership of the stock of another corporation as satisfying the value requirement. The Service and Treasury Department also request comments identifying any special issues that may arise if the good faith and inadvertence exceptions were to apply not only in the consolidated group context, but more broadly in the affiliated group context, and the manner in which those issues should be addressed.

.02 The Good Faith Exception. The Service and Treasury Department believe that, in order to establish that the affiliated group, in reliance on a good faith determination of value, treated the value requirement as satisfied, members of the affiliated group must have filed Federal income tax returns in a manner that is consistent with satisfaction of the value requirement. Consideration is being given to

whether evidence, such as a third party appraisal, should be required to establish reliance on a good faith determination of value.

The Service and Treasury Department are also considering whether the good faith exception should be presumptively available if the value of the affiliated group's ownership of the stock of the corporation does not fall below a requisite percentage that is relatively small. In addition, the Service and Treasury are considering whether to adopt a rule providing that, if the value of the affiliated group's ownership of stock of the corporation falls below a requisite percentage, the affiliated group's treatment of the value requirement as satisfied is not based in reliance on a good faith determination of value.

Finally, the Service and Treasury Department are considering whether the good faith exception should be available only if the affiliated group cures the value deficiency within a specified period of time after the deficiency arose, or, alternatively, after becoming aware of the deficiency.

.03 The Inadvertence Exception. The Service and Treasury Department are considering what evidence an affiliated group must produce to establish that the failure to satisfy the value requirement was inadvertent by reason of a change in the relative values of different classes of stock. The Service and Treasury Department are also considering whether the inadvertence exception should be available only if the value deficiency does not exceed a certain percentage.

The Service and Treasury Department are considering whether the inadvertence exception should be available only if the affiliated group cures the value deficiency within a certain period of time after the deficiency arose or the affiliated group became aware of it. In that regard, the Service and Treasury Department are considering whether the inadvertence exception should be available only if the value deficiency is cured by the end of the taxable year in which the affiliated group became aware of the value deficiency, by the date the original return (without extensions) for the taxable year in which the affiliated group became aware of the value deficiency, or by the end of the taxable year following the taxable year in which the group became aware of the value deficiency.

Finally, the Service and Treasury Department are considering what events, such as the designated events, should terminate the availability of the inadvertence exception.

The Service and Treasury Department are considering whether, in cases in which the inadvertence exception applies, the failure to satisfy the value requirement should not be disregarded for certain purposes. In particular, in the consolidated group context, the failure to satisfy the value requirement should not be disregarded to the extent treating that requirement as satisfied permits the group to obtain excess tax

benefits. One possible approach to prevent a consolidated group from obtaining excess tax benefits would be to limit the use of losses (for example, to prevent creating or increasing an excess loss account in the stock of the corporation) and credits of the corporation to offset income of other members of the consolidated group or to reduce the tax liability of the consolidated group for a taxable year during which the value requirement is not satisfied. Comments are requested regarding whether such an approach is appropriate and what the terms of such an approach should be.

.04 Application To Different Provisions. The Service and Treasury Department request comments regarding whether the parameters of the good faith and inadvertence exceptions should vary for purposes of determining whether corporations are affiliated for different provisions of the Internal Revenue Code. That is, the Service and Treasury Department request comments regarding whether the policies underlying the various provisions of the Code for which affiliated status is relevant suggests that the good faith and inadvertence exceptions should be interpreted differently for these various provisions.

.05 Comments. Comments should refer to Notice 2004-37, and should be submitted by July 31, 2004, to:

Internal Revenue Service:
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:LPD:PR
Room 5203

or electronically via the Service internet site at:

Notice.Comments@irs.counsel.treas.gov. All comments will be available for public inspection and copying.

SECTION 5. DRAFTING INFORMATION

For further information regarding this Notice, contact Mr. David Kessler of the Office of Associate Chief Counsel (Corporate) at (202) 622-7770 (not a toll-free call).