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Consolidated Return Tax Regulations

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Loss Disallowance Rules

By

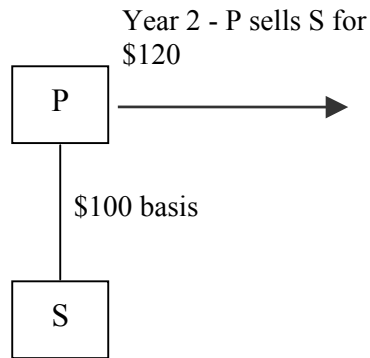
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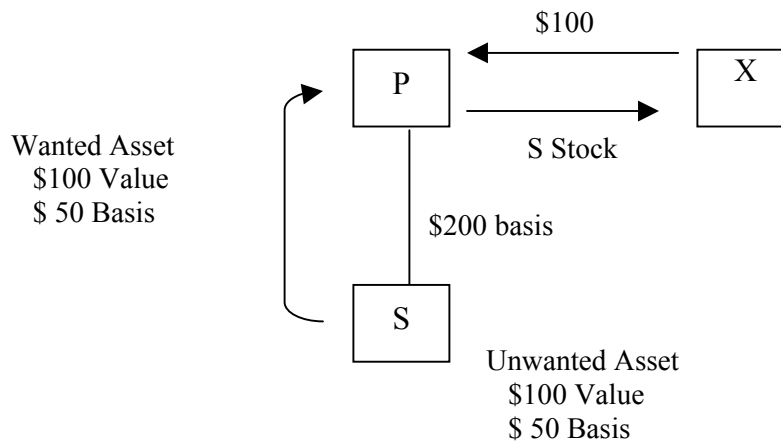
## The Investment Adjustment Rules



1. The investment adjustment rules under Treas. Reg. § 1.1502-32 require that annual adjustments be made to the basis of the stock of each subsidiary of a consolidated group. The adjustments are designed to ensure that consolidated group members pay a single corporate tax on the group's income and use losses only once.
2. Example
  - a. P acquires all of the stock of S for \$100. P and S elect to file a consolidated return.
  - b. S earns \$20 in Year 1. P's basis in its S stock is increased by the \$20 of taxable income to \$120. Treas. Reg. § 1.1502-32(b)(2)(i).
  - c. In Year 2, P sells S for \$120, recognizing no gain or loss. Because of the \$20 positive basis adjustment, P pays only one tax on its earned income.
3. The current investment adjustment regulations were promulgated in 1994. These regulations represented a dramatic change to the prior investment adjustment system. See T.D. 8560, 59 Fed. Reg. 41,666 (Aug. 15, 1994). These regulations apply with respect to basis adjustments in consolidated return years beginning on or after January 1, 1995. Although beyond the scope of this outline, in general these regulations increase or decrease P's basis in S to reflect S's taxable income or loss, tax-exempt income, and the like, rather than S's earnings and profits, as was the case under the prior rules.
4. The investment adjustment regulations also made various conforming changes to the loss disallowance rules. The bulk of the changes were to replace references to earnings and profits with references to gain, income, loss, deduction, and so on as the context may require. In several cases, however, a change to a particular rule was significant. Where pertinent, such changes are described in the examples that follow.
5. In 1995, the IRS issued regulations that revised the intercompany transaction rules. See T.D. 8597, 60 Fed. Reg. 36,671 (July 18, 1995). These regulations made a number of changes to the loss disallowance rules. Such changes, where significant, are also discussed below.

6. Finally, the IRS recently adopted a new set of loss disallowance rules. These rules added Treas. Reg. § 1.1502-32T(b)(4)(v), which provides for a special rule for loss carryovers of a subsidiary acquired in a transaction for which an election to proceed under Temp. Treas. Reg. § 1.1502-20T(i)(2) is made. For further discussion of the new loss disallowance rules, see pp. 6-7, 13-16, *infra*.

Son of Mirror Transactions and History Loss Disallowance Rules



1. The purpose of a son of mirror transaction is to dispose of a target corporation's unwanted built-in gain assets without a corporate-level tax.
2. Example
  - a. P purchases all of the stock of S for \$200. S has two assets, Unwanted Asset and Wanted Asset, each with a \$100 value and a \$50 basis. P wants to keep the Wanted Asset and dispose of the Unwanted Asset.
  - b. S distributes Wanted Asset to P, resulting in \$50 of section 311(b) gain to S, which is deferred. See Treas. Reg. § 1.1502-13(c)(2)(ii). P's basis in its S stock is reduced by \$100 as a result of the distribution. Treas. Reg. §§ 1.1502-13(f)(2)(ii), 1.1502-32(b)(2)(iv).
  - c. P sells all of its S stock for \$100 to X, an unrelated investor. This sale triggers S's \$50 deferred gain. Treas. Reg. §§ 1.1502-13(d)(1)(i), 1.1502-13(f)(2)(iii). This gain increases P's basis in its S stock to \$150. Treas. Reg. § 1.1502-32(b)(2)(i). Thus, P recognizes a \$50 loss on the sale of its T stock. The \$50 loss offsets the \$50 gain.
3. Arguably, the lack of a tax on P's disposition of S's assets is appropriate. P invested \$200 in S and receives a Wanted Asset worth \$100 and \$100 in cash when S is sold. However, the lack of a tax is inconsistent with the purpose of the repeal of the General Utilities doctrine in the Tax Reform Act of 1986: no tax has been paid on the built-in gain in the Wanted Asset, yet the asset has a stepped-up basis in the hands of P. In general, the loss disallowance rules of Treas. Reg. § 1.1502-20 or Temp. Treas. Reg. § 1.337(d)-2T operate to disallow P's loss on the sale of S's stock, thus preventing the offset of S's section 311(b) gain.

4. History of Treas. Reg. § 1.1502-20: At this point, it is helpful to review the history of the loss disallowance rules.
  - a. Notice 87-14, 1987-1 C.B. 445: The IRS indicated that regulations would be issued that would deny positive basis adjustments for earnings and profits (under the former basis adjustment rules) attributable to the sale or distribution of built-in gain property, using a “tracing” method. Notice 87-14 also indicated that the regulations would not apply to the disposition of a subsidiary acquired on or before January 6, 1987, the date Notice 87-14 was issued.
  - b. Original set of regulations: On March 9, 1990, temporary and proposed Treas. Reg. § 1.1502-20T was promulgated pursuant to Notice 87-14. Temp. Treas. Reg. § 1.1502-20T disallowed any loss recognized on the disposition of a consolidated subsidiary by a consolidated group member. However, it contained a reattribution rule, which permitted the selling member to elect to reattribute net operating losses of the subsidiary to itself. See Former Temp. Treas. Reg. § 1.1502-20T(f)(1); see *infra* pp. 53-57 for a discussion of the reattribution rule.
    - (1) Former Temp. Treas. Reg. § 1.1502-20T applied to all consolidated subsidiary stock that was disposed of on or after March 9, 1990, regardless of when the stock was acquired.
    - (2) A transitional rule was promulgated in temporary and proposed Treas. Reg. § 1.337(d)-1T(a), which generally applied to subsidiaries acquired after January 6, 1987 and disposed of before March 9, 1990. Under this rule, losses on the sale of such stock were disallowed, except to the extent that the group established that the loss was not attributable to the recognition of built-in gain.
  - c. Amended set of regulations: After receiving numerous comments on the loss disallowance regulations, on November 19, 1990, the IRS promulgated revised regulations.
    - (1) Temp. Treas. Reg. § 1.1502-20T was revoked.<sup>1</sup>
    - (2) Proposed Treas. Reg. § 1.1502-20 replaced Temp. Treas. Reg. § 1.1502-20T.
      - (a) The proposed regulations generally contained the same rules as the original -20T regulations, except that subparagraph (c) added a limited loss allowance rule, which permitted losses to be

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<sup>1</sup> A group could, however, elect to apply the former Temp. Treas. Reg. § 1.1502-20T in lieu of the transitional rules of Treas. Reg. §§ 1.337(d)-1 and -2, or with respect to pre-effective date transactions, in order to take advantage of the reattribution rule. Treas. Reg. §§ 1.337(d)-1(e)(3), 1.337(d)-2(g)(3), 1.1502-20(h)(4).

recognized to the extent they exceed (i) income or gain from extraordinary gain dispositions, (ii) the amount of positive investment adjustments, and (iii) the amount of any duplicated loss.

- (b) Prop. Treas. Reg. § 1.1502-20 generally applied to subsidiary stock disposed of after January 31, 1991. Therefore, despite the reassurances of Notice 87-14, the loss disallowance rules (with one minor exception provided in Treas. Reg. § 1.337(d)-1T) did apply to subsidiaries acquired prior to January 7, 1987.
- (3) The transitional rule in Temp. Treas. Reg. § 1.337(d)-1T was slightly amended and made final. Treas. Reg. § 1.337(d)-1. It is generally applicable to subsidiaries acquired after January 6, 1987 and disposed of before November 19, 1990.<sup>2</sup>
- (4) The former temporary and proposed Treas. Reg. § 1.337(d)-2T generally carried forward the transitional rule from November 19, 1990 to January 31, 1991.<sup>3</sup> Former Temp. Treas. Reg. § 1.337(d)-2T applied, however, to all subsidiaries, regardless of when they were acquired.
- d. Final regulations: On September 13, 1991, the IRS issued final regulations under Treas. Reg. §§ 1.1502-20 and 1.337(d)-2 and slightly modified Treas. Reg. § 1.337(d)-1 (collectively, the “final 1991 regulations”). Although the final 1991 regulations added some important provisions to Treas. Reg. § 1.1502-20, the IRS retained the same approach as in the proposed regulations. The final 1991 regulations did not change any of the effective dates.
- e. Consolidated groups could avoid the loss disallowance regulations and the “window period” transition rules in Former Temp. Treas. Reg. § 1.337(d)-2T by seeking permission to deconsolidate pursuant to Rev. Proc. 91-11, 1991-1 C.B. 470.
  - (1) Rev. Proc. 91-11 originally set the final date for filing an application to discontinue filing consolidated returns as June 30, 1991.

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<sup>2</sup> However, this rule may apply to stock disposed of after November 18, 1990. If stock of a transitional subsidiary was deconsolidated before November 19, 1990, and the remaining subsidiary stock held by the group was not subject to Treas. Reg. §§ 1.337(d)-2 or 1.1502-20, then the subsidiary continued to be treated as a transitional subsidiary. Treas. Reg. § 1.337(d)-1(e)(1).

<sup>3</sup> A selling group could, however, elect out of Treas. Reg. § 1.337(d)-2 and into the general loss disallowance regulations of Treas. Reg. § 1.1502-20. Treas. Reg. § 1.1502-20(h)(2).

- (2) However, the IRS in Rev. Proc. 91-39, 1991-2 C.B. 694, modified Rev. Proc. 91-11 by providing that such applications must be filed no later than 90 days after the date proposed Treas. Reg. § 1.1502-20 was finalized (i.e., by December 12, 1991).
- f. New temporary and proposed regulations. On March 7, 2002, the IRS promulgated new temporary and proposed loss disallowance regulations under sections 337(d) and 1502, adding Temp. Treas. Reg. §§ 1.337(d)-2T, 1.1502-20T(i), and 1.1502-32T(b)(4)(v). See 67 Fed. Reg. 11,034 (Mar. 12, 2002). The IRS amended these temporary and proposed regulations in May 2002. See 67 Fed. Reg. 37,998 (May 31, 2002). For further discussion of the temporary and proposed regulations, see pp. 13-16, *infra*.
- (1) In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the Federal Circuit held that the loss duplication factor of Treas. Reg. § 1.1502-20 was “manifestly contrary” to the statute. The new temporary regulations were issued in response to this decision. For further discussion of the Rite Aid decision, and the IRS’ reaction, see pp. 11-16, *infra*.
  - (2) For dispositions of stock occurring on or after March 7, 2002, Temp. Treas. Reg. § 1.337(d)-2T is generally applicable. Temp. Treas. Reg. § 1.337(d)-2T largely employs the rules in current Treas. Reg. § 1.337(d)-2. Losses on subsidiary stock are disallowed except to the extent that the parent establishes that the loss is not attributable to built-in gain on the disposition of an asset. Temp. Treas. Reg. § 1.337(d)-2T(c)(2). However, Temp. Treas. Reg. § 1.337(d)-2T differs from Treas. Reg. § 1.337(d)-2 in that the selling group is no longer required to dispose of its entire interest in the subsidiary. Temp. Treas. Reg. § 1.337(d)-2T.
  - (3) For dispositions of stock occurring before March 7, 2002, or for dispositions or deconsolidation of stock of a subsidiary after March 7, 2002 effected pursuant to a binding written contract entered into before March 7, 2002 that was in continuous effect, Temp. Treas. Reg. § 1.1502-20T(i)(2) allows a parent to choose one of three regulatory schemes for each separate disposition of subsidiary stock:
    - (a) Treas. Reg. § 1.1502-20 in its entirety.
    - (b) Treas. Reg. § 1.1502-20 without regard to the loss duplication factor.
    - (c) Temp. Treas. Reg. § 1.337(d)-2T.

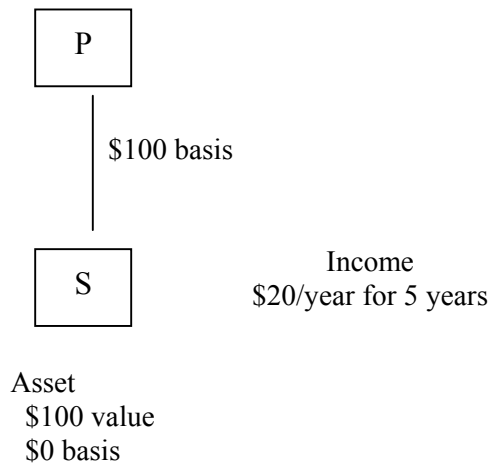
g. The following table summarizes the applicable loss disallowance provisions, which apply when a subsidiary is acquired and disposed of as follows:<sup>4</sup>

	Subsidiary acquired before 1/7/87:	Subsidiary acquired on or after 1/7/87:
Disposed of on or after 3/7/02:	§ 1.337(d)-2T	§ 1.337(d)-2T
Disposed of on or after 2/1/91 but before 3/7/02:	choice of: § 1.1502-20, § 1.1502-20 without loss duplication factor, or § 1.337(d)-2T	choice of: § 1.1502-20, § 1.1502-20 without loss duplication factor, or § 1.337(d)-2T
Disposed of on or after 11/19/90 but before 2/1/91:	§ 1.337(d)-2	§ 1.337(d)-2
Disposed of on or after 1/7/87 but before 11/19/90:	LDRs do not apply	§ 1.337(d)-1

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<sup>4</sup> See F.S.A. 199916007 (Jan. 2, 1999) (discussing the history of Treas. Reg. § 1.1502-20 and concluding that Treas. Reg. § 1.1502-20 was promulgated in accordance with the Administrative Procedure Act).

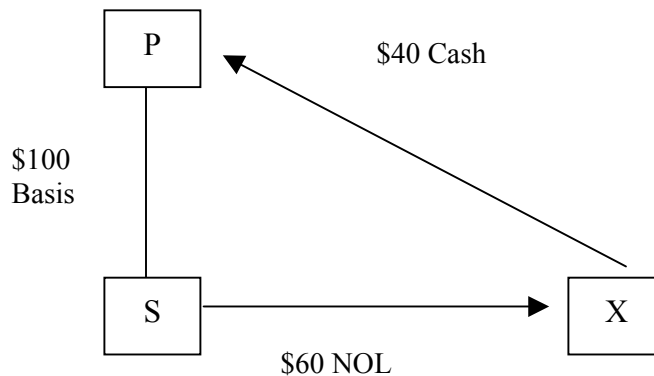
“Wasting” Assets Problem



1. In developing the original -20T regulations pursuant to Notice 87-14, the IRS became concerned with problems not described in Notice 87-14. See Preamble to the original -20T regulations, T.D. 8294, 55 Fed. Reg. 9,426-32 (March 14, 1990). These other problems apparently helped persuade the IRS to adopt a sweeping loss disallowance rule in former Temp. Treas. Reg. § 1.1502-20T(a).
2. In part, the IRS became concerned with “wasting” assets and built-in gain. See Preamble to the original -20T regulations, 55 Fed. Reg. at 9,427, Ex. 3.
3. Example
  - a. P acquires all the stock of S. S owns one asset with a value of \$100 and a basis of \$0.
  - b. S’s asset earns \$20 and declines in value by \$20 in each year over a five-year period. P’s basis in its S stock is increased by \$100. Treas. Reg. § 1.1502-32(b)(2)(i).
  - c. If P sells the S stock, it can recognize a \$100 loss.
4. According to the IRS, by using up an asset in the process of earning income, S can convert its built-in gain to income and avoid the corporate-level tax. Preamble to the original -20T regulations, 55 Fed. Reg. at 9,427, 9,430.
5. It is by no means clear that this problem is widespread. Additionally, the time value of money reduces the effect of the problem. Nevertheless, in the preambles to the proposed and final 1991 regulations, the IRS reaffirmed its concern with “wasting” assets. 55 Fed. Reg. 49,075, 49,078 (Nov. 26, 1990); 56 Fed. Reg. 47,379, 47,383 (Sept. 19, 1991). Although new Temp. Treas. Reg. § 1.337(d)-2T does not address wasting assets, recent

remarks by Eric Solomon, the Deputy Assistant Secretary for Regulatory Affairs of the Department of the Treasury, confirm that Treasury and the IRS consider wasting assets to be a serious problem and plan to address the issue in future regulations. See Sheryl Stratton, LDR Issues Are in State of Flux Following Rite Aid, 2002 Tax Notes Today 69-4 (April 9, 2002).

Loss Duplication



1. In developing the original -20T regulations pursuant to Notice 87-14, the IRS also became concerned with the potential duplication of losses by a subsidiary after the subsidiary left the group. Preamble to the original -20T regulations, 55 Fed. Reg. at 9,427, Ex. 4. The IRS has reiterated its desire to prohibit loss duplication in future regulations. Notice 2002-18 (Mar. 7, 2002).
2. Example
  - a. P forms S with a contribution of \$100. S has an operating loss of \$60, which the P group is unable to use on its consolidated return.
  - b. P's basis in its S stock remains at \$100, because S's loss has not been absorbed by the group. Treas. Reg. § 1.1502-32(b)(3)(i)(A).
  - c. P sells S to X for \$40, recognizing a \$60 loss.
  - d. S is apportioned its \$60 net operating loss carryover when it leaves the P group. Treas. Reg. §§ 1.1502-79(a), 1.1502-21(b)(2).
    - (1) P's loss on the sale of S is thus duplicated when S uses its loss after leaving the P group.
    - (2) S is restricted in its use of its apportioned losses by section 382, Treas. Reg. §§ 1.1502-21, 1.1502-22 (SRLY rules), etc.
  - e. Loss duplication can also occur if S uses the \$100 contributed by P to purchase an asset and the asset declines in value to \$40.
    - (1) When P sells S for \$40, P recognizes a \$60 loss.



- (1) Court of Federal Claims decision.
  - (a) The Court of Federal Claims held that Treas. Reg. § 1.1502-20 was not arbitrary, capricious, or manifestly contrary to law, and that it served the purpose of clearly reflecting income tax liability of both the parent and the subsidiary in a consolidated group.
  - (b) The court rejected the taxpayer's argument that the regulation was in derogation of section 165(a), which permits a deduction for losses sustained during the taxable year, and thus exceeded the Treasury's authority. The court noted that the taxpayer had an opportunity, which it did not take, to structure the sale of the subsidiary in a way that would have allowed the taxpayer to recognize the loss (i.e., as an asset sale instead of a stock sale).
  - (c) The court also rejected the taxpayer's argument that the Supreme Court's decision in *Illfield Co. v. Hernandez* stands for the proposition that a duplicated loss is a loss twice enjoyed by the group -- not by unrelated parties. The court noted that section 1502 permits the Treasury to implement regulations that clearly reflect income tax liability with respect to consolidated groups and their members "both during and after the period of affiliation," which is served by prohibiting group losses that otherwise may be taken both by the group and its former member.
- (2) The Federal Circuit decision
  - (a) The Court of Appeals for the Federal Circuit reversed the Court of Federal Claims' decision that Treas. Reg. § 1.1502-20 was a proper exercise of Treasury's regulatory authority. The Federal Circuit held that duplicated loss factor of the loss disallowance rules "distorts rather than reflects the tax liability of consolidated groups" and, therefore, the regulation is manifestly contrary to the statute.
  - (b) The Federal Circuit held that "in the absence of a problem created from the filing of consolidated returns, the Secretary is without authority to change the application of other tax code provisions to a group of affiliated corporations filing a consolidated return." Because the ability of a former consolidated subsidiary to realize a loss on its assets after the consolidated group realizes a loss on the subsidiary's stock is not limited to the consolidated return context, the Secretary is without authority to change the application of section 165 to the sale of the subsidiary's stock.
    - (i) This standard could have broad implications with respect to other consolidated return regulations, because the

consolidated return regulations change the application of many tax code provisions. See, e.g., Treas. Reg. §§ 1.1502-13(f)(2); -13(f)(6); -13(g)(3)(ii)(B)(2); -19; -32; -80.

- (ii) The Federal Circuit did not offer much guidance as to when a problem is “created” by the filing of consolidated returns.
    - (c) The Federal Circuit noted that Congress has already addressed the problem of duplicated losses by limiting the subsidiary’s potential future deduction under sections 382 and 383 – not by disallowing the parent’s loss on the subsidiary stock.
    - (d) The Federal Circuit rejected the government’s argument that if an affiliated group elects to take advantage of the benefits of filing a consolidated return, “it must take the bitter with the sweet,” noting that the “‘bitter with the sweet’ does not include the invalid.”
  - f. It is not clear from the court’s opinion whether it invalidated all of Treas. Reg. § 1.1502-20 or just the duplicated loss provision. The court stated that the “regulation” was manifestly contrary to the statute. Nonetheless, the court’s analysis clearly focuses on only the duplicated loss provision, and the IRS has interpreted the opinion to invalidate only the duplicated loss provision. See Notice 2002-11, 2002-7 I.R.B. 1 (Jan. 31, 2002).
  - g. On January 31, 2002, the IRS announced that (i) it would not seek certiorari from the Supreme Court in Rite Aid, (ii) it would not continue to litigate the validity of Treas. Reg. § 1.1502-20 in the interest of sound tax administration, and (iii) it would amend Treas. Reg. § 1.337(d)-2 and substitute it for Treas. Reg. § 1.1502-20.
4. New temporary and proposed regulations. On March 7, 2002, the IRS promulgated new temporary and proposed loss disallowance regulations under sections 337(d) and 1502, adding Temp. Treas. Reg. §§ 1.337(d)-2T, 1.1502-20T(i), and 1.1502-32T(b)(4)(v). See 67 Fed. Reg. 11,034 (Mar. 12, 2002). The IRS amended these temporary and proposed regulations in May 2002. See 67 Fed. Reg. 37,998 (May 31, 2002).
- a. For dispositions of stock occurring on or after March 7, 2002, Temp. Treas. Reg. § 1.337(d)-2T, which largely employs the rules in current Treas. Reg. § 1.337(d)-2, is generally applicable. Temp. Treas. Reg. § 1.337(d)-2T provides that losses on subsidiary stock are disallowed except to the extent that the parent establishes that the loss is not attributable to built-in gain. Temp. Treas. Reg. § 1.337(d)-2T(c)(2).
    - (1) “Built-in gain” includes only gain on the disposition of an asset that is already reflected in the basis of the stock (e.g., gain that is inherent in the asset when the stock is acquired). *Id.*

- (2) To claim the loss, the parent must file a “statement of allowed loss” with its tax return. Temp. Treas. Reg. § 1.337(d)-2T(c)(3).
  - (3) Temp. Treas. Reg. § 1.337(d)-2T differs from Treas. Reg. § 1.337(d)-2 in that the selling group is no longer required to dispose of its entire interest in the subsidiary. Temp. Treas. Reg. § 1.337(d)-2T.
- b. For dispositions of stock occurring before March 7, 2002, or for dispositions or deconsolidation of stock of a subsidiary after March 7, 2002 effected pursuant to a binding written contract entered into before March 7, 2002 that was in continuous effect, Temp. Treas. Reg. § 1.1502-20T(i)(2) allows a parent to choose one of three regulatory schemes for each separate disposition of subsidiary stock: (i) Treas. Reg. § 1.1502-20 in its entirety; (ii) Treas. Reg. § 1.1502-20 without regard to the loss duplication factor; or (iii) Temp. Treas. Reg. § 1.337(d)-2T.
- (1) The parent’s election under Temp. Treas. Reg. § 1.1502-20T(i)(2) must be filed with a timely filed (including extensions) original return for the taxable year that includes any date on or before March 7, 2002. Temp. Treas. Reg. § 1.1502-20T(i)(3)(v)(4). If the date of the disposition or deconsolidation of the stock is after March 7, 2002 pursuant to a binding contract, the election may either be filed (i) with or as part of a timely filed original return for the tax year that includes the disposition or deconsolidation date, or (ii) with or as part of an amended return filed before the date that the original return for the tax year that includes March 7, 2002 is due. <sup>5</sup> If no election is filed, Treas. Reg. § 1.1502-20 applies in its entirety, including the loss duplication factor invalidated by Rite Aid. See Temp. Treas. Reg. § 1.1502-20T(i)(2). Thus, a parent need not file an election under Temp. Treas. Reg. § 1.1502-20T(i)(2) if it will apply § 1.1502-20 in its entirety.
  - (2) If the parent had elected under Treas. Reg. § 1.1502-20(g) to reattribute the subsidiary’s losses that were disallowed under the prior loss disallowance rules, and the election under Temp. Treas. Reg. § 1.1502-20T(i) results in a reduction of the disallowed losses, the regulations provide rules for changing the amount of the reattributed losses. Temp. Treas. Reg. § 1.1502-20T(i)(3); see pp. 53-57, *infra*, for a discussion of the reattribution rule.
  - (3) If an election to apply Temp. Treas. Reg. § 1.1502-20T or § 1.337(d)-2T increases the loss allowed on the disposition of subsidiary stock, but the

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<sup>5</sup> Note that the election provisions were amended by the IRS in May 2002 to clarify that a timely filed return included extensions and to clarify that elections could be made on an original return filed for the tax year 2001, even though it does not include March 7, 2002. See 67 Fed. Reg. at 37,998.

year of the disposition is closed, and the absorption of such extra loss would have affected the tax treatment of another item that has an effect in an open year, then the taxpayer may adjust the other item. Temp. Treas. Reg. § 1.1502-20T(i)(3)(v).

- (a) For example, P and S file a consolidated return. P's S stock becomes worthless in 1995, but P's \$20 loss is disallowed under Treas. Reg. § 1.1502-20. P's worthless stock loss would not be disallowed under Temp. Treas. Reg. § 1.337(d)-2T. The 1995, 1996, and 1997 tax years are closed. Assume that the P group has the following consolidated net income for 1995-1998:

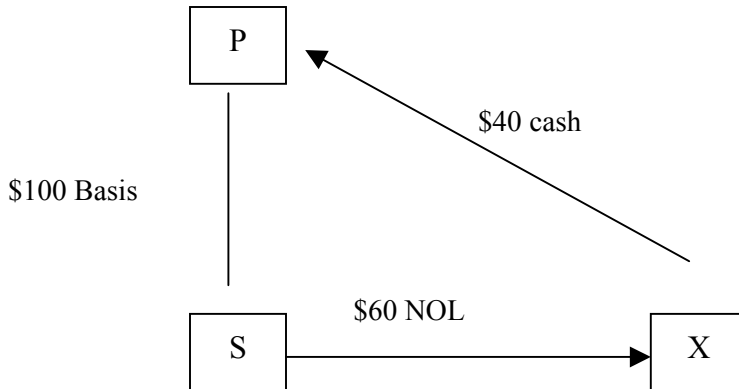
	1995	1996	1997	1998
Consolidated income	\$25	(\$20)	\$10	\$6
Net income after § 172	\$ 5	\$ 0	\$10	\$6

- (b) P's allowed loss would have reduced the P group's consolidated income in 1995 to \$5, and the \$20 operating loss in 1996 could have been carried back to offset the \$5 in 1995 and carried forward to offset the \$10 in 1997 and \$5 of the \$6 in 1998. Although the 1995-1997 tax years are closed, the P group may utilize the loss carryforward that would have otherwise been available to it in 1998 to reduce its net income after § 172 to \$1.
- (4) Many of the same rules apply to Treas. Reg. § 1.1502-20 and Temp. Treas. Reg. § 1.337(d)-2T. For example, rules regarding successors, anti-avoidance, and investment adjustments under Treas. Reg. § 1.1502-20 and incorporated into Temp. Treas. Reg. § 1.337(d)-2T. Temp. Treas. Reg. § 1.337(d)-2T(d)-(f). In addition, the IRS amended Temp. Treas. Reg. § 1.337(d)-2T to provide a netting rule similar to that of Treas. Reg. § 1.1502-20(a)(4) to permit gains on subsidiary stock to offset losses on such subsidiary's stock. Temp. Treas. Reg. § 1.337(d)-2T(a)(4), (b)(4); see pp. 30-31, *infra*, for a discussion of the netting rule.
- (5) A parent's choice of regulatory framework for the disposition of subsidiary stock may significantly affect the consequences of the disposition.
- (a) Temp. Treas. Reg. § 1.337(d)-2T uses a tracing rule, allowing basis reduction upon the deconsolidation of a share to the extent that the parent establishes that the basis is not attributable to the recognition of built-in gain. In contrast, Treas. Reg. § 1.1502-20 adopts certain presumptions, providing that the basis reduction is limited to the amount of the sum of the loss disallowance factors (i.e., duplicated losses, extraordinary gain dispositions, and

positive investment adjustments). In many situations, tracing may not be possible.

- (b) Temp. Treas. Reg. § 1.337(d)-2T does not provide for loss reattribution, but a parent proceeding under Treas. Reg. § 1.1502-20 generally may reattribute losses to the extent of the disallowed loss.
  - (c) If the loss was disallowed solely by reason of the extraordinary gain disposition factor of Treas. Reg. § 1.1502-20, the answer would be the same under either Temp. Treas. Reg. § 1.337(d)-2T or § 1.1502-20T(i).
- c. Concurrently with the issuance of the temporary and proposed regulations, the IRS issued Notice 2002-18, in which it noted that the IRS and Treasury continue to devote “substantial resources” to developing comprehensive regulations addressing loss duplication. Thus, the IRS clearly expects to issue new regulations in this area.

Allowable Loss -- Duplication of Loss



1. In Treas. Reg. § 1.1502-20(c), the IRS adopted a rule that permits the recognition of some economic loss in certain circumstances. Loss is permitted to the extent it exceeds a share's allocable part of the sum of the following factors:
  - a. Income or gain, net of directly related expenses, that is allocated to the share from "extraordinary gain dispositions;"
  - b. The amount of the positive adjustment with respect to the share under Treas. Reg. § 1.1502-32 for each consolidated return year, but only to the extent the amount exceeds the extraordinary gain amount; and
  - c. The amount of any duplicated loss.
2. The loss duplication factor is intended to ensure that a loss allowed under the final 1991 regulations is not duplicated at a later time.<sup>6</sup> The loss duplication factor is discussed immediately below, and the remaining two factors are discussed in the pages that follow.
3. Duplicated loss generally is the excess of (A) the sum of the aggregate asset basis, loss carryovers, and deferred deductions (such as suspended losses under the passive activity

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<sup>6</sup> Temp. Treas. Reg. § 1.337(d)-2T does not contain a loss duplication factor. Thus, the loss duplication factor will only apply when a taxpayer applies Treas. Reg. § 1.1502-20 in its entirety. However, in Notice 2002-18, the IRS indicated that it still is very concerned about preventing loss duplication and will issue regulations addressing loss duplication in the future. Notice 2002-18 (Mar. 7, 2002). The Notice states that a consolidated group cannot obtain a tax benefit from both the utilization of a loss from the disposition of stock and the utilization of a loss or deduction with respect to another asset that reflects the same economic loss. See id. Unlike Rite Aid, however, the example cited in the notice involves recognition of both losses by the same consolidated group.

loss rules) of the subsidiary, over (B) the value of the subsidiary's stock and any liabilities of the subsidiary. Treas. Reg. § 1.1502-20(c)(2)(vi).

- a. The amounts computed in the loss duplication formula must include the subsidiary's share of corresponding amounts with respect to lower tier subsidiaries. Id.
- b. Aggregate asset basis does not include any stock or securities in another subsidiary. Id.

4. Example

- a. P forms S with a contribution of \$100. S buys a manufacturing plant for \$100. S has an operating loss of \$60, which the P group is unable to use on its consolidated return and which cannot be carried back. S's basis in its assets is reduced to \$40.
- b. P's basis in its S stock remains at \$100. Treas. Reg. § 1.1502-32(b)(2) and (3).
- c. P sells S to X for \$40, recognizing a \$60 loss. S is apportioned its \$60 net operating loss carryover when it leaves the P group. Treas. Reg. §§ 1.1502-79(a), 1.1502-21(b)(2).
- d. Under Treas. Reg. § 1.1502-20, S's duplicated loss is \$60, determined as follows:

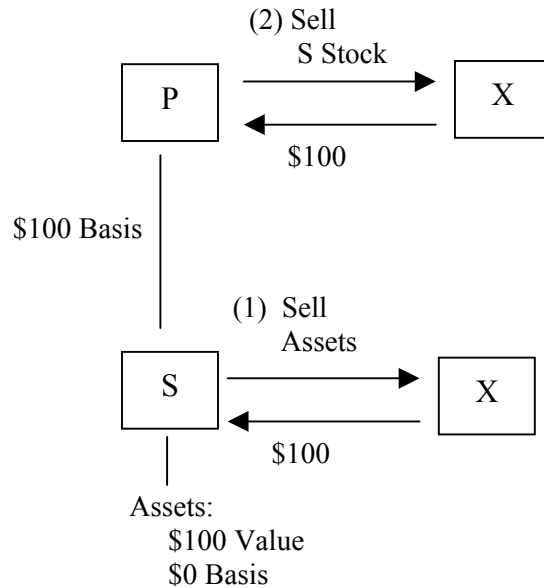
Sum of S's asset bases (\$40)	
and loss carryovers (\$60):	\$100
Less value of S's stock:	\$ 40
Duplicated Loss:	\$ 60

- e. Because P's \$60 loss on the sale of S does not exceed the \$60 duplicated loss, all of P's loss is disallowed.
  - f. Importantly, P would be permitted to reattribute to itself S's \$60 loss carryover. See pp. 53-57, *infra*. However, if the duplicated loss is attributable to a built-in loss asset, no such relief is available to P. Possible solution: prior to selling S, P could cause S to sell the built-in loss asset and recognize the loss. If the P group could not utilize the loss, P could reattribute the loss to itself.
  - g. Under Temp. Treas. Reg. § 1.337(d)-2T or § 1.1502-20 without the loss duplication factor, P's loss would be allowed.
5. The IRS has taken the position that so-called "contingent liability tax shelter" transactions, which are described in Notice 2001-17, result in a duplication of loss and thus a disallowance under Treas. Reg. § 1.1502-20.

- a. The transaction typically involves the transfer of one or more assets with a basis that approximates its value in exchange for stock of the transferee corporation and the transferee's assumption of a contingent liability that would be deductible if paid by the transferor.
  - (1) The asset will typically be a security issued by another member of the group. The liability is only slightly less than the basis of the asset.
  - (2) Shortly after the exchange, the transferor sells the stock received in the exchange and claims a loss approximating the present value of the contingent liability assumed by the transferee.
  
- b. The IRS took the position that, at the time of the loss duplication calculation, the subsidiary holds the proceeds of the member security, not the security itself, thus resulting in a duplicated loss. The IRS reaches this conclusion through a somewhat strained interpretation of Treas. Reg. § 1.1502-13(g).
  - (1) Under Treas. Reg. § 1.1502-13(g), a member security is deemed satisfied and reissued if a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its rights or obligations under the member security. The deemed satisfaction occurs immediately before the transaction in which the amount is realized, and the deemed reissuance occurs immediately after the transaction.
  - (2) The IRS took the position that the sale of the stock in Notice 2001-17 transactions triggers Treas. Reg. § 1.1502-13(g) with respect to the member security, because it produces an indirect realization of loss from the assignment of all or part of an interest in the member security.
    - (a) If the transfer of the member security qualifies as a tax-free section 351 exchange, the IRS additionally argued that the stock is a successor asset within the meaning of Treas. Reg. § 1.1502-13(j)(1) and, therefore, Treas. Reg. § 1.1502-13(g) applies to the stock.
  - (3) Next, the IRS took the position that the member security is deemed satisfied immediately before the stock sale and deemed reissued after the sale, and that the loss duplication calculation is made at the time of the sale. Thus, at the time of the loss duplication calculation, the subsidiary holds the proceeds from the deemed satisfaction of the member security.
  
- c. In addition to the technical argument based on Treas. Reg. § 1.1502-13(g), the IRS argues that Notice 2001-17 transactions violate the anti-avoidance and anti-stuffing rules of Treas. Reg. § 1.1502-20(e).

- d. These arguments appear to have become moot, however, as a result of the Federal Circuit's decision in *Rite Aid Corp.* Nonetheless, the IRS has identified a number of other grounds upon which to attack these transactions. See, e.g., Notice 2001-17, 2001-9 I.R.B. 730; CC-2001-033a (June 28, 2001).
- e. In light of the new temporary and proposed regulations, the IRS is unlikely to pursue these arguments.

Allowable Loss -- Extraordinary Gain Dispositions



1. As discussed above, Treas. Reg. § 1.1502-20(c) permits the recognition of loss to the extent it exceeds a share's allocable part of the sum of the following factors: (i) income or gain, net of directly related expenses, that is allocated to the share from extraordinary gain dispositions; (ii) the amount of the positive adjustment with respect to the share under Treas. Reg. § 1.1502-32 for each consolidated return year, but only to the extent the amount exceeds the extraordinary gain amount; and (iii) the amount of any duplicated loss.
2. Extraordinary gain dispositions are dispositions after November 18, 1990 resulting in gain from the disposition of capital assets, property used in a trade or business, and certain bulk asset dispositions. Treas. Reg. § 1.1502-20(c)(2)(i).
  - a. Income from discharge of indebtedness and a change in method of accounting resulting in positive section 481 adjustments are also treated as extraordinary gain dispositions.
  - b. Loss from extraordinary dispositions cannot be used to offset gain from extraordinary gain dispositions.
  - c. Even though the IRS excluded pre-November 19, 1990 dispositions from the extraordinary gain disposition factor, the IRS has taken the position that such dispositions are not excluded from the loss disallowance rules altogether. Instead, the IRS treats such dispositions as positive investment adjustments under Treas. Reg. § 1.1502-20(c)(1)(ii). F.S.A. 199945037 (Aug. 17, 1999).

3. Example

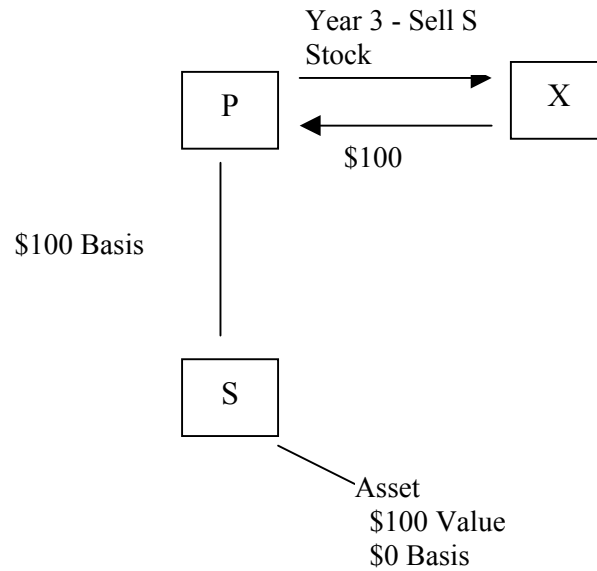
- a. P acquires all of the stock of S for \$100. S has assets it uses in its trade or business with a value of \$100 and a basis of \$0. S sells the assets, resulting in a \$100 gain. This gain increases P's basis in its S stock to \$200. S uses the cash to buy a capital asset for \$100.
- b. P sells its S stock for \$100, resulting in a \$100 loss (\$200 basis less \$100 value). The amount of extraordinary gain is \$100. Because the \$100 loss does not exceed the \$100 extraordinary gain, all of the \$100 loss is disallowed.
- c. In determining the amount of extraordinary gain, Treas. Reg. § 1.1502-20 permits such amount to be reduced by directly related expenses from the disposition. Treas. Reg. § 1.1502-20(c)(1)(i).
  - (1) With regard to federal income taxes, the regulations specifically provide that "federal income taxes may be directly related to extraordinary gain dispositions only to the extent of the excess (if any) of the group's income tax liability actually imposed . . . over the group's income tax liability for the taxable year redetermined by not taking into account the extraordinary gain dispositions." Treas. Reg. § 1.1502-20(c)(2)(i) (flush language). Accordingly, if a subsidiary sells an asset that results in extraordinary gain, but the group has no consolidated tax liability for the year, no federal income tax expense may be allocated to reduce the amount of extraordinary gain.
  - (2) The regulations fail to mention state income taxes. Presumably, state income taxes would be a directly related expense to an extraordinary gain disposition if the rule regarding federal income taxes is satisfied (i.e., the group pays the state income tax on the extraordinary gain). It is unclear how the rule would work with respect to state income taxes where all group members do not join in the state consolidated return or where the state does not recognize consolidated returns.
- d. Note that new Temp. Treas. Reg. § 1.337(d)-2T, with its focus on built-in gain items, essentially retains the extraordinary gain disposition factor. Thus, the conclusion would be the same under the new loss disallowance rules.

4. The IRS rejected proposals to modify the extraordinary gain disposition rule to exclude the following categories of assets (such assets could not possibly have preacquisition built-in gain):

- a. Assets acquired by a subsidiary in a cost basis transaction (e.g., a purchase) after the subsidiary joined the group.
- b. Assets subject to a section 338 election (with or without a section 338(h)(10) election).

- c. Assets originally acquired by a group member in a cost basis transaction that were transferred to a subsidiary in a carryover basis transaction (e.g., a section 351 transaction).
- d. Assets to the extent that gain on their disposition is attributable to the recovery of depreciation deductions that were allowed after the group acquired the asset (including an asset with preacquisition built-in gain). Such gain is attributable solely to postacquisition events -- postacquisition loss produced by depreciation deductions and postacquisition gain when the asset is sold and the basis is recovered.

Allowable Loss -- Positive Investment Adjustments



1. For purposes of determining the allowable loss under Treas. Reg. § 1.1502-20(c)(1)(ii), a positive adjustment is defined as the sum of the amounts under § 1.1502-32(b)(2)(i) through (iii) for the consolidated return year (the adjustment determined without taking distributions into account). Thus, the basis adjustments attributable to taxable income, tax loss, tax-exempt income, and noncapital, nondeductible expenses are netted for the taxable year to determine the amount (if any) of the positive investment adjustment. This amount is not reduced by negative adjustments attributable to distributions. In addition, losses are taken into account as they arise, not when they are absorbed. Treas. Reg. § 1.1502-20(c)(2)(ii).
  - a. All net positive adjustments are presumed to be attributable to built-in gain.
  - b. The reason for the positive investment adjustments factor is the IRS's concern over "wasting" assets.
2. Netting of profits and losses arising in the same year is permitted under the final 1991 regulations. But netting positive and negative investment adjustments from different years is not permitted. See Treas. Reg. § 1.1502-20(c)(4), Ex. 3.
  - a. While the IRS rejected proposals to permit netting on a prospective basis, the final 1991 regulations did add a transitional netting rule for certain taxable years ending on or before September 13, 1991. The IRS corrected the transitional netting rule in T.D. 8364 to clarify certain misleading errors.
  - b. Under the corrected transitional netting rule of Treas. Reg. § 1.1502-20, the amount of positive investment adjustments computed under the general rule is limited for taxable years of the subsidiary ending on or before September 13, 1991. The amount cannot exceed the net increase in the basis of a share from (i)

the date the share was first acquired by the group to (ii) the end of the last taxable year ending on or before September 13, 1991 (or, if earlier, the date of the disposition or deconsolidation). Treas. Reg. § 1.1502-20(c)(2)(v)(A).

- (1) If the share is transferred basis property from a prior consolidated group, the starting date is the date the share was first acquired by the prior group.
- (2) If the overall amount of positive investment adjustments would be less if the netting permitted by the rule ceased as of an earlier year which ended after 1986, then the ending date for netting purposes shall be the end of such taxable year, and the remaining taxable years of the subsidiary ending on or before September 13, 1991 shall be calculated under the general rule in Treas. Reg. § 1.1502-20(c)(1)(ii). Treas. Reg. § 1.1502-20(c)(2)(v)(B).

### 3. Example

- a. P acquires all of the stock of S for \$100. S has an asset with a \$100 value and a \$0 basis.
- b. In Year 1, S earns \$100 of operating income. P's basis in S is increased by \$100 to \$200.
- c. In Year 2, S's asset declines in value to \$0. S invests the \$100 from operating income in another asset, which loses \$25 during the year. The loss is absorbed by the P group. P's basis in S is reduced to \$175.
- d. In Year 3, P sells S for \$75, realizing a \$100 loss.
- e. Under the limited loss allowance rule of the final 1991 regulations, the loss disallowed is equal to the amount of the positive investment adjustments -- \$100 from Year 1. This amount is not reduced by the \$25 loss from Year 2. Thus, all of P's \$100 loss is disallowed.
- f. Note that the positive investment adjustment factor is inapplicable under new Temp. Treas. Reg. § 1.337(d)-2T. Thus, P's \$100 loss would be allowed under the new rules.

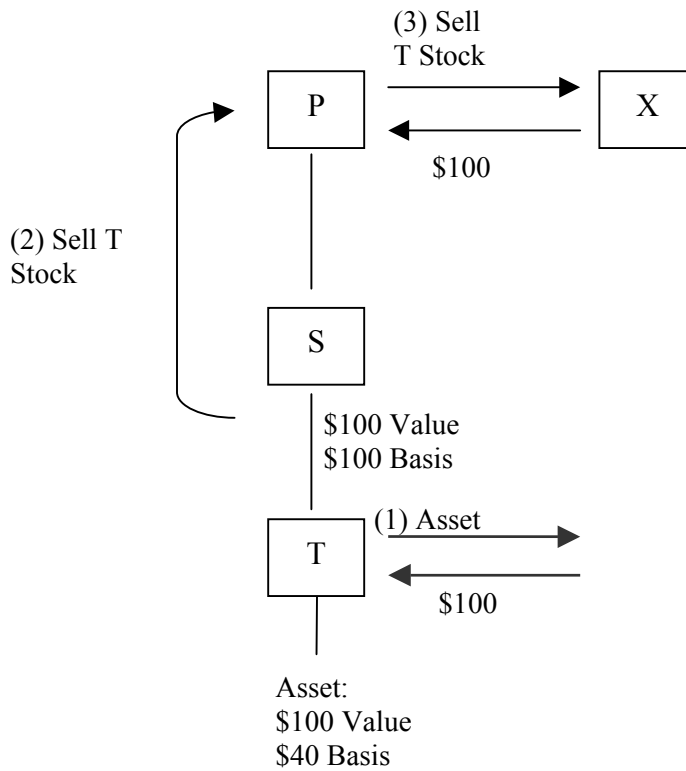
4. Because losses from extraordinary dispositions cannot offset gains from extraordinary dispositions, absorption of such losses should be timed to fall in years in which the subsidiary would otherwise have net positive investment adjustments.

- a. If losses from extraordinary dispositions are absorbed in years in which the subsidiary would have negative investment adjustments, such losses cannot be used to offset positive investment adjustments in other years.

5. After the Federal Circuit invalidated the loss duplication factor in Rite Aid, the IRS conceded the loss disallowance issue in the context of a positive investment adjustment

factor in *Square D Co. v. Comm'r*, 118 T.C. 299 (2002). See Michael L. Schler, Consolidated Return Loss Disallowance: Conceptual Issues, 2002 Tax Notes Today 88-30 n.10 (May 3, 2002).

Coordination with Loss Deferral and Other Loss Disallowance Rules



1. The general rule in Treas. Reg. § 1.1502-20 is that any loss recognized on the disposition of consolidated subsidiary stock by a consolidated group member after January 31, 1991 is disallowed. Treas. Reg. § 1.1502-20(a), (h)(1). A worthless stock deduction under section 165(g)(3) constitutes a “disposition” that triggers the general loss disallowance rule. See Treas. Reg. § 1.1502-20(a)(1), (2).
2. Special rules apply in the case where a loss on the sale of subsidiary stock would be deferred or disallowed under a Code provision or regulation other than Treas. Reg. § 1.1502-20. Treas. Reg. § 1.1502-20(a)(3)(i) provides that any other provision of the Code or regulations that disallows or defers a loss on the disposition of subsidiary stock applies before the general loss disallowance rule. If loss is deferred under another provision, the loss is subject to the loss disallowance rule when the loss is taken into account. *Id.*
3. However, if a so-called “overriding event” occurs prior to the time that a deferred loss is taken into account, the loss is subject to the loss disallowance rule at that time. Treas. Reg. § 1.1502-20(a)(3)(i), (ii). The overriding events include the following:
  - a. The subsidiary stock ceases to be owned by a member of the consolidated group;

- b. The subsidiary stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock); and
- a. The subsidiary stock is treated as disposed of under Reg. § 1.1502-19(c)(1)(ii)(B) or (c)(1)(iii). Under Treas. Reg. § 1.1502-19(c)(1)(ii)(B) and (c)(1)(iii), a disposition is deemed to occur as follows:
  - (1) At the time S becomes a nonmember, or P's basis in the stock is reflected, directly or indirectly, in whole or in part, in the basis of any asset other than member stock;
  - (2) At the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes;
  - (3) At the time an indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Treas. Reg. § 1.1502-32(b)(3)(ii)(C); or
  - (4) At the time a member takes into account a deduction or loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S's taking into account a corresponding amount of income.

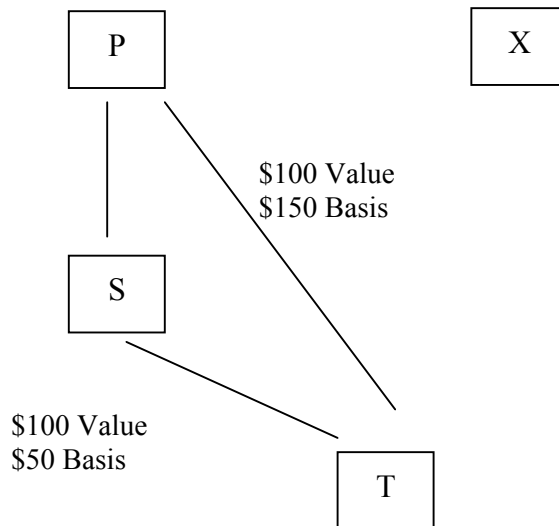
#### 4. Example

- a. P owns all of the stock of S, and S owns all of the stock of recently purchased T. S has a \$100 basis in its T stock, which is worth \$100. T owns one asset with a basis of \$40 and a value of \$100. T sells the asset for \$100, recognizing a \$60 gain. The gain increases S's basis in the T stock from \$100 to \$160.
- b. S sells its T stock to P for \$100 resulting in a \$60 deferred loss under section 267(f) and Treas. Reg. § 1.1502-13(c). (This sale is not subject to section 304(a)(1). See Rev. Rul. 74-605, 1974-2 C.B. 97; Treas. Reg. § 1.1502-80(b)).
- c. P later sells all of the T stock for \$100 to X, a member of the same controlled group (as defined in section 267(f)) as P but not a member of the P consolidated group.
- d. Pursuant to Treas. Reg. § 1.1502-20(a)(3), the loss disallowance rule would not ordinarily apply to S's \$60 loss, because the loss is deferred under section 267(f) and Treas. Reg. § 1.1502-13(c). Although P's sale of the T stock to X would cause S's deferred loss to be taken into account under Treas. Reg. § 1.1502-13(d), Treas. Reg. § 1.267(f)-1(b)(1) and -1(c)(1)(i) provide that the loss is not taken into account, because X is a member of the same controlled group as P and S. Nevertheless, the sale of the T stock to X is an "overriding event," since T ceases to be a member of the P consolidated group. Therefore, S's \$60 loss is disallowed

under Treas. Reg. § 1.1502-20(a)(1) and is never taken into account under section 267(f). See Treas. Reg. § 1.1502-20(a)(5), Ex. 6(ii).

5. The outcome should be the same if the parent elects to proceed under Temp. Treas. Reg. § 1.337(d)-2T. See Temp. Treas. Reg. § 1.337(d)-2T(a)(3) (the rules of Treas. Reg. § 1.1502-20(a)(3) apply, “with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20”).
6. Although Treas. Reg. § 1.1502-20(a)(3) overrides the section 267(f) regulations in the above example, that was not the case under the old rules.
  - a. Same facts as in the above example, except that prior to P’s sale of the T stock to X, P sells its S stock to Y, an unrelated investor. S’s \$60 deferred loss would not have been restored under the prior rules. Prior Temp. Treas. Reg. §§ 1.267(f)-2T(d)(2), 1.267(f)-1T(c)(6).
  - b. However, P was entitled to increase the basis of its T stock by the amount of the deferred loss -- \$60. Prior Temp. Treas. Reg. §§ 1.267(f)-2T(d)(2), 1.267(f)-1T(c)(7). Thus, when P sold its T stock to X, it would result in a \$60 disallowed loss (\$100 value less \$160 basis). Treas. Reg. § 1.1502-20(a)(1).
7. The prior regulations under section 267(f) were revised in 1995. Reg. § 1.267(f)-1, 60 Fed. Reg. 36,669, 36,680. The regulations also revised Treas. Reg. § 1.1502-20(a)(5), Ex. 6, described above, in order to conform the example with the changes. These regulations were issued along with the final intercompany transaction regulations.

Netting Gains and Losses



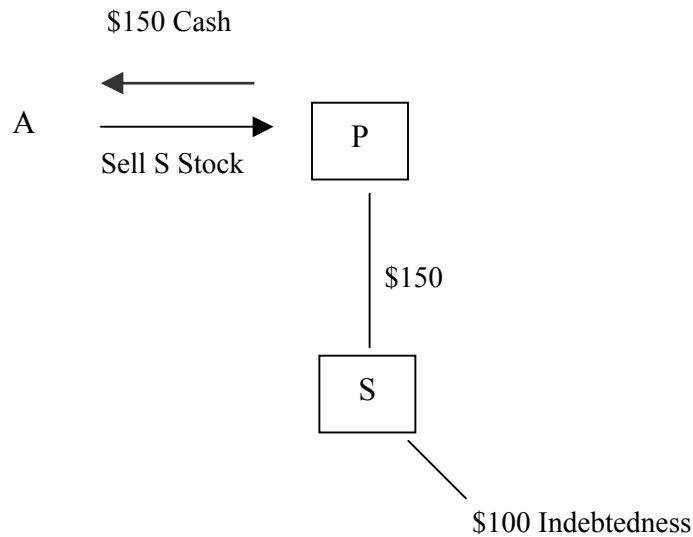
1. There is a narrow exception to the loss disallowance rule of Treas. Reg. § 1.1502-20: Loss can be recognized to the extent that gain is taken into account by group members on the sale of the subsidiary stock having the same material terms as a consequence of the same plan or arrangement. Treas. Reg. § 1.1502-20(a)(4).<sup>7</sup> Temp. Treas. Reg. § 1.337(d)-2T(a)(4) also allows netting under the same circumstances.
2. Example
  - a. P owns all of the stock of S and 50 shares of T common stock. S owns the remaining 50 shares of T common stock. P has a \$150 basis in its T stock, which is worth \$100. S has a \$50 basis in its T stock, which is also worth \$100.
  - b. P and S sell all of their T stock outside the group to X, an unrelated buyer. S's \$50 gain is permitted to offset P's \$50 loss.
    - (1) If P and S sell their T stock to the public, the public would be treated as one purchaser for purposes of applying the netting rule. Treas. Reg. § 1.1502-20(a)(5), Ex. 5.

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<sup>7</sup> Prior to September 13, 1991 and after January 31, 1991, the former proposed regulations permitted netting of gains and losses on the sale of common stock with different material terms. If a group relied on the netting rule of the former proposed regulations, the group could request relief under section 7805(b) to have the final netting rule apply prospectively only. See Preamble to the final 1991 regulations, 56 Fed. Reg. at 47,388.

- (2) In addition, netting is permitted if stock is sold to more than one purchaser, provided it is pursuant to the same plan or arrangement.
  - c. Assume that S distributes its T stock to P, resulting in \$50 of section 311(b) gain that is deferred. Treas. Reg. §§ 1.1502-13(c); -13(f)(2)(iii). If P sells all of the T stock outside the group, the deferred gain is taken into account. Treas. Reg. § 1.1502-13(d)(2)(i). Loss will be permitted to be recognized under Treas. Reg. § 1.1502-20(a)(4) and Temp. Treas. Reg. § 1.337(d)-2T(a)(4) -- but only to the extent of the \$50 deferred gain.
3. The subsidiary stock must have the same material terms for the netting rule to apply.
- a. If, in the above example, the T stock owned by S was preferred stock, netting would not be available, because the preferred stock does not have the same material terms as the T common stock owned by P.
  - b. However, if both P and S owned preferred stock of T, netting would be permitted if the loss on the sale of preferred stock is offset by the gain on the sale of preferred stock having the same material terms.
  - c. Note that this requirement also has the effect of restricting the election to reattribute excess loss accounts (“ELAs”) to, and thus reduce the basis of, stock of a retained subsidiary under Prior Treas. Reg. § 1.1502-19(a)(6). Under Treas. Reg. § 1.1502-19(a)(6)(ii), “[t]he basis of stock may not be reduced pursuant to an election under § 1.1502-19(a)(6)(i) to the extent the reduction has the effect of netting gain or loss in a manner that would not be permitted under § 1.1502-20(a)(4) and § 1.1502-20(b)(4).” This election to reattribute ELAs to stock of the subsidiary that is retained was eliminated for years beginning on or after January 1, 1995.

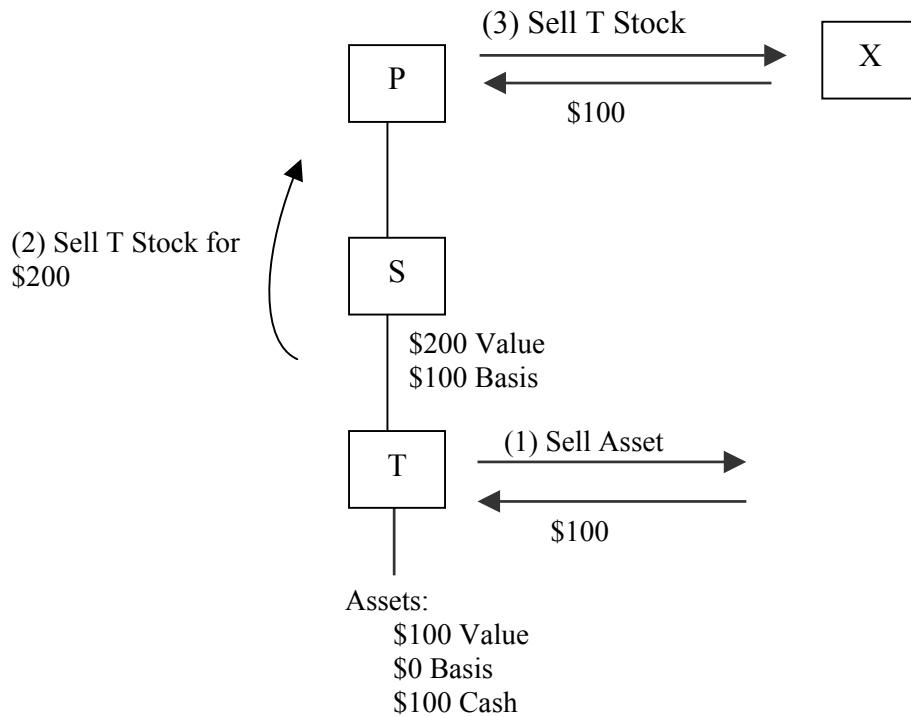
Special Earnings and Profits Rule



1. Treas. Reg. § 1.1502-20(c)(2)(iii) states that extraordinary gain and positive investment adjustments are taken into account “only to the extent they are reflected in the basis of the share, directly or indirectly, immediately before the disposition or deconsolidation.” Treas. Reg. § 1.1502-20(c)(2)(iii).
2. Example 7 in Treas. Reg. § 1.1502-20(c)(4) illustrates this rule.
  - a. A forms S and S’s assets appreciate. S borrows \$100 on a nonrecourse basis secured by the appreciated assets. P buys the S stock for \$150. S subsequently has a \$100 loss that is absorbed in the P group and P’s basis in the S stock is reduced to \$50.
  - b. S’s assets then decline in value, and S’s creditors discharge \$60 of S’s \$100 indebtedness. The \$60 discharge is not included in S’s gross income (section 108(a)), but no attributes are reduced under section 108(b).
  - c. An extraordinary gain disposition is defined to include the discharge of debt. However, under Treas. Reg. § 1.1502-32(b)(3)(ii)(C), the discharge amount is reflected as a positive basis adjustment to the extent that attributes are reduced under sections 108(b) and 1017. Under Reg. § 1.1502-32(b)(3)(ii)(C), a reduction in, among other items, a loss carryover is reflected as a negative basis adjustment.
  - d. Because S had no attributes to reduce, the \$60 is not treated as tax-exempt income that increases P’s basis in the S stock. Consequently, there is no extraordinary gain disposition.

- e. The facts are the same as above, except that \$60 of S's loss cannot be used by the P group. On the subsequent discharge of debt of \$60, the \$60 NOL carryover is eliminated under section 108(b).
  - f. The \$60 discharge of debt is treated as tax-exempt income that increases P's basis in the S stock, and the \$60 attribute reduction is treated as a noncapital, nondeductible expense that reduces P's basis in the S stock. Thus, P's basis in the S stock remains \$110. Because P's basis in the S stock is \$110 rather than \$50, the discharge of indebtedness income of \$60 is treated as an extraordinary gain disposition under Treas. Reg. § 1.1502-20(c)(1)(i).
3. The same result was obtained under the loss disallowance rules in effect before the final 1991 regulations. However, because the prior investment adjustment rules were dependent on changes in the earnings and profits of S, the loss disallowance rules had to incorporate section 1503(e) to reach the correct result. Section 1503(e)(1)(B) provides that, for purposes of determining gain or loss on the disposition of stock, earnings and profits do not include any amount excluded under section 108 to the extent such amount was not applied to reduce tax attributes. Cf. Treas. Reg. § 1.1502-32(b)(3)(ii)(C).

Related Party Rule



1. As noted in the prior discussion, under the final 1991 regulations, the extraordinary gain disposition and positive investment adjustment factors are taken into account only to the extent that they are “reflected in the basis” of a subsidiary’s stock immediately before the disposition of such stock. However, the amount of extraordinary gain and positive investment adjustments are not reduced by reason of an acquisition of subsidiary stock from a related person. Treas. Reg. § 1.1502-20(c)(2)(iv).<sup>8</sup>
  - a. A related person is determined by reference to section 267(b) and 707(b)(1), substituting “10 percent” for “50 percent” each place that it appears. *Id.*
2. The related party rule of the final 1991 regulations is intended in part to address the case in which a subsidiary that has generated income is sold to another member in an intercompany transaction. Under Treas. Reg. § 1.1502-80(b), the sale would not be a section 304 transaction. Accordingly, the purchasing member’s basis in the subsidiary stock would be equal to the stock’s cost, and such basis would not reflect the prior basis adjustments. Without the related party rule, if the subsidiary declines in value immediately after the intercompany transaction and is then sold, there would be no reduction of the allowable loss.

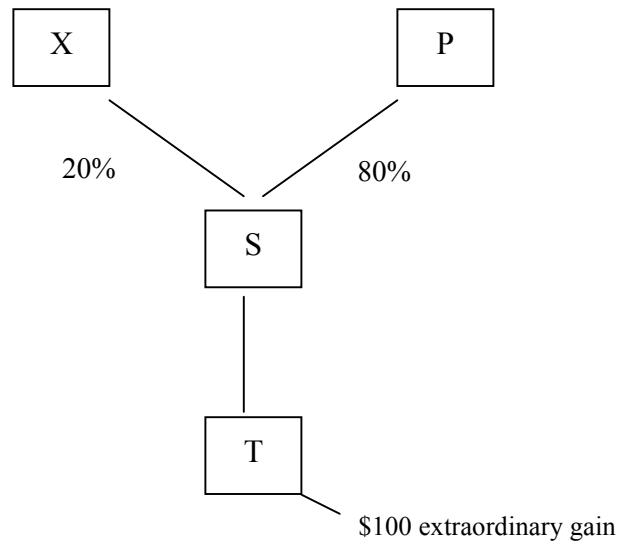
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<sup>8</sup> Temp. Treas. Reg. § 1.337(d)-2T does not include a related party rule.

3. Example

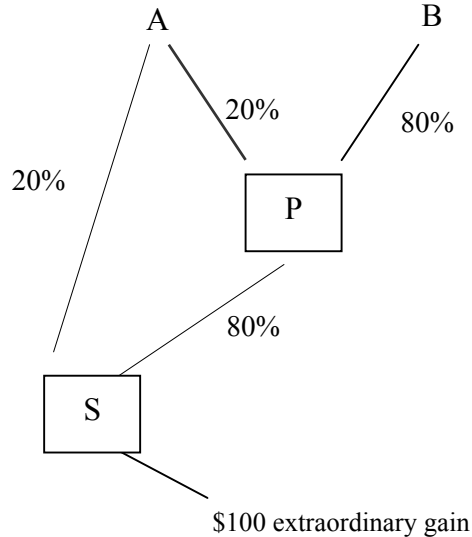
- a. P owns all of the stock of S, and S owns all the stock of T. The T stock has a \$200 value and \$100 basis. T holds \$100 cash and a capital asset with a \$100 value and \$0 basis. T sells the asset. The \$100 gain increases S's basis in its T stock to \$200.
  - b. S sells T to P for \$200 resulting in no gain or loss. T later declines in value to \$100. P sells T to X, an outside investor for \$100, resulting in a \$100 loss. Without the related party rule, P's \$100 loss would be allowed, since the \$100 of extraordinary gain is not reflected in P's basis in its T stock. Thus, the P group would be in a better position by reason of the intercompany stock sale. If S had not sold T to P, the \$100 extraordinary gain would have been reflected in S's basis in its T stock, and the \$100 loss on the sale of the T stock to the outside investor would have been disallowed.
4. The related party rule also works in conjunction with the intercompany transaction rules of section 267(f) and Treas. Reg. § 1.1502-13. Thus, if in the example above, S sold its T stock to P at a loss, such loss would be triggered at the time P sold T to an outside investor. S's loss is tested under Treas. Reg. § 1.1502-20 at that time. See Reg. § 1.1502-20(c)(4), Ex. 9.
5. The next two examples illustrate the overreaching effects of the related party rule as it applies to certain transactions.

Overreaching Effect of Related Party Rule I



1. The related party rule in Treas. Reg. § 1.150-20(c)(2)(iv) appears to be overreaching as it applies to certain sales and other dispositions of subsidiary stock.
2. Example
  - a. Corporation P owns 80 percent and corporation X owns 20 percent of the stock of S. S owns all the stock of T. P, S, and T file consolidated returns. In Year 1, T recognizes \$100 in an extraordinary gain disposition. As a result, S's basis in its T stock increases by \$100 and P's basis in its S stock increases by \$80. X's basis in its S stock remains unchanged.
  - b. In Year 2, X exchanges its S stock for all of the stock of T in a redemption transaction. X takes a fair market value basis in the T stock. X and T elect to file consolidated returns. The T stock then declines in value by \$100. X sells the T stock, resulting in a \$100 loss.
  - c. The \$100 extraordinary gain disposition in Year 1 is not reflected in X's basis in its T stock. However, under the related party rule, X and S are related, since X owned more than 10 percent of the S stock. See section 267(b)(3), as modified by Treas. Reg. § 1.1502-20(c)(2)(iv). Accordingly, the \$100 extraordinary gain is taken into account. Because X's loss does not exceed the \$100 extraordinary gain, X's entire loss is disallowed.

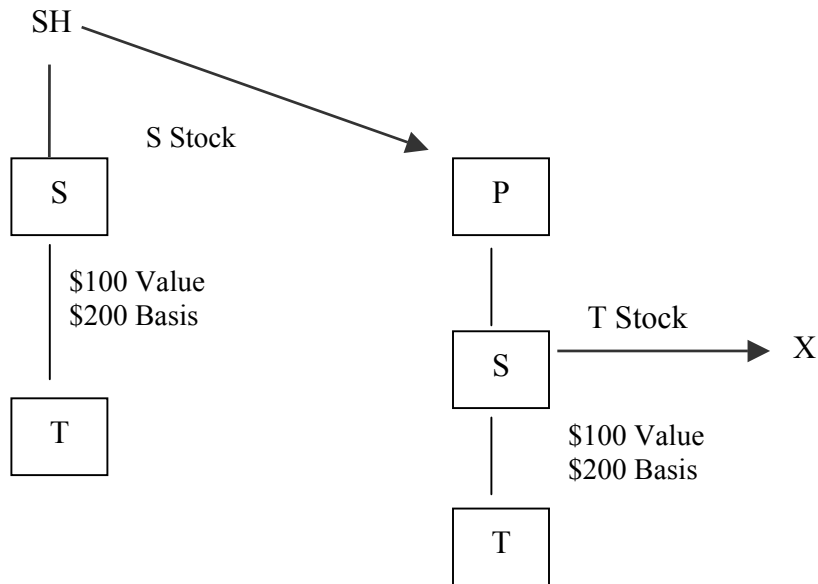
Overreaching Effect of Related Party Rule II



1. The following example also demonstrates the overreaching effect of the related party rule.
2. Individual A owns 20 percent and individual B owns 80 percent of the stock of P. P owns 80 percent and A owns 20 percent of the stock of S. P and S file consolidated returns. In Year 1, S recognizes \$100 in an extraordinary gain disposition. P's basis in its S stock increases by \$80. A's basis in its S stock remains unchanged.
3. In Year 2, P purchases A's 20-percent block of S stock for \$500. The 20-percent block of S stock then declines in value by \$20 to \$480. P sells the 20-percent block of S stock to an unrelated investor for \$480, resulting in a \$20 loss.
4. A's share of the extraordinary gain disposition in Year 1 is \$20 (20 percent of \$100). Such extraordinary gain is not reflected in P's basis of the 20-percent block of S stock, since they were generated prior to P's purchase of the S stock from A. However, under the related party rule, A and P are related, since A owns more than 10 percent of the P stock. See section 267(b)(2), as modified by Treas. Reg. § 1.1502-20(c)(2)(iv). Accordingly, the \$20 extraordinary gain is taken into account. Because P's \$20 loss does not exceed the \$20 extraordinary gain, P's entire loss is disallowed.
5. In the above example, because S's share of the \$20 extraordinary gain does not increase A's basis in S, there is no opportunity for an artificial loss due to a basis increase. Therefore, it is by no means clear why P's \$20 loss should be disallowed.
6. Additionally, the result in the above example would not occur if A's share of the \$20 were of operating income rather than \$20 of extraordinary gain. The positive investment adjustments factor is taken into account only if it results in positive investment

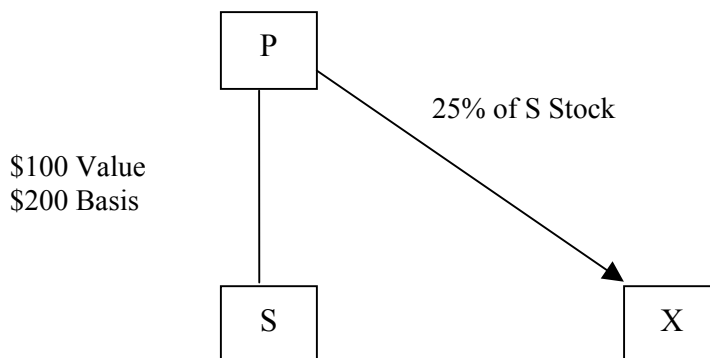
adjustments. Treas. Reg. § 1.1502-20(c)(1)(ii). The extraordinary gain factor is not so limited.

Prior Consolidated Return Years



1. In determining whether there is extraordinary gain or positive investment adjustments under the final 1991 regulations, a selling group member must take into account all prior consolidated return years of the subsidiary and any prior consolidated return years of a prior group if the subsidiary was not acquired by direct purchase.
2. Example
  - a. In Year 1, S acquires all of the stock of T for \$100. T recognizes \$100 gain from the sale of an asset. S's basis in T increases from \$100 to \$200.
  - b. In Year 2, P buys all of the stock of S. S and T are now members of the P group. S then sells T for \$100, resulting in a \$100 loss (\$200 basis less \$100 value).
  - c. The \$100 of operating income in Year 1 continues to be reflected in S's basis in the T stock immediately before the T stock is sold. Because S's \$100 loss does not exceed the \$100 positive investment adjustment, S's entire loss is disallowed.
  - d. Under new Temp. Treas. Reg. § 1.337(d)-2T, the result would be the same. Gain recognized on the disposition of an asset is built-in gain to the extent attributable to any excess of value over basis that is reflected, before the disposition, in the basis of the share. Temp. Treas. Reg. § 1.337(d)-2T(c)(2). Loss or basis may be attributable to recognition of built-in gain on the disposition of an asset by a prior group. See Temp. Treas. Reg. § 1.337(d)-2T(c)(4), Ex.

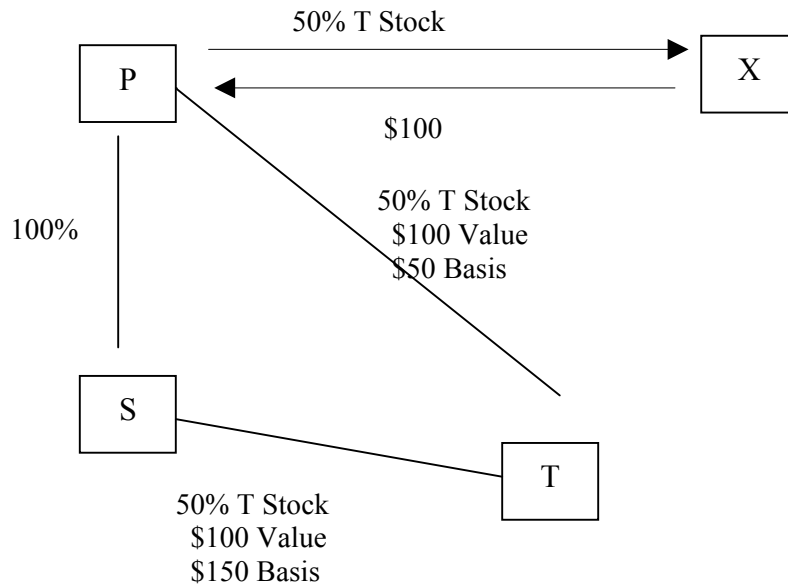
Deconsolidation Rule



1. Deconsolidation rule: If a parent's basis in its subsidiary stock exceeds the stock's fair market value immediately before the stock is deconsolidated, the parent's basis in the subsidiary stock is reduced to the stock's fair market value. Treas. Reg. § 1.1502-20(b)(1); Treas. Reg. § 1.337(d)-2T(b).
2. "Deconsolidation" is "any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member." Treas. Reg. § 1.1502-20(b)(2); Temp. Treas. Reg. § 1.337(d)-2T(b)(2).
3. Example
  - a. P owns all of the stock of S. The S stock has a value of \$100 and a basis of \$200 (attributable to the disposition of a built-in gain asset).
  - b. P sells 25% of its S stock to X, an unrelated investor, for \$25.
    - (1) P's \$25 loss on the sale is disallowed. Treas. Reg. § 1.1502-20(a); Temp. Treas. Reg. § 1.337(d)-2T(a).
    - (2) P's basis in its remaining block of S stock is reduced from \$150 to \$75, its fair market value. Treas. Reg. § 1.1502-20(b)(1); Temp. Treas. Reg. § 1.337(d)-2T(b)(1).
    - (3) The S stock is no longer subject to the loss disallowance rule as S is no longer a consolidated group member. Section 1504(a); Treas. Reg. § 1.1502-20(a)(1); Temp. Treas. Reg. § 1.337(d)-2T(a)(1). But P's built-in loss in its S stock is eliminated.
  - c. After P's initial sale of S stock, if P's remaining S stock appreciates, there is no recovery of previously reduced basis.

- d. The limited loss allowance rule in Treas. Reg. § 1.1502-20(c) applies to the basis reduction in the S stock held by P as well as to the S stock sold by P. Thus, the amount of the basis reduction is limited to the sum of the extraordinary gain dispositions, positive investment adjustments, and duplicated loss factors allocable to P's remaining S stock. Treas. Reg. § 1.1502-20(c)(1). Similarly, the loss disallowance rule in Treas. Reg. § 1.337(d)-2T(c) limits basis reduction in the S stock held by P to the amount of built-in gain recognized on the disposition of an asset.
4. Under Treas. Reg. § 1.1502-20(b)(5)(i), if a share of stock retained by a group is deconsolidated and then disposed of within two years after the date of deconsolidation, the group must file a statement with its return for the year of the disposition. The preamble to the final 1991 regulations clarified that the statement must be filed regardless of whether there is a reduction in the basis of stock under the deconsolidation rule. 56 Fed. Reg. at 47,384. If the group sells its deconsolidated stock at a loss within the two-year period and fails to file the statement, the regulations provide that no deduction for the loss will be allowed. There is no corresponding provision in Temp. Treas. Reg. § 1.337(d)-2T

Netting Under the Deconsolidation Rule

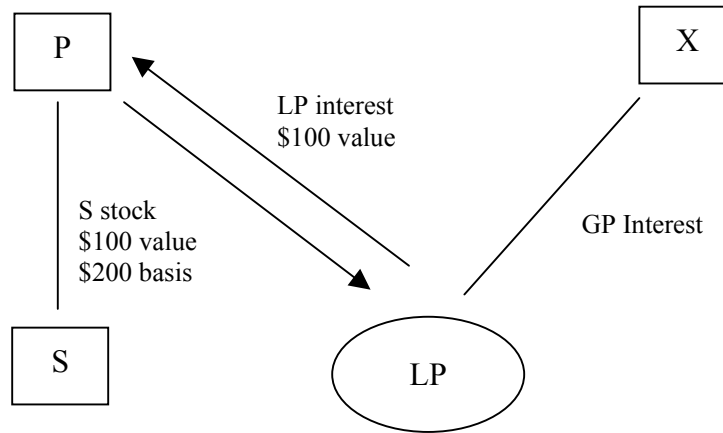


1. The final 1991 regulations contain a netting rule applicable to the deconsolidation rule that is analogous to the netting rule applicable to the general loss disallowance rule. Treas. Reg. § 1.1502-20(b)(4) provides that basis in the stock of a subsidiary will not be reduced by reason of the deconsolidation rule if “as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, gain is taken into account by members with respect to stock of the same subsidiary having the same material terms.”
2. Temp. Treas. Reg. § 1.337(d)-2T did not originally contain a netting rule, but it was amended on May 30, 2002 to include a similar netting rule. Temp. Treas. Reg. § 1.337(d)-2T(b)(4); see Preamble to Temp. Treas. Reg. § 1.337(d)-2T, 67 Fed. Reg. 37,998 (May 31, 2002) (indicating that Temp. Treas. Reg. § 1.337(d)-2T was amended to provide a netting rule similar to that of Treas. Reg. § 1.1502-20(b)(4)).
3. Example
  - a. P owns all of the stock of S and 50 shares of T. S owns the remaining 50 shares of T. P has a \$50 basis in its T stock, which is worth \$100. S has a \$150 basis in its T stock, which is also worth \$100. All of the T stock has the same material terms.
  - b. P sells all of its T stock to an unrelated buyer for \$100, resulting in a \$50 gain. Under the deconsolidation rule, S must reduce the basis of its T stock by \$50 from \$150 to \$100, the value of the T stock immediately before deconsolidation. However, under the netting rule of the final 1991 regulations, because P’s \$50 gain is recognized as a consequence of the same plan or arrangement as that giving rise to the deconsolidation, S’s \$50 basis reduction in its T stock is

eliminated. S's basis in its T stock remains at \$150. See Treas. Reg. § 1.1502-20(b)(6), Ex. 6. The same basis adjustments should be made if P applies Temp. Treas. Reg. § 1.337(d)-2T.

- c. Of course, the P group could have avoided a gain if S had sold its T stock instead of P.
4. The netting rules of Treas. Reg. § 1.1502-20 also provide for an anti-duplication rule in the event the loss disallowance rule and deconsolidation rule apply to the same transaction. If gain from the sale of subsidiary stock could be used to allow the use of a loss that would otherwise be disallowed and also to prevent a reduction in basis that would be required under the deconsolidation rule, the gain may be taken into account only once. Treas. Reg. §§ 1.1502-20(b)(4), 1.1502-20(b)(6), Ex. 7. In this circumstance, the group has the option to use either the netting rule under the loss disallowance rule or the deconsolidation rule.
- a. Assume in the above example that S owns 100 shares of T stock with a \$200 value and a \$300 basis. At the same time P sells its T stock for a \$50 gain, S sells 50 shares of T stock for a \$50 loss (\$100 value less \$150 basis). The \$50 loss would be disallowed under Treas. Reg. § 1.1502-20(a).
  - b. The \$50 gain on P's sale of the T stock can be used under the netting rule in the loss disallowance rule or the deconsolidation rule, but may be taken into account only once. If the P group chooses to use the \$50 gain to offset the \$50 loss, S must reduce the basis of its remaining T stock by \$50 to its \$100 value.
  - c. The outcome under Temp. Treas. Reg. § 1.337(d)-2T should be the same as under Treas. Reg. § 1.1502-20. Although there is no such example in Temp. Treas. Reg. § 1.337(d)-2T, the regulation's language regarding netting and deconsolidation is identical to that of Treas. Reg. § 1.1502-20, and the preamble to Temp. Treas. Reg. § 1.337(d)-2T, 67 Fed. Reg. 37,998 (May 31, 2002), indicates that the temporary regulation is intended to include a netting rule similar to that of Treas. Reg. § 1.1502-20.

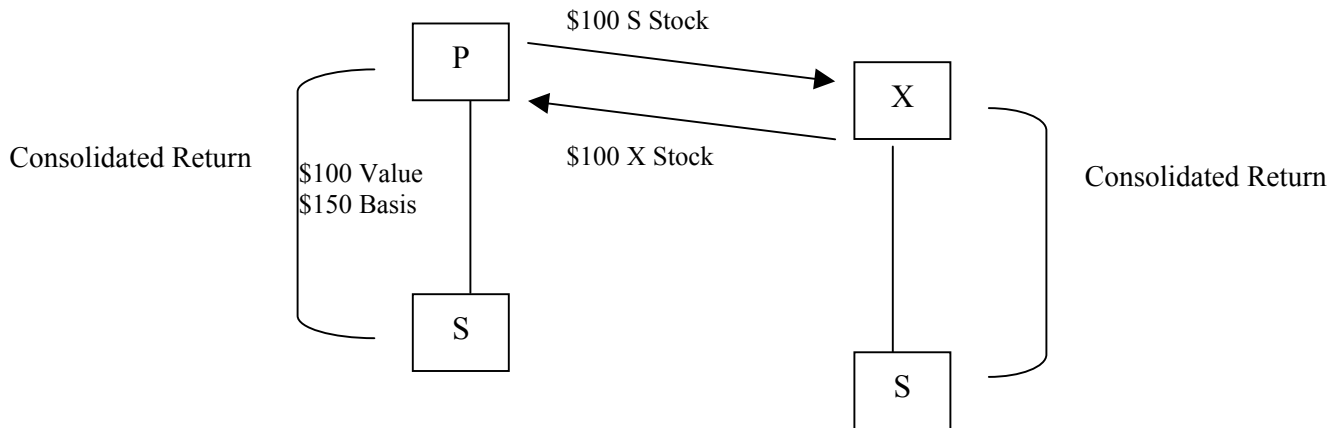
Successor Rule



1. Successor rule: Treas. Reg. § 1.1502-20 “applies, to the extent necessary to effectuate the purposes of [Treas. Reg. § 1.1502-20], to any property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of a subsidiary’s stock.” Treas. Reg. § 1.1502-20(d)(1).
2. Example
  - a. P owns all of the stock of S, which has a value of \$100 and a basis of \$200.
  - b. P contributes its S stock to LP partnership, which takes a \$200 basis in the stock. Section 723. P receives an interest in the partnership with a \$100 value and \$200 basis. Section 722.
  - c. Pursuant to the deconsolidation rule, P is required to reduce the basis of its S stock to its \$100 fair market value immediately before the transfer of the S stock to LP. As a result, P takes a \$100 basis in its partnership interest and the partnership takes a \$100 basis in the S stock.
  - d. P’s partnership interest is a successor interest to the S stock. If P sells the partnership interest at a loss within two years, P’s loss will be disallowed, unless P files the statement required under the deconsolidation rule with its return for the year of the deconsolidation. Treas. Reg. § 1.1502-20(d)(2), Ex. 2.
  - e. The outcome should be the same under Temp. Treas. Reg. § 1.337(d)-2T as under § 1.1502-20. Temp. Treas. Reg. § 1.337(d)-2T(d) provides that the successor rules of Treas. Reg. § 1.1502-20(d) apply, “with appropriate adjustments to reflect differences between the approach in this section and that of § 1.1502-20.”

Even if P applies Temp. Treas. Reg. § 1.337(d)-2T, P must still file a statement if it sells the partnership interest within two years of its contribution of S stock. See Temp. Treas. Reg. § 1.337(d)-2T(d) (incorporating the rules and examples of Treas. Reg. § 1.1502-20(d)).

B Reorganization Loophole



1. The successor rule (and deconsolidation rule) also apply when a parent exchanges loss subsidiary stock for other stock in a tax-free reorganization or in a section 351 transaction with a nonmember.
2. Example
  - a. P owns all of the stock of S, which is worth \$100. P's basis in the S stock is \$150. P wants to dispose of S, but wants to recognize the built-in loss. X wants to acquire S for \$100.
  - b. P transfers the S stock to X solely in exchange for X common stock worth \$100 in a B reorganization. X and S file a consolidated return. X does not become a member of the P group. P has a \$150 basis in its X stock. Section 358. P later sells the X stock for \$100, resulting in a \$50 loss.
  - c. The B reorganization triggers the successor rule and deconsolidation rule. Treas. Reg. § 1.1502-20(d)(2), Ex. 1.
    - (1) The X stock is treated as a successor interest to the S stock, because P's basis in the X stock is determined by reference to P's basis in the S stock.
    - (2) The B reorganization is treated as a deconsolidation event. According to the IRS, the purposes of Treas. Reg. § 1.1502-20 require basis a reduction, because otherwise, P would be permitted to recognize the \$50 loss that was attributable to the S stock. Treas. Reg. § 1.1502-20(d)(2), Ex. 1(iv). P must reduce its basis in the S stock immediately before the deconsolidation from \$150 to \$100. Upon the exchange of the S and X

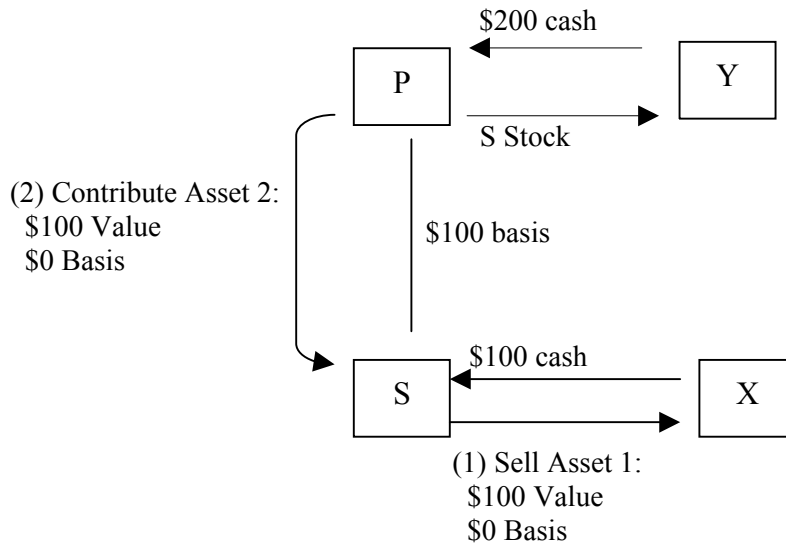
stock, P takes a \$100 basis in its X stock. No loss is recognized on P's sale of the X stock.

- (3) However, the deconsolidation rule is not applied to the S stock acquired by X, because S is a member of the X consolidated group. Under Treas. Reg. § 1.1502-20(b)(2), a deconsolidation does not occur with respect to subsidiary stock that is owned by a member of any consolidated group of which the subsidiary is also a member. Thus, X takes a \$150 basis in its newly acquired S stock. Section 362.9
- (4) This discussion should also apply to deconsolidations under Temp. Treas. Reg. § 1.337(d)-2T, as Temp. Treas. Reg. § 1.337(d)-2T(d) states that the rules and examples of Treas. Reg. § 1.1502-20(d) generally apply.

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<sup>9</sup> Note that this was changed from the former proposed regulations under 1.1502-20. In the proposed regulations, the example provided that the application of the deconsolidation rule required X to take a \$100 basis in its S stock, rather than a \$150 basis. Compare Prop. Treas. Reg. § 1.1502-20(d)(2), Ex. 1 with Treas. Reg. § 1.1502-20(d)(2), Ex. 1.

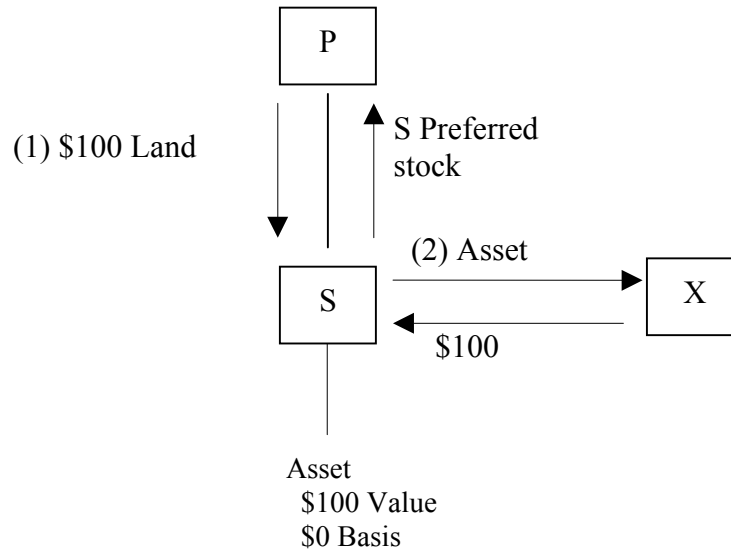
Anti-Stuffing Rule



1. The anti-stuffing rule is triggered when (i) any asset is transferred to a subsidiary, (ii) the stock of the subsidiary is disposed of within two years of the transfer, and (iii) the transfer is “with a view” to avoiding, directly or indirectly, the loss disallowance rule, deconsolidation rule, or gain recognition on the transferred asset. Treas. Reg. § 1.1502-20(e)(2)(i).
2. If the anti-stuffing rule is triggered, the basis of the subsidiary stock that is disposed of is reduced immediately prior to the disposition so as to cause gain recognition in the amount equal to the avoided loss disallowance, basis reduction, or gain recognition. Treas. Reg. § 1.1502-20(e)(2)(ii).
3. Example
  - a. In Year 1, P acquires S for \$100 and S becomes a member of the P group. S has an asset with a \$0 basis and \$100 value, which it sells outside the group to X. P’s basis in its S stock increases from \$100 to \$200.
  - b. In Year 5, P transfers to S in a section 351 transaction an asset with a \$0 basis and a \$100 value with a view to avoiding the loss disallowance rule.
  - c. In Year 6, P sells its S stock for \$200. P must reduce its basis in S to \$100 immediately before the sale of the S stock, resulting in a \$100 gain to P. This gain is equal to the \$100 gain P avoided by making the asset transfer. Treas. Reg. § 1.1502-20(e)(3), Ex. 2.

- d. If P would have waited for more than two years after the asset transfer to sell S, provided the sale was not pursuant to a prearranged plan, the anti-stuffing rule would not have applied.
  - e. If the S stock were deconsolidated in Year 6 rather than sold, P would still be required to reduce the basis in its S stock by \$100 immediately before the deconsolidation. Treas. Reg. § 1.1502-20(e)(3), Ex. 2(iii).
  - f. If the P stock were acquired by another group in Year 6, the \$100 basis reduction would still be required, even though the asset transfer took place outside the acquiring group. According to the IRS, the anti-stuffing rule “requires only that the transferor have the view at the time of the transfer.” Treas. Reg. § 1.1502-20(e)(3), Ex. 2(iv).
4. The anti-stuffing rule also applies to a transfer of a consolidated subsidiary’s stock to another consolidated subsidiary. Treas. Reg. § 1.1502-20(e)(3), Ex. 4.
5. The above discussion should apply equally to dispositions under Temp. Treas. Reg. § 1.337(d)-2T. Temp. Treas. Reg. § 1.337(d)-2T(e) provides that the anti-avoidance “rules and examples of § 1.1502-20(e) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.”

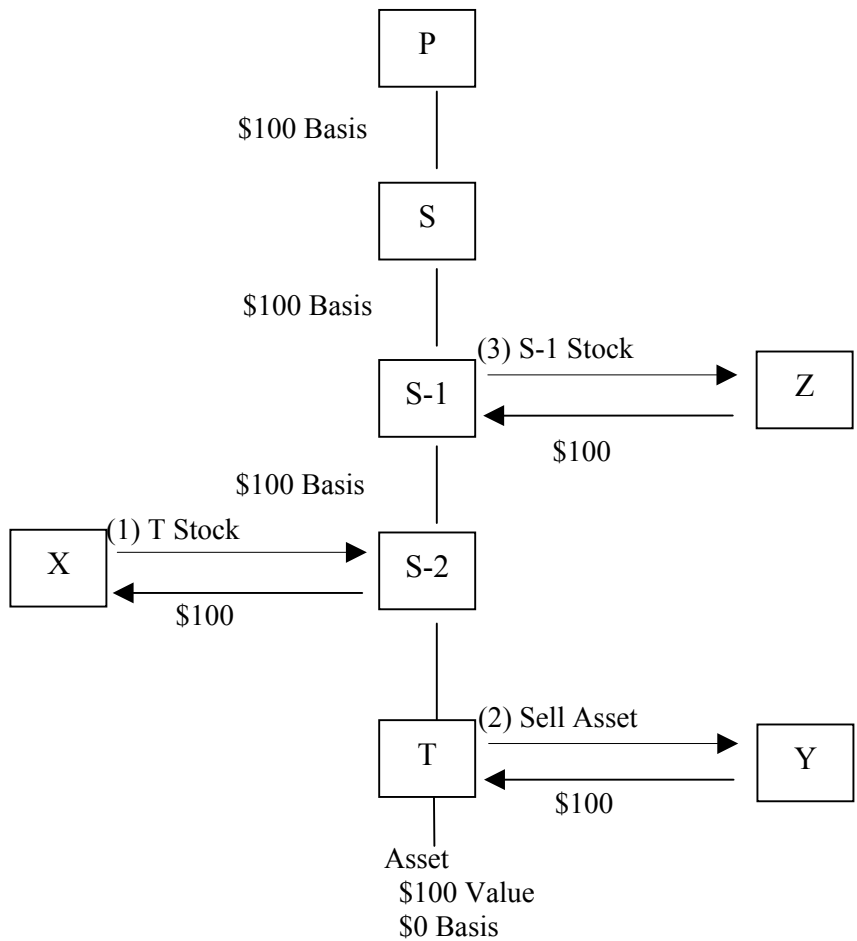
Anti-Avoidance Rule



1. The final 1991 regulations added a catch-all “anti-avoidance” rule in Treas. Reg. § 1.1502-20(e)(1): “The rules of section 1.1502-20 must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments will be made as necessary to carry out their purposes.”
2. The final 1991 regulations include an example of the application of the anti-avoidance rule. See Treas. Reg. § 1.1502-20(e)(3), Ex. 1.
  - a. P buys all of the stock of S for \$100, and S becomes a member of the P group. S holds an asset with a basis of \$0 and a value of \$100. With the proscribed view, P transfers land with a value of \$100 to S in exchange for preferred stock with a \$200 redemption price. The \$100 redemption premium ultimately increases the value of the preferred stock to \$200 and decreases the value of the common stock. S sells the built-in gain asset for \$100, increasing P’s basis in the S stock (common and preferred) to \$300. As a result of the cumulative redetermination under Treas. Reg. § 1.1502-32(c)(4), P’s basis in the S preferred stock increases from \$100 to \$200 and P’s basis in the common stock remains \$100. P sells the S common stock at a loss.
  - b. Under section 305, the redemption premium on the preferred stock is treated as a section 301 distribution. As a result, P’s bases in the preferred and common stock are unaffected.
  - c. P’s loss on the sale of the common stock is disallowed under paragraph (e)(1).

3. Note that the catch-all “anti-avoidance” rule of § 1.1502-20 also applies to dispositions under Temp. Treas. Reg. § 1.337(d)-2T, as the regulation provides that the anti-avoidance “rules and examples of § 1.1502-20(e) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20.” Temp. Treas. Reg. § 1.337(d)-2T(e). Thus, the above discussion should apply equally to dispositions under Temp. Treas. Reg. § 1.337(d)-2T.

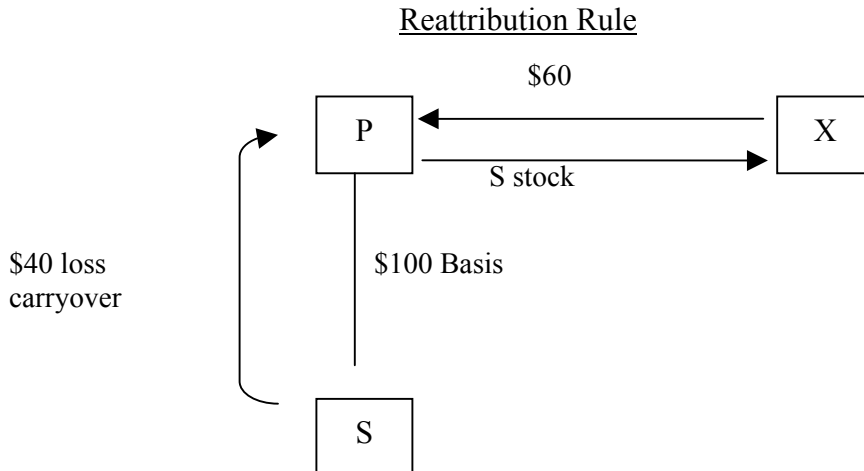
Earnings and Profits Rule



1. A loss that is recognized but disallowed is treated as a noncapital, nondeductible expense, and under Treas. Reg. § 1.1502-32(b)(3)(iii), causes a negative investment adjustment. Under Treas. Reg. § 1.1502-33, a subsidiary's earnings and profits are similarly reduced (for earnings and profits purposes) by the amount of the subsidiary's disallowed loss. Under Treas. Reg. § 1.1502-33(b), the reduction in earnings and profits is reflected in the earnings and profits of the parent of such a subsidiary.
  
2. In the case of a deconsolidation of a subsidiary, as noted, the basis of the stock of the subsidiary will be reduced to reflect its fair market value. In that case, the earnings and profits of the parent will be reduced by a similar amount immediately prior to the deconsolidation. Under Treas. Reg. § 1.1502-32(b)(3)(iii), the reduction of the basis of the subsidiary's stock will be treated as a noncapital, nondeductible expense and will cause a negative investment adjustment.
  - a. Treas. Reg. § 1.1502-20(f)(1) provides that if the basis of a subsidiary's stock is reduced upon the deconsolidation of such subsidiary's stock, then no

corresponding adjustment is made under the investment adjustment system to the basis of the stock of the subsidiary's parent, if there is a deconsolidation or disposition of the parent's stock in the same transaction.

- b. Likewise, no adjustment to the basis of the stock of the subsidiary's parent should be necessary under Temp. Treas. Reg. § 1.337(d)-2T(f). See Temp. Treas. Reg. § 1.337(d)-2T(f) ("the rules and examples of § 1.1502-20(f) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502-20")
3. The foregoing summary of Treas. Reg. § 1.1502-20(f) is illustrated by the following example. Treas. Reg. § 1.1502-20(f)(2).
    - a. P owns all of the stock of S, S owns all the stock of S-1, and S-1 owns all the stock of S-2. P's basis in the S stock is \$100, S's basis in the S-1 stock is \$100, and S-1's basis in the S-2 stock is \$100.
    - b. S-2 buys the stock of T for \$100. T holds an asset with a basis of \$0 and a value of \$100. T sells the asset for \$100. Under the investment adjustment system, the basis of each subsidiary's stock increases from \$100 to \$200. S sells the S-1 stock for \$100 and recognizes a loss of \$100.
    - c. The \$100 loss resulting from the sale of the S-1 stock is disallowed. Under Treas. Reg. § 1.1502-32(b)(3)(iii), S's disallowed loss is treated as a noncapital, nondeductible expense that reduces P's basis in the S stock. Under Treas. Reg. § 1.1502-33, S's earnings and profits are reduced, and this reduction is also reflected in P's earnings and profits.
    - d. Under Treas. Reg. § 1.1502-20(b)(1) or Temp. Treas. Reg. § 1.337(d)-2T(b)(1), the basis of the stock of T and S2 must be reduced immediately before the sale from \$200 to \$100, because their stock is deconsolidated as a result of S's sale of the S-1 stock. However, under Treas. Reg. § 1.1502-20(f)(1) and Temp. Treas. Reg. § 1.337(d)-2T(f), the basis reduction to neither the T stock nor the S-2 stock tiers up, because the S-2 stock is deconsolidated and the S-1 stock is disposed of in the same transaction.
    - e. Similar treatment applies for purposes of the tiering up of earnings and profits under Treas. Reg. § 1.1502-33.
  4. Note that if a member's basis in the subsidiary stock was reduced under Treas. Reg. § 1.1502-32 by reason of a disallowed loss, and such disallowed loss is reduced by reason an election under Temp. Treas. Reg. § 1.1502-20T(i), but would have expired or been absorbed in a closed year, then the member's basis in the subsidiary stock may be increased for purposes of determining the group's or member's federal income tax liability for open years. Temp. Treas. Reg. § 1.1502-20T(i)(3)(v)(B).



1. The final 1991 regulations.
  - a. Upon the disposition of subsidiary stock, a parent may elect to reattribute to itself the subsidiary's net operating and net capital losses (including SRLY losses) to the extent of the disallowed loss. Treas. Reg. § 1.1502-20(g)(1).
    - (1) The parent may elect to retain any or all such losses, and may specify the particular year and the character of the loss that is subject to reattribution.
    - (2) The parent may also reattribute to itself losses of a lower tier subsidiary.
  - b. Example
    - (1) P owns the stock of S, which has a basis of \$100. S has an unused net operating loss of \$40. P sells S for \$60, producing a \$40 loss, which is disallowed under the loss disallowance rule.
    - (2) P elects to reattribute to itself S's \$40 loss carryover. The reattribution is treated as a reduction of the subsidiary's loss carryover, which creates a negative investment adjustment under Treas. Reg. § 1.1502-32(b)(3)(iii).<sup>10</sup> Thus, P's basis in S's stock is reduced by \$40, and P has no gain or loss on the sale of S's stock.

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<sup>10</sup> Under the prior investment basis adjustment regime, the reattributed loss was treated as absorbed by the P group, which leads to the same results. Prior Treas. Reg. § 1.1502-20(g)(3). Because the final 1991 regulations make Treas. Reg. § 1.1502-20(g)(3) unnecessary, it was eliminated from the final 1991 regulations.

- (3) Although P's sale of the S stock may result in an ownership change under section 382, the reattributed losses are not subject to the section 382 limitation on the use of losses. Treas. Reg. § 1.1502-20(g)(1).
- c. There are a number of limitations on a parent's ability to reattribute losses to itself.
- (1) Losses of a subsidiary may not be reattributed to the extent that the subsidiary (and all higher tier subsidiaries) are insolvent. Treas. Reg. § 1.1502-20(g)(2).
  - (2) A SRLY loss reattributed to a parent retains its SRLY taint in the parent's hands.
  - (3) Reattributed losses may not be carried back to a parent's taxable year.
  - (4) The reattribution election is not available if the anti-stuffing rule is applied or for stock whose basis is reduced because of the deconsolidation rule.
  - (5) In the event of bankruptcy, a judge may enjoin a parent from making the reattribution election on the ground that the loss is an asset of the bankrupt subsidiary's estate. See *In re Prudential Lines Inc.*, 928 F.2d 565 (2d Cir. 1991), *aff'd*, 107 Bankr. 832 (S.D.N.Y. 1989) (enjoining parent from claiming worthless stock deduction which would have effectively eliminated subsidiary's loss carryover under section 382).
  - (6) If a parent reattributes to itself the losses of a subsidiary, usually the subsidiary will have less value and the parent will receive less consideration for the subsidiary stock. If the subsidiary has minority shareholders, they may complain that the parent as majority shareholder has breached its fiduciary duty to them. See e.g., *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967) (business judgment rule protects parent's use of subsidiary's losses).
2. The new temporary and proposed regulations.
- a. Temp. Treas. Reg. § 1.337(d)-2T, effective for dispositions or deconsolidations on or after March 7, 2002, does not contain a reattribution rule.
  - b. However, for dispositions and deconsolidations before March 7, 2002, Temp. Treas. Reg. § 1.1502-20T(i) permits taxpayers to elect to apply (i) Treas. Reg. § 1.1502-20 in its entirety, (ii) Treas. Reg. § 1.1502-20 without the loss duplication factor, or (iii) Temp. Treas. Reg. § 1.337(d)-2T.
  - c. The regulations contain a special rule where an election to reattribute losses under Treas. Reg. § 1.1502(g) was in place and the amount of such losses are reduced by reason of an election under Temp. Treas. Reg. § 1.1502-20T(i).

- (1) If the parent elects to apply Treas. Reg. § 1.1502-20 without the loss duplication factor pursuant to Temp. Treas. Reg. § 1.1502-20T(i)(2)(i), the amount of reattributed loss is reduced to the extent that it exceeds the greater of (i) the amount of loss disallowed under Treas. Reg. § 1.1502-20 without the loss duplication factor; and (ii) the amount of reattributed losses that the consolidated group absorbed in the closed years. Temp. Treas. Reg. § 1.1502-20T(i)(3)(i). However, in order to reattribute losses under Treas. Reg. § 1.1502-20(g), the parent must have made a valid election under Treas. Reg. § 1.1502-20(g). The new regulations do not extend the time for filing this election. Further, if the parent already made an election under Treas. Reg. § 1.1502-20(g), it may not revoke the election. Temp. Treas. Reg. § 1.1502-20T(i)(3)(i).
- (2) A parent may not reattribute any losses if it elects to apply Temp. Treas. Reg. § 1.337(d)-2T. Temp. Treas. Reg. § 1.1502-20T(i)(3)(ii). However, if the parent had already elected under Treas. Reg. § 1.1502-20(g) with respect to the disposition of subsidiary stock, the parent may reattribute losses equal to the greater of zero or the amount of reattributed losses that the consolidated group absorbed in the closed years. Temp. Treas. Reg. § 1.1502-20T(i)(3)(ii).
- (3) If any losses are reattributed under Treas. Reg. § 1.1502-20(g), such reattribution is binding on the subsidiary and any group of which the subsidiary is or becomes a member. Temp. Treas. Reg. § 1.1502-20T(i)(3)(vii).
  - (a) Indeed, even if the subsidiary subsequently ceases to be a member of the group, the subsidiary may not take advantage of the reattributed losses.
  - (b) On the other hand, if the election to apply Treas. Reg. § 1.1502-20 without the loss duplication factor or Temp. Treas. Reg. § 1.337(d)-2T results in the reduction in the losses reattributed to the parent pursuant to a § 1.1502-20(g) election, the subsidiary, or any group of which the subsidiary is a member, may use such losses. Temp. Treas. Reg. § 1.1502-20T(i)(3)(vii).
  - (c) As such, the parent must notify the subsidiary prior to the date that the consolidated group filed its income tax return for the year that includes March 7, 2002. Temp. Treas. Reg. § 1.1502-20T(i)(3)(D)(iv). If the acquiror of the subsidiary stock was a member of a consolidated group at the time of the disposition, the parent must also notify the parent of the acquiror's group. Id.
- (4) Temp. Treas. Reg. § 1.1502-20T provides special rules for apportioning a section 382 limitation when the reattributed losses were subject to such limitation.

- (a) Reduction of section 382 limitation by parent. A parent may reduce the amount of section 382 limitation apportioned to itself, if, as a result of the application of the reattribution rules of Temp. Treas. Reg. § 1.1502-20T(i)(3)(i) or (ii), and Temp. Treas. Reg. § 1.1502-20T(i)(3)(vii), pre-change attributes subject to a 382 limitation are treated as the subsidiary's losses and the parent previously elected to apportion all or part of such limitation to itself under Treas. Reg. § 1.1502-96(d). This applies to separate, subgroup, and consolidated section 382 limitations. See Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(A)-(C).
- (b) Subsidiary no longer member of group or subgroup. If the subsidiary is no longer a member of the loss group or subgroup to which the pre-change attributes relate, the parent may increase the total amount of the section 382 limitation apportioned to such subsidiary (or loss subgroup that includes the subsidiary) under Treas. Reg. § 1.1502-95(c). Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(B)-(C).
  - i) Subgroup section 382 limitation – The amount by which the parent may increase the subgroup 382 limitation apportioned to the subsidiary is limited to the amount by which the section 382 limitation apportioned to the parent is reduced under Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(B).
  - ii) Consolidated section 382 limitation – The amount by which the parent may increase the consolidated 382 limitation (or subgroup section 382 limitation where the common parent was a member of the loss subgroup) apportioned to the subsidiary is limited to the product of the element (described in Treas. Reg. § 1.1502-95(c)) and the percentage of the total consolidated (or loss subgroup) pre-change attributes in the year that the subsidiary left the group that are treated as the subsidiary's losses. Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(C).<sup>11</sup>
- (c) P's reduction under Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(A) or (B) of its section 382 limitation is effective as of the date on which the previous apportionment was effective. Temp. Treas.

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<sup>11</sup> Specifically, the formula in Treas. Reg. § 1.1502-20T(i)(3)(III)(C) is as follows: the element x (prechange attributes subject to the 382 limitation treated as losses of the subsidiary or loss subgroup due to Temp. Treas. Reg. § 1.1502-20T(i)(3)(i) or (ii) and § 1.1502-20T(i)(3)(vii)) ÷ (total pre-change attributes subject to the limitation determined as of the close of the taxable year in which the subsidiary ceases to be a member of the group (or loss subgroup)).

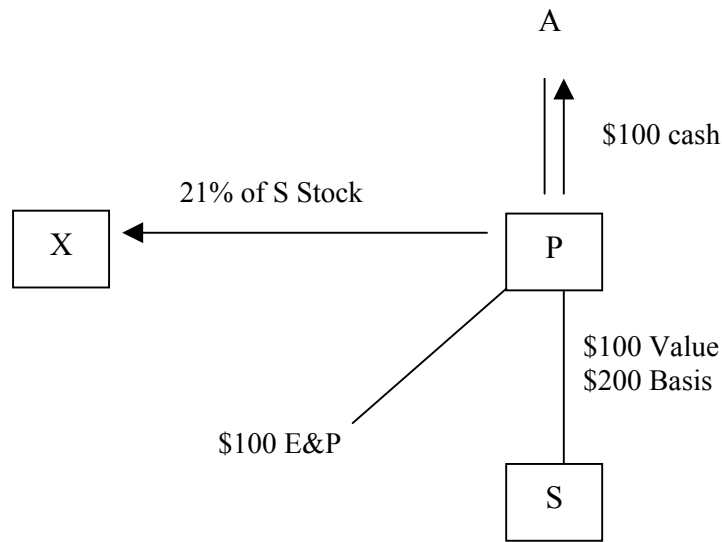
Reg. § 1.1502-20T(i)(3)(iii)(D)(ii). Increases in a subgroup or consolidated section 382 limitation apportioned to a departing subsidiary (or loss subgroup that includes such subsidiary) under Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(B) or (C) are effective for all years ending after the date that the subsidiary ceases to be a member of the group or loss subgroup.

- (d) Temp. Treas. Reg. § 1.1502-20T prescribes several limitations on the adjustments to the section 382 limitation.
  - i) In adjusting the consolidated or subgroup's section 382 limitation, the parent cannot include section 382 limitations that have been previously apportioned to another subsidiary or loss subgroup prior to the date of the Temp. Treas. Reg. § 1.1502-20T(i)(2) election. Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(D)(i).
  - ii) Any adjustment must be "consistent with the principles of § 1.1502-95(c)." Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(D)(ii). For example, if apportionment of a separate section 382 limitation to a parent is reduced under the 382 limitation rules, the amount of such limitation available to the subsidiary is increased.
  - iii) A parent may only make adjustments under Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(A), (B), and (C). Temp. Treas. Reg. § 1.1502-20T(i)(3)(iii)(D)(iv). These adjustments must be made as part of the election to apply Treas. Reg. § 1.1502-20 without the loss disallowance rule or to apply Temp. Treas. Reg. § 1.337(d)-2T.

3. Factors to be weighed in considering reattribution election:

- a. Any section 382 limitation, SRLY limitation, or other limitation affecting the use of the losses.
- b. Loss carryover positions of the seller and purchaser.
- c. Present values of the expected tax benefits of loss carryovers to the seller and purchaser.

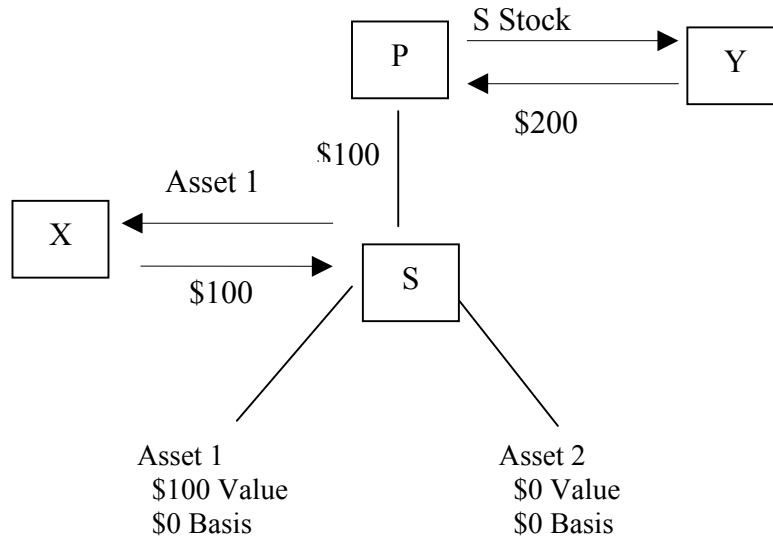
Reducing or Eliminating Dividends



1. Under the prior investment adjustment regime, earnings and profits were decreased when either (i) loss was disallowed, (ii) stock basis was decreased under the deconsolidation rule, or (iii) losses were reattributed to a parent. Prior Treas. Reg. §§ 1.1502-20(f)(1), 1.1502-20(g)(3). As a result, there was an opportunity to change the character of a distribution from a dividend to a return of capital.
2. Example
  - a. Individual A owns all of the stock of P, which is the common parent of the P group. P has \$100 of current earnings and profits and \$0 of accumulated earnings and profits. P owns all of the stock of S, with a basis of \$200 and a value of \$100.
  - b. P wants to distribute \$100 to A, but does not want the distribution to be a dividend. P sells 21% of the S stock for \$21 to an unrelated buyer. The resulting \$21 loss is disallowed and reduces both S and P's current earnings and profits by \$21.
  - c. The sale of the S stock also results in a deconsolidation event. Immediately before the sale, the basis of the 79% of the S stock that is retained by P is reduced from \$158 to \$79, the stock's fair market value. The amount of the basis reduction is treated as a disallowed loss, which reduces both S and P's earnings and profits by \$79.
  - d. In total, S's current earnings and profits are reduced by \$100. Thus, P's distribution of \$100 is a return of capital to the extent of A's basis in P under section 301(c)(2) or is gain to the extent it exceeds A's basis in P under section 301(c)(3).

- e. A deconsolidation event would also occur if P sells or distributes the 21% stock interest in S to A, as A is not a member of the P group.
3. Treas. Reg. § 1.1502-20 eliminated former Treas. Reg. § 1.1502-20(g)(3), and it has not been reinstated by the new temporary and proposed loss disallowance regulations. Therefore, earnings and profits are not decreased when losses are reattributed to a parent. Rather, earnings and profits are decreased when losses arise (even if they are not absorbed until some other time). See Treas. Reg. § 1.1502-33(a) and (b). However, under Temp. Treas. Reg. § 1.1502-20T and § 1.337(d)-2T, stock basis will continue to be reduced when loss is disallowed or when stock basis is decreased under the deconsolidation rule. Temp. Treas. Reg. § 1.1502-20(f); Temp. Treas. Reg. § 1.337(d)-2T(d).

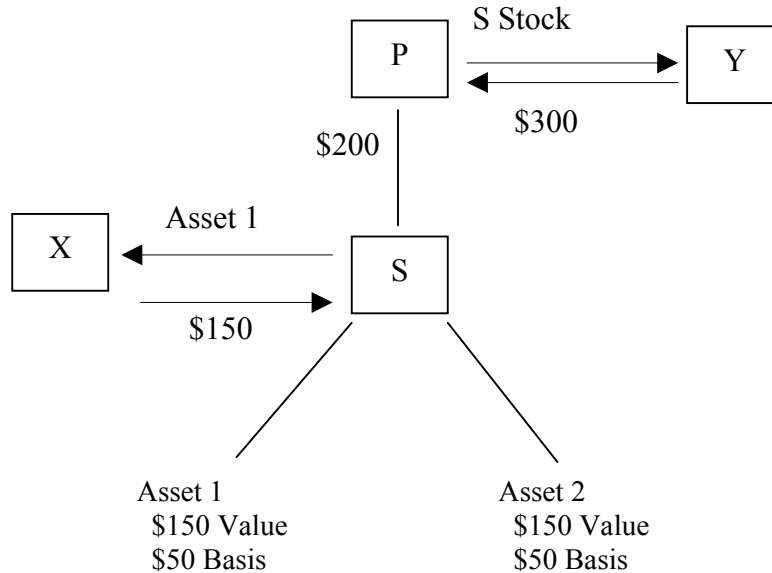
Sheltering Post-Acquisition Appreciation



1. Under Treas. Reg. § 1.1502-20, the loss disallowance rule is tempered by the ability to offset unrealized post-acquisition appreciation against a loss that would otherwise be recognized on the sale of a subsidiary's stock. This ability can be a significant benefit to consolidated groups with gain subsidiaries.
2. Example
  - a. P acquires all of the stock of S for \$100. S has two assets, one with a basis of \$0 and a value of \$100 and another with a basis and value of \$0.
  - b. S sells the first asset for \$100, resulting in a \$100 gain. P's basis in S increases by \$100 to \$200. The second asset appreciates in value to \$100. P sells S for \$200, recognizing no gain or loss.
3. Treas. Reg. § 1.1502-20 permits this taxpayer-favorable result, because the IRS determined that administratively burdensome tracing would be required to reverse the \$100 positive basis adjustment attributable to the built-in gain recognized on the sale of the first asset.
4. As a result, a consolidated group could transfer assets that are expected to a subsidiary with built-in gain assets subject to the anti-stuffing rule, anti-avoidance rule, and section 269, a consolidated group.
  - a. If a subsidiary is "stuffed" with assets with a high value and low basis, the anti-stuffing rule will apply if the subsidiary stock is sold or deconsolidated within two years of the assets' transfer.

- b. If the subsidiary is transferred an asset with a basis equal to its value, which it expects to appreciate, on its face the anti-stuffing rule may apply. However, the mere hope that an asset will appreciate seems to be a slender reed on which to apply the anti-stuffing rule.
- 5. The result would be the same under Temp. Treas. Reg. § 1.337(d)-2T.

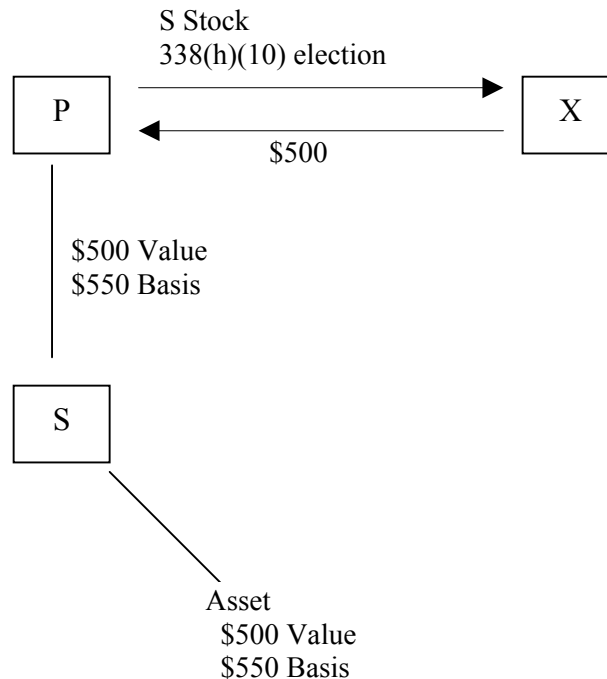
Possible Anti-Breakup Rule



1. In the preamble to the original -20T regulations, the IRS stated that it was considering an anti-breakup rule so as not to permit the sheltering of post-acquisition appreciation that may result if a target's individual assets are sold separately, with positive investment adjustments attributable to the recognition of built-in gain. An anti-breakup rule would eliminate any positive basis adjustments where the stock of the subsidiary is disposed of within two years after its acquisition and would be retroactive to the effective date of the regulations. 55 Fed. Reg. at 9,431.
2. Example
  - a. P acquires the stock of S for \$200. S has only two assets, each with a basis of \$50. When sold separately outside the subsidiary, the assets are each worth \$150.
  - b. S sells one asset to X for \$150, recognizing a \$100 gain. P's basis in its S stock increases by \$100 to \$300. Treas. Reg. § 1.1502-32(b)(3)(i). P then sells the S stock to Y for \$300, recognizing no gain or loss.
  - c. If P sells S more than two years after its acquisition, the anti-breakup rule presumably would not apply, and P will have sheltered the appreciation in the asset that remained in S. If P sells S within two years of its acquisition, the \$100 positive basis adjustment would be reversed, and P would recognize a gain of \$100.
3. In the preamble to the 1991 final regulations, the IRS states that "in the absence of evidence of significant abuse," an anti-breakup rule will not be adopted. 56 Fed. Reg. at 47,383. The preamble indicates that if an anti-breakup rule is adopted, it would be

applied prospectively. *Id.* The IRS does not appear inclined to adopt an anti-breakup rule; the preamble to the new temporary and proposed loss disallowance regulations does not even address the possibility of such a rule. See 67 Fed. Reg. 11,037; 67 Fed. Reg. 37,998.

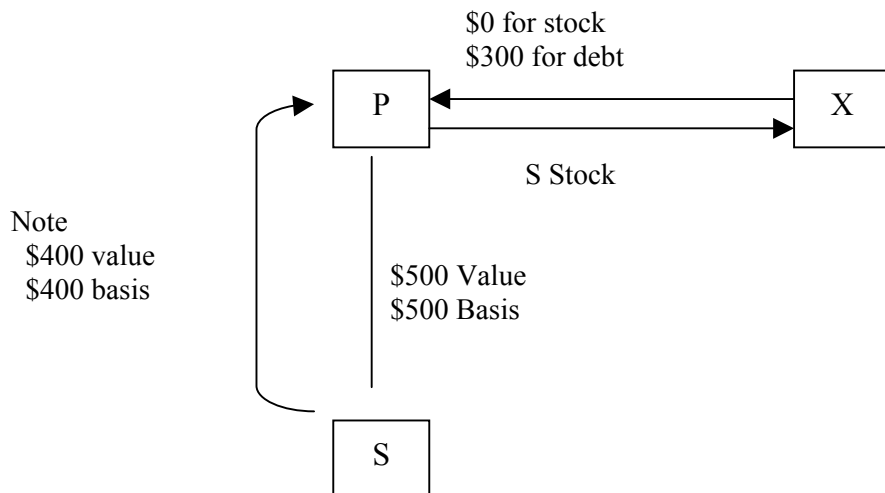
Asset Sales and Section 338(h)(10)



1. If a consolidated group would recognize a loss on the sale of subsidiary stock, the selling group should consider structuring the transaction as an asset sale or as a stock sale with a section 338(h)(10) election. If the subsidiary sells its assets at a loss, the loss will be recognized.
2. If a subsidiary and buyer jointly make a section 338(h)(10) election, a stock sale will be treated as a deemed asset sale, with the following consequences:
  - the subsidiary is treated as selling its assets while it was a member of the group;
  - the subsidiary is deemed to be completely liquidated under section 332, and all of the subsidiary's tax attributes move up to the parent;
  - the buyer acquires none of the tax attributes of the subsidiary and takes a fair market value basis in the subsidiary's assets; and
  - gain or loss on the sale of stock is ignored.
3. Example
  - a. P owns all of the stock of S. P's basis in the S stock is \$550 and its value is \$500. S holds one asset, which has a basis of \$550 and a value of \$500.

- b. X wants to purchase the S stock for \$500. If the S stock is sold, P would recognize a \$50 loss, which would be disallowed. Instead, P and X make an election under section 338(h)(10) to treat the stock sale as a deemed asset sale.
- (1) S recognizes a \$50 loss that is includable on P's consolidated return.
  - (2) S's tax attributes move up to P.
  - (3) X takes the asset with a step-down in basis to its value of \$500, and X loses all of the tax attributes of S.
  - (4) If a section 338(h)(10) election is not made, X acquires S with its tax attributes, including its built-in loss assets, preserved. As a result, even though section 382, SRLY, etc. apply, X may not be willing to join in a section 338(h)(10) election or may pay less for the S stock before X will agree to a section 338(h)(10) election.
4. As an alternative to a section 338(h)(10) election, P could merge S into a single-member limited liability company ("LLC") formed by P and sell all of the LLC interests to X. Because the LLC is disregarded as an entity separate from P, P would be treated as selling the assets of the LLC to X. See Treas. Reg. § 301.7701-2(a).
5. As another alternative, P could cause S to distribute its asset to P before selling the S stock to X. Under Treas. Reg. § 1.1502-13(f)(2)(iii), the principles of section 311(b) apply to intercompany distributions. Thus, S's \$50 loss would be deferred under Treas. Reg. § 1.1502-13(c) and triggered when S leaves the group under Treas. Reg. § 1.1502-13(d). P would reduce its basis in the S stock by the \$50 loss on the distribution and by the \$500 value of the asset. Treas. Reg. § 1.1502-32(b)(2)(i), (iv). Because the value of S is reduced by the value of the property no longer owned by S, P would recognize no gain or loss on the sale of the S stock to X. See F.S.A. 200012046 (Dec. 9, 1999); George White, *Loss Disallowance Regulations Flanked?*, 41 Tax Mgmt. Memo. 248 (June 19, 2000).

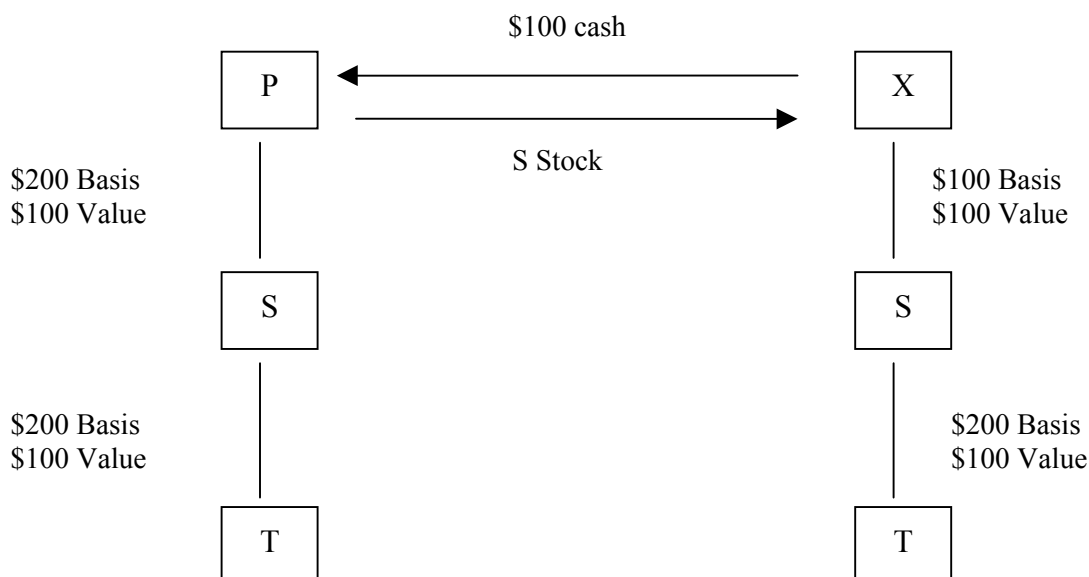
Using Debt in Lieu of Stock



1. Historically, in the consolidated return area, a parent and its subsidiaries have not needed to concern themselves with debt versus equity issues. However, because Treas. Reg. § 1.1502-20 does not apply to the disposition of a subsidiary's debt, it may make sense to capitalize a corporation with debt. Moreover, if the subsidiary became worthless, the parent would be entitled to a bad debt deduction under section 166, but not a worthless stock deduction under section 165. However, Treas. Reg. § 1.1502-13(g)(3) appears to eliminate much of the benefit of using debt.
2. Example
  - a. P owns all of the stock of S, which has a value and basis of \$500. P causes S to distribute to P a note with a face value of \$400. The basis of the note should be \$400, see Treas. Reg. § 1.301-1(h)(2)(i); P.L.R. 8922056 (March 7, 1989), and P's basis in the S stock is reduced to \$100, see Treas. Reg. §§ 1.301-1(d)(1)(ii); 1.1502-13(f)(2); and Treas. Reg. § 1.1502-32(b)(3)(v).
  - b. In a later year, S declines in value. P sells its S stock for \$0 and the note for \$300. Under Treas. Reg. § 1.1502-13(g)(3), the sale of the note by P triggers a deemed satisfaction and reissuance of the note. See also Prop. Treas. Reg. § 1.1502-13(g)(3). As a result, S is deemed to satisfy the note for \$300. Thus, P recognizes a \$100 loss on the satisfaction of the note, and S recognizes an offsetting \$100 of cancellation of indebtedness income. P's basis in the S stock is increased by \$100 to \$200, but the \$200 loss on the stock sale is likely disallowed under the loss disallowance rule. Thus, the loss on the sale of the stock is disallowed under Treas. Reg. § 1.1502-20, and the loss on the sale of the note is effectively disallowed by Treas. Reg. § 1.1502-13(g)(3).

3. Note, however, that if a loss on subsidiary stock is disallowed under Treas. Reg. § 1.1502-20, stock basis is reduced all the way up the chain. The deemed satisfaction and reissuance resulting from the sale of the note under Treas. Reg. § 1.1502-13(g)(3), on the other hand, does not cause a basis reduction in the S stock or any higher tier member's stock. Thus, the use of debt may avoid downward basis adjustments in higher tier entities.
4. Because new Temp. Treas. Reg. § 1.337(d)-2T requires a disposition of a built-in gain asset, the loss on the stock sale should not be disallowed under the new loss disallowance rules.

Preserving Built-In Loss of Lower Tier Subsidiary

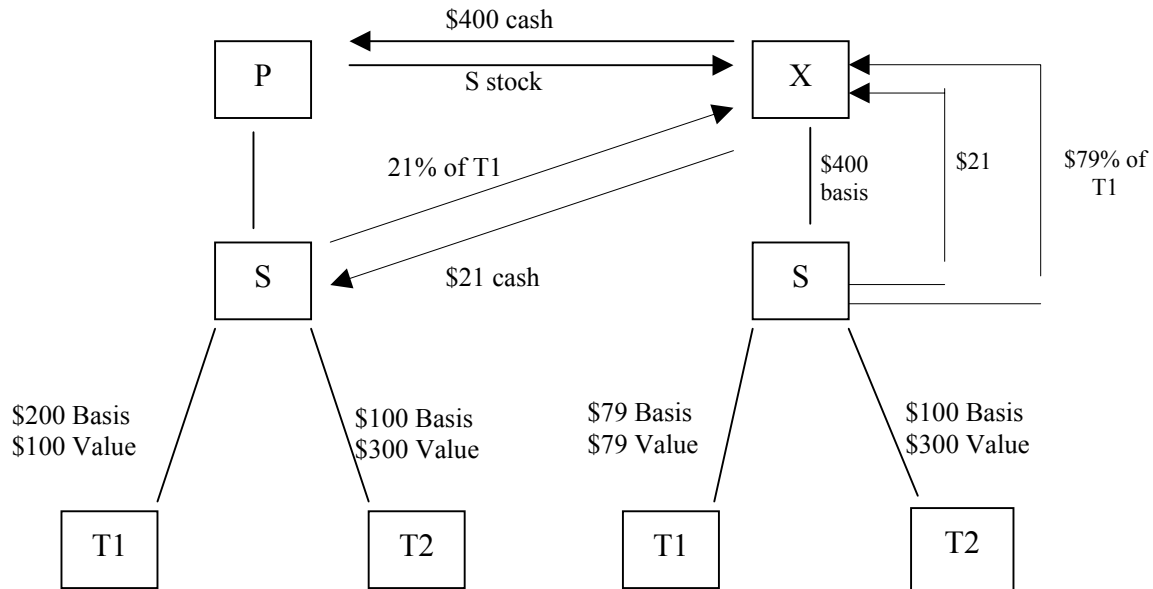


1. The deconsolidation rule operates to preserve the built-in loss in lower tier subsidiary stock.
2. Example
  - a. P owns the stock of S, and S owns the stock of T. P has a \$200 basis in S (attributable to the disposition of a built-in gain asset). S's only asset is its T stock, which has a \$200 basis and \$100 value.
  - b. P sells all of the stock of S to X for \$100, resulting in a \$100 disallowed loss. X, S, and T file a consolidated return.
  - c. Because T is still owned by a member of a consolidated group, the deconsolidation rule does not apply. Treas. Reg. § 1.1502-20(b); Temp. Treas. Reg. § 1.337(d)-2T. S's basis in T remains at \$200.
  - d. X may expect post-acquisition appreciation to be sheltered by the loss with respect to the T stock. Alternatively, X may be willing to "stuff and wait" two years and avoid the application of the anti-stuffing rule.
3. In anticipation of a possible sale, consolidated groups may want to preserve a lower tier subsidiary stock's built-in loss by arranging for a member holding company to own the stock.
  - a. However, if a holding company is formed in a section 351 transaction, and the holding company's stock is sold shortly thereafter, the step-transaction doctrine

may be applied to disqualify the stock contribution as tax free under section 351. See, e.g., *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976); Rev. Rul. 70-140, 1970-1 C.B. 73.

- b. Additionally, the contribution of a lower tier subsidiary's built-in loss stock to a holding company with a view to selling the holding company stock and avoiding the loss disallowance rule may trigger the anti-stuffing rule when the holding company's stock is sold.

The Deconsolidation Rule and  
Distribution of Subsidiary Stock



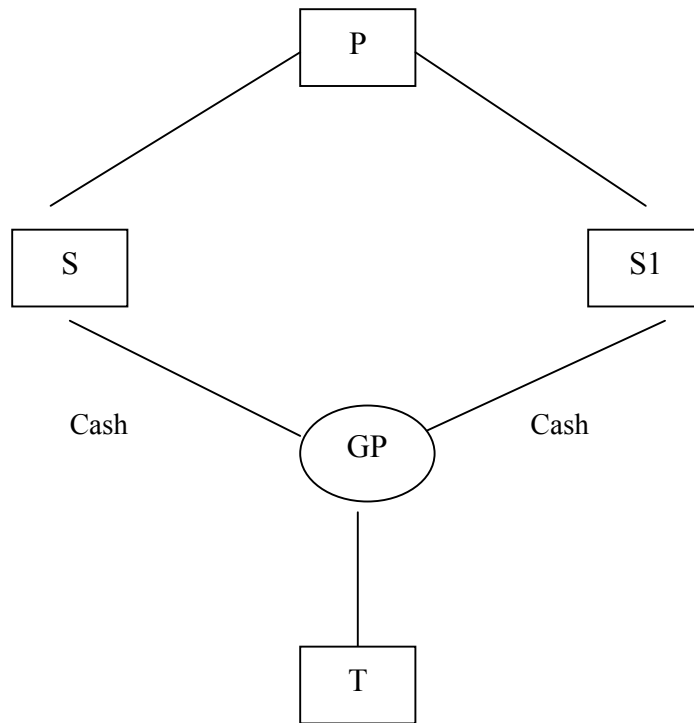
1. Purpose: To dispose of built-in gain subsidiary stock at no gain.
2. P owns all of the stock of S, which has two assets -- the stock of subsidiaries T1 and T2. S's basis in T1 is \$200 and the T1 stock is worth \$100. S's basis in T2 is \$100 and the T2 stock is worth \$300. X is willing to acquire S for \$400, but does not want the T2 stock.
3. If X purchases S and sells T2 immediately, the X group would recognize a \$200 gain. If X instead immediately causes S to distribute T1 to X, S would recognize a deferred intercompany loss equal to \$100. Treas. Reg. § 1.1502-13(f)(2)(iii). X's basis in its S stock would ultimately be reduced by \$200 (i.e., \$100 value of T1 upon distribution, plus \$100 loss when absorbed). Thus, a sale by X of S would result in \$100 of gain.
4. Alternatively, S sells 21% of the T1 stock to X, producing a \$21 loss which is disallowed under the loss disallowance rules of Treas. Reg. § 1.1502-20 and Temp. Treas. Reg. § 1.337(d)-2T. Because the sale results in a deconsolidation of T1 from S, S's basis in its remaining 79% of T1's stock is reduced to the stock's fair market value -- \$79. Treas. Reg. § 1.1502-20(b); Temp. Treas. Reg. § 1.337(d)-2T(b).
5. X purchases S for \$400. X then causes S to distribute its remaining 79% of T1's stock and the \$21 of cash to X. As a result of the distribution, X's basis in S is reduced only by \$100, the adjusted basis of the T1 stock and the cash. See Treas. Reg. § 1.1502-13(f)(2).

6. X's basis in the S stock is now \$300. X sells S for \$300 (the value of T2) and recognizes no gain or loss.
7. The \$21 disallowed loss on S's sale of 21% of the T1 stock and the \$79 basis reduction to the remaining 79% of the T1 stock resulting from the deconsolidation are treated as noncapital, nondeductible expenses for purposes of computing investment adjustments. Treas. Reg. § 1.1502-32(b)(3)(iii). The deemed \$100 loss produces a \$100 reduction in P's basis in S. Therefore, P's gain on the sale of S is increased by \$100 (the amount of gain eliminated by X).<sup>12</sup>

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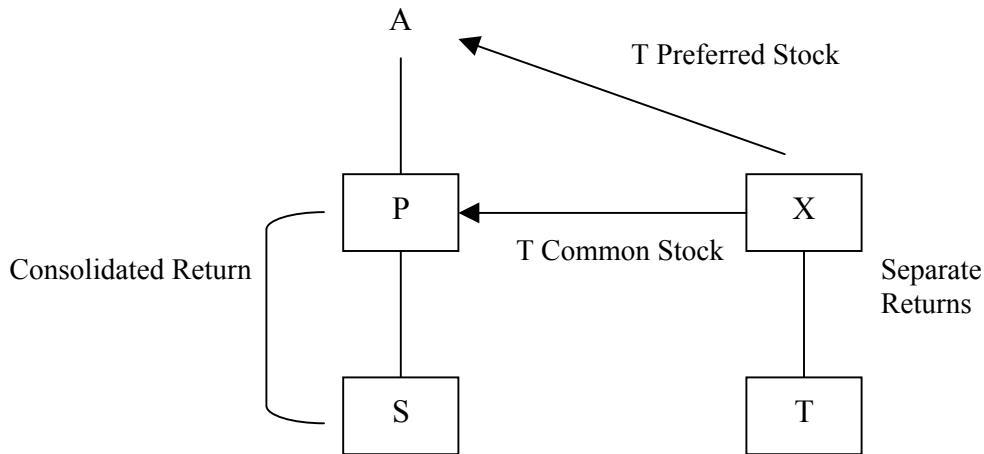
<sup>12</sup> The same result was obtained under the prior rules, because the disallowed loss and the basis reduction resulting from deconsolidation were treated as absorbed. Prior Treas. Reg. § 1.1502-20(f)(1).

Breaking the Consolidated Return Chain



1. Purpose: To break the chain of consolidated ownership with respect to a controlled corporation.
2. P owns all of the stock of S and S1. S and S1 contribute cash (or business assets) to the general partnership in exchange for partnership interests. The partnership contributes its cash to a newly formed corporation, T. The partnership owns all of the stock of T.
3. T is not a member of the P consolidated group. If P subsequently wants to bring T into the group, the partnership could simply distribute the T stock tax free. Section 731.
4. Do the section 701 anti-abuse regulations apply to this transaction?

Controlled But Nonconsolidated Subsidiaries

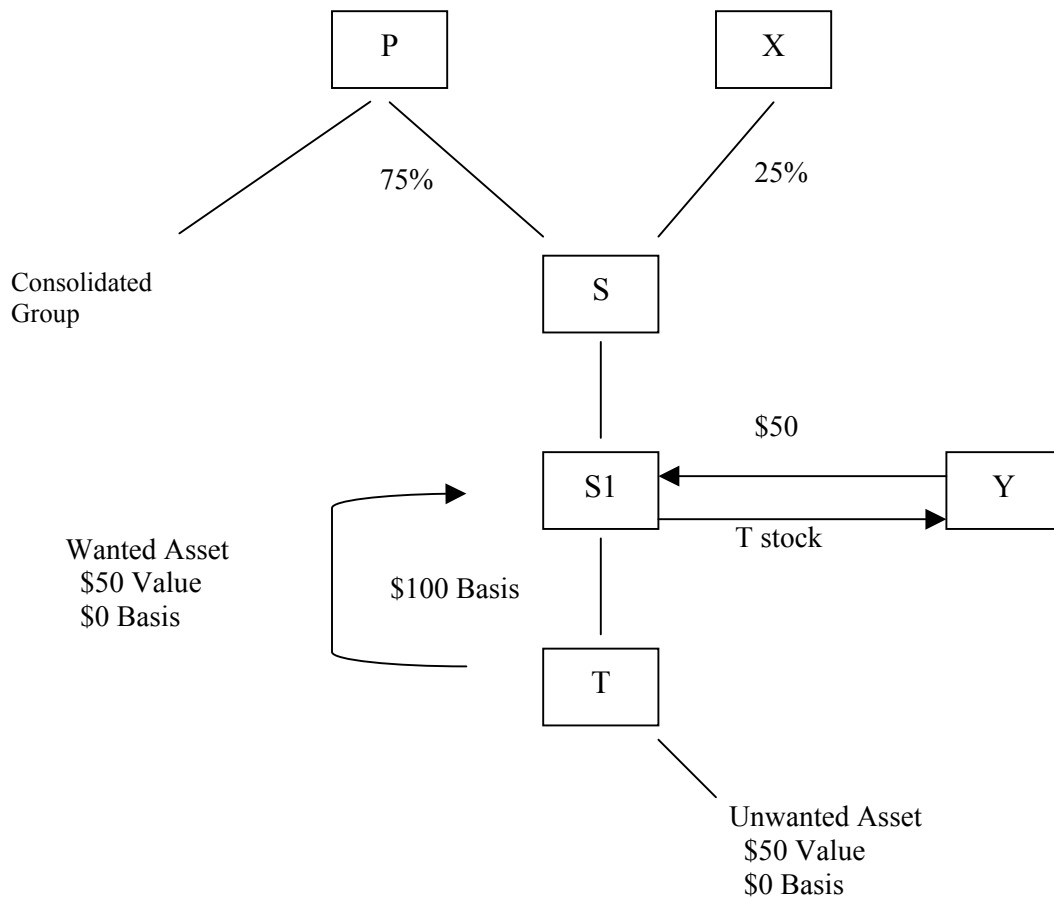


1. A consolidated group may find it advantageous to deconsolidate an existing subsidiary member or prevent a newly acquired subsidiary from being required to join in the group's consolidated return.
  - a. A consolidated return generally must include every corporation that is a member of the affiliated group. Treas. Reg. § 1.1502-75(a)(2), (e).
  - b. A subsidiary generally is a member of an affiliated group if group members own 80% of the total voting power and 80% of the total value of the subsidiary's stock. Section 1504(a).
2. Example
  - a. X owns all of the stock of T. P wants to acquire T but does not want to have T join the P group's consolidated return. P also wants to retain all of the growth potential in the T stock.
  - b. P acquires all of the common stock of T from X. A, the controlling individual shareholder of P, acquires all of the voting preferred stock of T. The preferred stock constitutes 21% of the voting stock of T.
3. Generally, preferred stock is not taken into account in applying the 80% tests if (i) the stock is not entitled to vote, (ii) the stock does not participate in corporate growth "to any significant extent," (iii) redemption and liquidation rights do not exceed the issue price of the stock (except for a reasonable redemption premium), and (4) the stock is not convertible into another class of stock. Section 1504(a)(4).
4. Section 1504(a)(5) authorizes Treasury to promulgate regulations to treat certain stock interests as non-stock and certain non-stock interests as stock. In 1992, regulations were

issued that provide rules regarding the treatment of warrants, options, and convertible obligations as stock. Treas. Reg. § 1.1504-4.

5. Because T's preferred stock is entitled to vote, it is taken into account for purposes of determining affiliation under section 1504(a). Thus, the preferred stock issued to A results in T's not being a member of P's consolidated group. As a result, T may file a separate return.

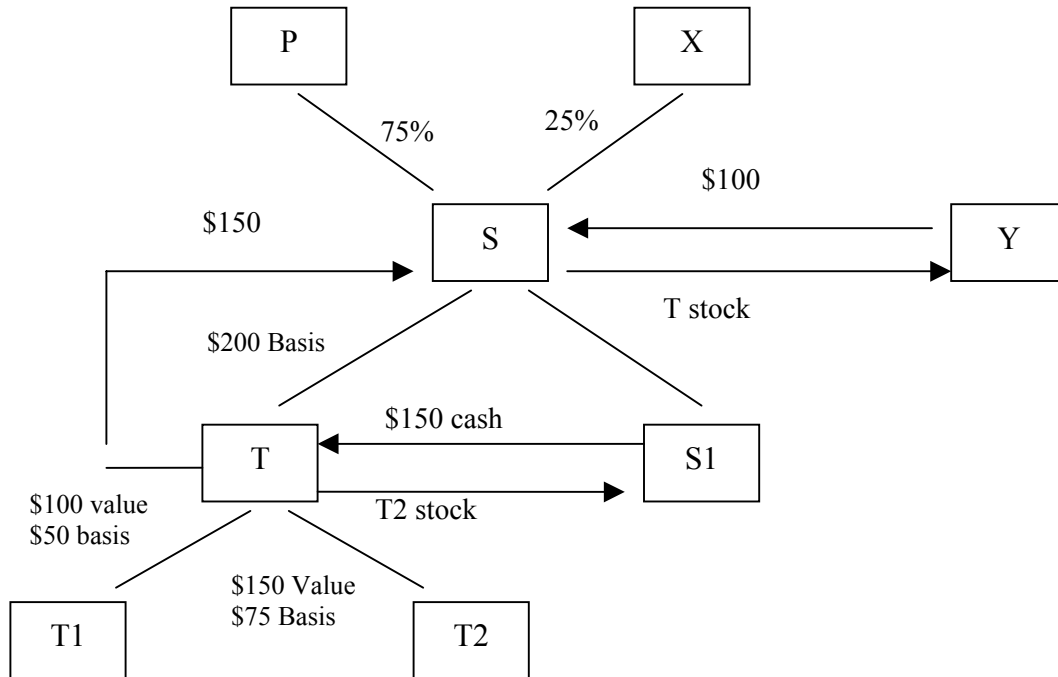
Son of Mirrors in the Separate Return Context



1. It is possible to accomplish results similar to son of mirrors transactions by filing separate returns.
2. P is the common parent of the P consolidated group. P also owns 75% of the stock of S, with the remaining S stock owned by X, an unrelated investor. S owns all of the stock of S1. S and S1 file separate returns.
3. P causes S1 to acquire the stock of T for \$100. T owns two assets, Wanted Asset and Unwanted Asset. Each asset has a value of \$50 and a \$0 basis.
4. T distributes Wanted Asset to S1. The distribution results in \$50 of section 311(b) gain to T, which is immediately recognized. The dividend qualifies for the 100% dividends-received deduction, resulting in no tax to S1. Section 243(b). S takes Wanted Asset with a fair market value basis.

- a. Section 1059 does not apply to reduce S1's \$100 basis in T, assuming S1 had held the T stock for more than two years prior to the dividend announcement date relating to the earlier distribution.
5. T is left with Unwanted Asset worth \$50. S1 then sells T to Y, an unrelated investor, for \$50. This sale results in a \$50 capital loss to S1.
6. Thus, the dividends-received deduction under section 243 serves the same function for affiliated corporations as the investment adjustment rules do for consolidated groups. Unlike the investment adjustment rules, however, the dividends-received deduction is triggered only if there is a distribution.

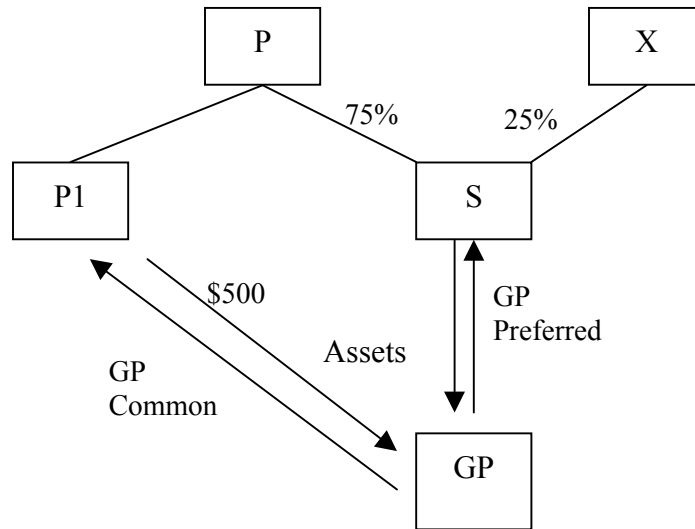
Section 304 -- Cousin of Mirrors in the Separate Return Context



1. An offspring of son of mirrors is cousin of mirrors. A consolidated group that owns a nonconsolidated subsidiary that has its own subgroup that files separate returns may be able to achieve favorable results in a cousin of mirrors transaction.
2. P is the common parent of the P consolidated group. P also owns 75% of the stock of S. The remaining S stock is owned by X, an unrelated investor. S owns all of the stock of T. S has a \$200 basis in its T stock. T owns all of the stock of T1 and T2. T1 has a value of \$100 and a basis of \$50. T2 has a value of \$150 and a basis of \$75. S, T, T1 and T2 file separate returns.
3. P wants to dispose of T1 without recognizing the \$50 built-in gain. P has S1, a subsidiary of S, acquire the T2 stock for \$150 from T. T then distributes the \$150 to S. After the acquisition, S sells T to Y, an unrelated investor, for \$100.
4. Tax consequences:
  - a. Under section 304, S1's acquisition of the T2 stock is treated as a distribution by S1 in redemption of its own stock, and T is treated as having contributed the T2 stock to the capital of S1 in a carryover basis transaction. The amount distributed is treated as a dividend to the extent of S1's earnings and profits. Sections 301, 302, 304.
  - b. Assume that the deemed dividend from S1 to T, as well as the distribution from T to S, qualifies for the 100% dividends-received deduction under section 243.

- c. Assume also that section 1059 does not apply. Thus, S's basis in T is not reduced because of the distribution. S recognizes a \$100 loss on the sale of T (\$100 sales proceeds less \$200 basis). Because S is not subject to the loss disallowance rule, the \$100 loss may be recognized.
- d. Because the S nonconsolidated subgroup remains an affiliated group under section 1504(a), section 304(b)(4) would apply. T may be required to recognize gain in the amount of the excess of T2's \$150 value over its \$75 basis, or \$75. Still, this would leave a loss of \$25, which is more favorable than recognizing a \$50 gain on the sale of T1.

Frozen Partnership Interest



1. Purpose: To shift future growth potential and any losses from a nonconsolidated group member to a consolidated group member.
2. P is the common parent of the group of which P1 is a member. P owns 75% of the stock of S, with the remainder owned by X, an unrelated investor.
3. P1 contributes \$500 cash to the general partnership in exchange for a “common” interest. S contributes its business assets worth \$500 to the general partnership in exchange for a “preferred” interest.
4. Sample allocation arrangement:
  - a. Preferred interest has right to receive:
    - (1) 10% return on its investment each year;
    - (2) Liquidation preference up to amount contributed plus 5%.
  - b. Common interest has right to receive:
    - (1) Income above 10% preferred return;
    - (2) Liquidation right to assets above amount not allocated to preferred interest.
  - c. Losses are allocated 90% to P1 and 10% to S. Losses can be utilized on the P group’s consolidated return.

5. Issues:

- a. Do we have a Partnership? Because a general partnership is formed and not a limited partnership, P's control of P1 and S should not cause the IRS to argue that the partnership should be taxed as a corporation. See *MCA, Inc. v. United States*, 502 F. Supp. 838 (C.D. Cal. 1980), rev'd, 685 F.2d 1099 (9th Cir. 1982); Rev. Rul. 77-214, 1977-1 C.B. 408.
- b. Is everyone a partner? If S's preferred interest is a section 707(c) guaranteed payment, S arguably is not a partner, because it does not share in any entrepreneurial risk.
- c. Will the formation of the partnership be characterized as a sham transaction?
- d. Does section 482 apply?
- e. Do the section 701 anti-avoidance regulations apply?