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RITE AID: A TOUGH PILL FOR THE GOVERNMENT TO SWALLOW

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By: Mark J. Silverman and Lisa M. Zarlenga

I. INTRODUCTION

The loss disallowance rules of the consolidated return regulations, in part, disallow losses on the disposition of subsidiary stock to the extent such losses may be duplicated by the subsidiary subsequent to the disposition.¹ This rule has been widely criticized and was recently invalidated by the Court of Appeals for the Federal Circuit (the “Federal Circuit”). In Rite Aid Corp. v. United States,² the Federal Circuit held that the loss duplication factor contained in Treas. Reg. § 1.1502-20 exceeds the scope of authority granted to the Internal Revenue Service (the “Service”) and is, therefore, invalid.³ The government filed a petition for rehearing en banc, but the Federal Circuit denied the petition on October 3, 2001.⁴

The Federal Circuit’s decision represents a victory for taxpayers. Indeed, it achieves results many practitioners urged at the time the regulations were issued. However, the decision uses very broad language to invalidate a legislative regulation and it provides little analysis and guidance as to the standard applied for determining the validity of the loss duplication factor. As a result, it creates uncertainty about the reach of the court’s holding and

¹ Treas. Reg. § 1.1502-20(c)(1)(iii), (c)(2)(vi).

² 255 F.3d 1357 (Fed. Cir. 2001), rev’g, 46 Fed. Cl. 500 (2000).

³ Id. at 1360.

⁴ The Service decided not to file a petition for certiorari, because it believed that the Supreme Court was unlikely to grant a petition for certiorari absent a split in the circuit courts of appeals. The Service further announced that it would not continue to litigate the validity of the loss duplication factor, but that it plans to issue new rules governing the disallowance of losses on the sale of member stock. Notice 2002-11, 2002-7 I.R.B. 1 (Jan. 31, 2002).

raises questions about the validity of many of the consolidated return provisions. In our view, the reach of the court's holding is limited to the duplicated loss factor and does not extend to the rest of Treas. Reg. § 1.1502-20. In addition, we believe that before other courts extend the Rite Aid standard to other consolidated return regulations, a more careful analysis and a more clear statement of the standard should be made.

II. OVERVIEW OF LOSS DISALLOWANCE RULES

Before discussing the Rite Aid case, it is helpful to review the loss disallowance rules and their history.

A. History of Loss Disallowance Rules

1. Notice 87-14

The Tax Reform Act of 1986 repealed the General Utilities doctrine by requiring corporate-level gain recognition on a corporation's sale or distribution of appreciated property, regardless of whether it occurs in a liquidating or nonliquidating context.⁵ Congress granted the Service regulatory authority to protect the purposes behind the General Utilities repeal, including "regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations . . .)."⁶

⁵ Pub. L. No. 99-514. In General Utilities and Operating Co. v. Helvering, 296 U.S. 200 (1936), the Supreme Court held that corporations could distribute appreciated property to their shareholders tax-free. The Tax Reform Act of 1986 repealed the General Utilities doctrine by amending section 311(b) to the Code. Section 311(b) imposes a corporate-level tax on the distribution of appreciated property to shareholders, as if the corporation sold such property for its fair market value.

⁶ I.R.C. § 337(d)(1).

A transaction, known as the “son of mirrors” transaction, prompted the Service to take action pursuant to this grant of authority. The son of mirrors transaction is illustrated by the following example:

Example 1. P is the common parent of a consolidated group. S is a corporation that owns two assets – a wanted asset with a \$50 adjusted basis and \$100 fair market value, and an unwanted asset with a \$0 adjusted basis and \$75 fair market value. P acquires the S stock for \$175. After joining the P group, S distributes the wanted asset to P. S’s \$50 of section 311(b)⁷ gain is deferred, and P takes a \$100 basis in the asset.⁸ Under the investment adjustment rules, P’s basis in the S stock is \$125.⁹ P sells the stock of T (holding only the unwanted asset) to an unrelated person for \$75, thus recognizing a \$50 loss.

S’s built-in gain in its assets was already reflected in P’s initial cost basis in the S stock. Thus, the positive investment adjustment for S’s section 311(b) gain artificially increases P’s basis in its S stock and permits P to recognize an offsetting loss, in effect eliminating S’s gain from corporate-level tax.¹⁰

The Service concluded that the result in the son of mirrors transaction undermined the repeal of the General Utilities doctrine and issued Notice 87-14¹¹ in response. In Notice 87-

⁷ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and to the regulations thereunder.

⁸ I.R.C. § 301(d); Treas. Reg. § 1.1502-13(f)(2).

⁹ Specifically, P’s \$175 cost basis is reduced by the \$100 value of the wanted asset distributed and increased by the \$50 of gain recognized by S as a result of the distribution. Treas. Reg. § 1.1502-32(b)(2)(i), (iv).

¹⁰ Note that the loss will offset the gain only if the character of the section 311(b) gain is the same as that of the loss. If, on the other hand, the gain was ordinary under section 1245 or 1250, then the P group would have to find a capital gain to be able to utilize the loss on the sale of the T stock.

¹¹ 1987-1 C.B. 445 (Jan. 6, 1987).

14, The Service announced that it intended to promulgate regulations affecting adjustments to the basis of stock of a subsidiary that is a member of the consolidated group in cases where the stock of such subsidiary was acquired and the subsidiary had a built-in-gain asset. The Notice stated:

In general, the adjustment to stock basis will not reflect built-in gains that are recognized by target on sales of, or by reason of distributions of, its assets. Thus, in cases where a target's stock is sold, the regulations will prevent recognition of losses that are attributable to the subsidiary's recognition of built-in gains.¹²

The Notice also indicated that regulations would be effective with respect to stock in a target that was acquired after January 6, 1987, the date of the Notice.

2. Temporary and Proposed Regulations

On March 9, 1990, the Service issued Temp. Treas. Reg. § 1.1502-20T.¹³ In marked contrast to the approach of Notice 87-14, which disallowed a positive investment adjustment for recognition of built-in gains, the temporary regulations adopted a blanket rule disallowing all losses on the disposition of subsidiary stock. The temporary regulations were effective for dispositions of subsidiary stock on or after March 9, 1990.¹⁴

¹² Id.

¹³ 55 Fed. Reg. 9,426 (1990). Proposed regulations were issued on the same date, which incorporated by cross reference the text of Temp. Treas. Reg. §§ 1.1502-20T and 1.337(d)-1T. 55 Fed. Reg. 9,462 (1990).

¹⁴ Temp. Treas. Reg. § 1.1502-20T(g). Because the temporary regulations significantly departed from Notice 87-14, the Service provided certain transitional rules. Temp. Treas. Reg. § 1.337(d)-1T provided a loss limitation rule that applied with respect to stock of corporations that became members of a group after January 6, 1987 and prior to March 9, 1990 ("transitional subsidiaries"). This rule disallowed loss on the disposition of stock of a transitional subsidiary except to the extent the taxpayer established that the loss is not attributable to basis increases resulting from the recognition of built-in gains by the subsidiary.

The preamble to the temporary regulations noted that the loss disallowance rules could result in the disallowance of economic losses,¹⁵ but cited two justifications for the loss disallowance rules. First, the Service believed that the investment adjustment rules could be used to obtain a stepped-up basis in corporate assets without the payment of corporate-level tax, as in Example 1 above, thereby conflicting with the repeal of the General Utilities doctrine.¹⁶ Second, the Service believed that a subsidiary's losses could be duplicated as investment losses of the parent when the parent disposed of the subsidiary's stock, as illustrated in the following example:

Example 2. P forms a subsidiary, S, with a contribution of \$100, and P and S elect to file a consolidated return. S's assets decline in value to \$40. Because the loss is unrealized, P's basis in its S stock is not reduced.¹⁷ P sells the S stock for \$40, recognizing a \$60 loss.¹⁸ Later, S sells its assets for \$40, recognizing a \$60 loss.

Thus, P's loss on the sale of the S stock is duplicated when S later sells its built-in loss assets.

The preamble noted that gain duplication can also occur when S's assets increase in value, but that taxpayers could use self-help measures to avoid duplication of gain (i.e., through an asset sale or section 338(h)(10) election) and, at the same time, preserving duplication of loss.¹⁹

¹⁵ Preamble to Temp. Treas. Reg. § 1.1502-20T, 55 Fed. Reg. at 9,430, 9,431.

¹⁶ Id. at 9,427.

¹⁷ Treas. Reg. § 1.1502-32(b)(3)(i).

¹⁸ Id.

¹⁹ Preamble to Temp. Treas. Reg. § 1.1502-20T, 55 Fed. Reg. at 9,427-28. Section 338(h)(10) provides generally that, if the seller and the buyer jointly elect, a stock sale may be treated as an asset sale for federal income tax purposes.

The Service went to great lengths to explain the approaches it did not adopt in the temporary regulations. First, the preamble noted that the most accurate method of eliminating losses resulting from the recognition of built-in gain would be a tracing regime to eliminate positive investment adjustments to the extent such adjustments are attributable to the recognition of built-in gain. The Service rejected the tracing approach as administratively burdensome – it would require an appraisal of the subsidiary’s assets at the time the subsidiary was acquired.²⁰ Second, the preamble noted that a simpler, but less accurate, method of preventing the investment adjustment rules from eliminating corporate-level tax would be to create a presumption concerning the extent to which a subsidiary’s recognized gain is built-in gain and eliminate positive basis adjustments to that extent. This approach was rejected because it would produce harsh results in some cases while failing to prevent the elimination of corporate-level tax in other cases.²¹ Third, the Service rejected several approaches involving the combination of tracing with some form of presumption because of the degree of inaccuracy associated with the presumption rule and the complexity associated with the tracing rule.²² Fourth, the Service rejected a loss limitation approach, which would have disallowed a loss unless the taxpayer could establish that the loss was not attributable to investment adjustments resulting from recognition of built-in gain, because taxpayer would have to resort to tracing to take advantage of the rule.²³

²⁰ Id. at 9,428.

²¹ Id.

²² Id. at 9,428-29.

²³ Id. at 9,429.

As if contemplating taxpayers' criticism of the loss disallowance rules, the Service tossed out a couple of other bones to taxpayers. The loss disallowance rules could, in many cases, permit the parent to shelter post-acquisition appreciation in stock of an acquired subsidiary, as illustrated in the following example:²⁴

Example 3. S has two assets, one with a basis of \$0 and a value of \$100 and the other with a basis and value of \$0, and P buys the S stock for \$100. S sells the first asset for \$100, and P increases its basis in the S stock to \$200. The second asset appreciates in value to \$100, and P sells its S stock for \$100, recognizing no gain or loss.

Because of the post-acquisition appreciation of the second asset, P's basis increase does not create a loss, but instead shelters P's investment gain on the sale of the S stock.

In addition, the Service noted that the taxpayer may avoid the effect of the loss disallowance rules by either making a section 338(h)(10) election or causing the subsidiary to sell its assets before selling the stock of such subsidiary.²⁵

²⁴ Id.

²⁵ Id. If the loss on the sale of the subsidiary's assets cannot be utilized by the consolidated group prior to the sale of the subsidiary's stock, the selling group may elect to retain the loss to the extent the loss on the subsidiary's stock is disallowed. Temp. Treas. Reg. § 1.1502-20(f)(1) (current Treas. Reg. § 1.1502-20(g)(1)).

3. Re-proposed Regulations

The temporary regulations were widely criticized.²⁶ The duplicated loss provision was one of the most criticized features. In response, on November 19, 1990, the Service withdrew the temporary regulations and re-proposed new regulations in their place.²⁷ The re-proposed regulations retained the general rule of the temporary regulations that losses on subsidiary stock were disallowed.²⁸ However, in an attempt to address the criticism that the temporary regulations disallowed economic losses, the re-proposed regulations added an exception that would allow all or a portion of the loss.²⁹

The Service continued to reject a tracing rule as unadministrable, so the computation of the allowed loss was based on a set of presumptions as to what contributes to the avoidance of corporate-level tax.³⁰ In general, the amount of loss disallowed would not exceed

²⁶ See, e.g., American Bar Association, Section of Taxation, Committee on Affiliated and Related Corporations, Comments Re: Temp. and Prop. Regs. Sections 1.1502-20T and 1.337(d)-1T (Oct. 2, 1990), reprinted in 90 TNT 213-32; Philadelphia Bar, Tax Section, Letter to Fred T. Goldberg, Jr. (June 27, 1990), reprinted in 90 TNT 145-37; Paul Zagortz, Hallmark Cards, Inc., Letter to Robert Boyer (June 12, 1990), reprinted in 90 TNT 129-33; New York State Bar Association, Tax Section, Outline of Presentation by Tax Section of New York State Bar Association Re: Treasury Regulation 1.1502-20T (June 7, 1990), reprinted in 90 TNT 126-43; Tax Executives Institute, Outline of Oral Comments of Michael A. DeLuca Household International, Inc. Prospect Heights, Illinois on behalf of Tax Executives Institute, Inc. (June 1, 1990), reprinted in 90 TNT 135-27; Fred W. Peel, Jr., Outline of Oral Comments on Reg. Section 1.1502-20T (May 23, 1990), reprinted in 90 TNT 119-20; New York State Bar Association, Tax Section, Letter to Kenneth W. Gideon (April 17, 1990), reprinted in 90 TNT 83-16; Arthur S. Hoffman, Chairman American Institute of Certified Public Accountants, Federal Taxation Executive Committee, Letter to Fred T. Goldberg, Jr. (March 20, 1990), reprinted in 90 TNT 79-30.

²⁷ 55 Fed. Reg. 49,075 (1990).

²⁸ Prop. Treas. Reg. § 1.1502-20(a)(1).

²⁹ Preamble to Prop. Treas. Reg. § 1.1502-20, 55 Fed. Reg. at 49,077.

³⁰ Id. at 49,081.

the sum of three factors: (i) earnings and profits from extraordinary gain dispositions; (ii) the aggregate amount of positive investment adjustments (to the extent not included in the extraordinary gain disposition factor); and (iii) the amount of duplicated loss.³¹ The re-proposed regulations were effective with respect to dispositions and deconsolidations after January 31, 1991.³²

The Service apparently anticipated litigation on the validity of the loss duplication factor, because it went to great lengths to document its reasons for retaining the loss duplication rule, which closely resemble the arguments made by the Department of Justice before the Court of Federal Claims and the Federal Circuit in Rite Aid. The Service made several arguments in the preamble to the proposed regulations:³³

1. The consolidated return regulations have developed an extensive system of rules for adjusting the basis of subsidiary stock, the primary effect of which is to reduce duplication of gain and loss. The attempt to reduce loss duplication in the consolidated return context dates back to the Supreme Court decision in Charles Ifield Co. v. Hernandez.³⁴
2. There has been a shift, both statutory and regulatory, in favor of single-entity treatment of consolidated groups.

³¹ Prop. Treas. Reg. § 1.1502-20(c). See infra Part II.B for a more detailed discussion of this provision.

³² Prop. Treas. Reg. § 1.1502-20(h). The transitional rule contained in Temp. Treas. Reg. § 1.337(d)-1T was amended to extend the effective date to November 19, 1990 and made final. Treas. Reg. § 1.337(d)-1. An additional transitional rule was adopted in conjunction with the re-proposed regulations. See Temp. Treas. Reg. § 1.337(d)-2. The new transitional rule generally carries forward the prior transitional rule from November 19, 1990 to January 31, 1991. However, Temp. Treas. Reg. § 1.337(d)-2T only applies if the group disposes of its entire equity interest in a subsidiary. In addition, unlike Treas. Reg. § 1.337(d)-1, Temp. Treas. Reg. § 1.337(d)-2T applies to all subsidiaries, regardless of when they were acquired.

³³ Preamble to Prop. Treas. Reg. § 1.1502-20, 55 Fed. Reg. at 49,079-80.

³⁴ 292 U.S. 62 (1934).

3. Although loss duplication is permitted in the separate return context, corporations electing to file consolidated returns may not retain all the benefits of separate returns and, at the same time, avail themselves of the benefits of consolidated returns.
4. Even though losses may be limited under other Code and regulation provisions, including sections 269, 382, 383(b), 384, and the separate return limitation year rules, these provisions may not significantly limit the duplicated loss. In addition, these provisions were aimed at trafficking in tax benefits, not duplication of loss.

In promulgating the loss duplication factor, the Service relied upon its regulatory authority under both sections 337(d) and 1502:

The repeal of the General Utilities doctrine compelled a major change in the investment adjustment rules. New proposed § 1.1502-20 retains the elimination of loss duplication as an appropriate exercise of authority that simplifies the rules necessary for preventing circumvention of General Utilities repeal. It is not possible to differentiate between loss attributable to built-in gain and duplicated loss without resorting to tracing.

* * *

Eliminating loss duplication is consistent with the historical concerns under the consolidated return regulations and is an appropriate exercise of authority under section 1502.³⁵

As discussed above, section 337(d) grants the Service regulatory authority to protect the purposes behind the General Utilities repeal, including “regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations . . .).”³⁶ Section 1502 grants the Service regulatory authority to clearly reflect the income tax liability of consolidated groups:

³⁵ Preamble to Prop. Treas. Reg. § 1.1502-20, 55 Fed. Reg. at 49,079-80.

³⁶ I.R.C. § 337(d)(1).

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.³⁷

4. Final Regulations

The final loss disallowance regulations were issued on September 13, 1991.³⁸

Notwithstanding continued criticism of the loss disallowance rules, including the loss duplication rule,³⁹ the final regulations largely adopted the rules of the re-proposed regulations. The final regulations are effective for dispositions and deconsolidations on or after February 1, 1991.⁴⁰

The Service defended its decision to retain the approach of the re-proposed regulations by noting that the approach reflects a balancing of tax policy considerations:

³⁷ Id. § 1502.

³⁸ 56 Fed. Reg. 47,379 (1991).

³⁹ See, e.g., American Bar Association, Section of Taxation, Committee on Affiliated and Related Corporations, Comments Re: Final, Temporary and Proposed Regulations Sections 1.1502-20, 1.337(d)-1, and 1.337(d)-2T (April 22, 1991), reprinted in 91 TNT 112-48; New York State Bar Association, Tax Section, Letter to Fred T. Goldberg, Jr. (January 29, 1991), reprinted in 91 TNT 37-21; Tax Executives Institute, Letter to Fred T. Goldberg, Jr. (January 23, 1991), reprinted in 91 TNT 35-38; Lawrence M. Axelrod, Letter to Fred T. Goldberg, Jr. (January 18, 1991), reprinted in 91 TNT 35-37; American Institute of Certified Public Accountants, Corporations and Shareholders Taxation Committee, Letter to Carol Savage (January 15, 1991); reprinted in 91 TNT 19-20.

⁴⁰ Treas. Reg. § 1.1502-20(h)(1). A group may elect to apply the final regulations in lieu of the transitional rules of Treas. Reg. § 1.337(d)-2 with respect to dispositions and deconsolidations on or after November 19, 1990. Treas. Reg. § 1.1502-20(h)(2). In addition, a group may elect to apply Temp. Treas. Reg. § 1.1502-20T in lieu of the transitional rules of Treas. Reg. § 1.337(d)-1 with respect to dispositions and deconsolidations between March 9, 1990 and November 19, 1990. Treas. Reg. § 1.1502-20(h)(4).

The modified loss disallowance approach contained in § 1.1502-20 represents a balancing of tax policy considerations: (i) It is effective in implementing General Utilities repeal because it prevents the elimination of corporate level tax; (ii) it allows the deduction of certain readily identifiable economic loss; (iii) it is administrable by both taxpayers and the Service; and (iv) by limiting loss duplication, it is consistent with the single entity principles reflected in the investment adjustment rules and other consolidated return regulations⁴¹

The Service also responded to comments questioning its authority to promulgate the loss duplication rules, which are contrary to specific provisions of the Code:

The essence of the Service's authority under sections 1502 and 337(d) is the authority to adapt Code provisions to solve problems resulting from the filing of consolidated returns. In addition, regulatory authority under both section 1502 and section 7805 includes the authority to adopt administrable rules. The regulatory authority under which the investment adjustment system was adopted includes the authority to adapt the system to legislative enactments and changing circumstances. As a consequence of the repeal of the General Utilities doctrine, final § 1.1502-02 [sic] modifies the application of the investment adjustment rules to prevent elimination of corporate level tax. Because it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss, the final regulations disallow loss with respect to subsidiary stock that is duplicated by the subsidiary's operating losses or built-in losses with respect to its assets. In so doing, the regulations provide an administrable solution to General Utilities repeal and extend the single entity principles underlying the investment adjustment rules and other existing consolidated return rules to losses with respect to subsidiary stock.⁴²

⁴¹ Preamble to Treas. Reg. § 1.1502-20, 56 Fed. Reg. at 47,382.

⁴² Id.

B. Description of Loss Disallowance Rules

Treas. Reg. § 1.1502-20 governs the tax treatment of losses incurred by a member of a consolidated group upon the disposition of shares of a consolidated subsidiary. In general, such losses are disallowed.⁴³ In addition to disallowing loss on the disposition of subsidiary stock, Treas. Reg. § 1.1502-20 requires a reduction in the basis of a consolidated subsidiary's stock to the fair market value of the stock immediately before a deconsolidation of the subsidiary.⁴⁴ This rule prevents avoidance of the loss disallowance rule by first deconsolidating a subsidiary (e.g., by selling 21 percent of the subsidiary's stock) and then selling the remaining stock of the then nonmember at a loss. Because the nonmember is not a "subsidiary" (which is defined as being a member),⁴⁵ the loss disallowance rule would not apply to the disposition of the remainder.

However, the regulations contain an exception to the general rules of loss disallowance and basis reduction, which provides that the amount of the disallowed loss shall not exceed the sum of (i) the income or gain from extraordinary gain dispositions, (ii) the amount of positive investment adjustments with respect to the stock, to the extent they exceed the amount of extraordinary gain dispositions, and (iii) the amount of duplicated loss with respect to the stock.⁴⁶

⁴³ Treas. Reg. § 1.1502-20(a)(1).

⁴⁴ Id. § 1.1502-20(b).

⁴⁵ Id. § 1.1502-1(c).

⁴⁶ Id. § 1.1502-20(c)(1).

Thus, the loss disallowance rules effectively disallow two types of losses. The first type are losses that enable consolidated taxpayers to circumvent the repeal of the General Utilities doctrine (i.e., avoiding the corporate-level tax). This corresponds to the first two items listed above (i.e., extraordinary gain and positive investment adjustment factors). It prevents, for example, the son of mirrors transaction described above. The second type are losses attributable to members' unrecognized, or recognized but unutilized, losses that would be preserved for later recognition or use outside the group. This corresponds to the third item listed above (i.e., duplicated loss factor). Thus, for example, assume that a subsidiary has a net operating loss that has not yet been used by the group, so that it has not yet resulted in a reduction of the subsidiary's stock basis. If the parent sells the stock of the subsidiary, the parent is able to utilize its unreduced stock basis in the subsidiary, and the subsidiary is able to utilize its net operating loss on its separate return or in its new consolidated group.

At issue in the Rite Aid case is the second type of loss, or the duplicated loss factor. Duplicated loss is determined by a formula that attempts to compute the excess of the subsidiary's tax attributes that will give rise to future deductions (i.e., inside asset basis, loss carryovers, and deferred deductions) over the cost to the purchaser (i.e., stock value plus assumed liabilities). Specifically, the duplicated loss equals the excess (if any) of—

(A) The sum of—

- (1) The aggregate adjusted basis of the assets of the subsidiary other than any stock and securities that the subsidiary owns in another subsidiary, and
- (2) Any losses attributable to the subsidiary and carried to the subsidiary's first taxable year following the disposition or deconsolidation, and
- (3) Any deferred deductions (such as deductions deferred under section 469) of the subsidiary, over

(B) The sum of—

- (1) The value of the subsidiary's stock, and
- (2) Any liabilities of the subsidiary, and
- (3) Any other relevant items.⁴⁷

III. RITE AID CASE

A. Facts

Rite Aid Corporation (“Rite Aid”) is the common parent of an affiliated group of corporations that files a consolidated return. During 1983 and 1984, Rite Aid was looking for other retail businesses to acquire in an effort to diversify its drug store business into other retail businesses. One of the potential acquisition targets was Penn Encore, Inc. (“Encore”), which operated a small discount bookstore chain. Rite Aid acquired 80 percent of the Encore stock in 1984 for \$3 million (for which a section 338 election was made) and purchased the remaining 20 percent in 1988 for \$1.5 million.

Rite Aid operated Encore from 1984 through 1994 and included it in its consolidated return. During that period, Encore experienced net negative earnings and profits of approximately \$10.9 million and borrowed approximately \$44.9 million from Rite Aid. In January 1994, Rite Aid adopted a restructuring plan, which included the sale of Encore. Rite Aid asked prospective bidders whether they would join in making an election under section 338(h)(10). The only bidder for Encore, Lauriat’s Inc., a subsidiary of CMI Holding Corp., refused to join in a section 338(h)(10) election.

⁴⁷ Id. § 1.1502-20(c)(2)(vi).

On November 23, 1994, Rite Aid sold all of the Encore stock to Lauriat's, Inc. for a net sales price of approximately \$17.8 million. At the closing, Rite Aid contributed the intercompany debt of \$44.9 million to Encore's capital to satisfy a condition precedent to the sales agreement. Rite Aid incurred selling costs of approximately \$1.3 million. Rite Aid claimed a loss of approximately \$22.1 million on the sale of the Encore stock⁴⁸ computed as follows:

Amount realized:		
\$17.8 million (sales proceeds)		
<u>(\$ 1.3 million)</u> (selling costs)		\$16.5 million
Less adjusted basis:		
\$ 4.6 million (original purchase price plus tax)		
(\$10.9 million) (negative basis adjustments)		
<u>\$44.9 million</u> (contribution of debt)		<u>(\$38.6 million)</u>
		(\$22.1 million)

However, Rite Aid's loss was disallowed under Treas. Reg. § 1.1502-20. Rite Aid determined that Encore's duplicated loss factor was approximately \$28.5 million,⁴⁹ its extraordinary gain disposition factor was \$9,624, and its positive investment adjustment factor was approximately \$6.2 million. Because the sum of the loss disallowance factors, or

⁴⁸ It is not clear whether Rite Aid claimed a bad debt deduction with respect to the \$44.9 million Encore debt.

⁴⁹ Specifically, Encore's duplicated loss was computed as follows:

Adjusted asset basis	\$52.4 million	
Aggregate NOLs	-0-	
Deferred deductions	<u>-0-</u>	\$52.4 million
Less: Value of stock	\$17.8 million	
Liabilities	\$ 6.1 million	
Other relevant items	<u>-0-</u>	<u>(\$23.9 million)</u>
Duplicated Loss Factor		\$28.5 million

approximately \$34.7 million, exceeded Rite Aid's investment loss, Rite Aid's entire loss was disallowed under Treas. Reg. § 1.1502-20. Rite Aid paid the tax and filed a claim for refund in the United States Court of Federal Claims, claiming that the regulation was invalid. The government moved for summary judgment on the validity of the regulation, arguing that it is not arbitrary, capricious or manifestly contrary to the statute. Rite Aid cross moved for summary judgment on the invalidity of the regulation, arguing that it exceeds the authority delegated to the Service under section 1502 in manifest contradiction of the Code and is arbitrary and capricious.

B. Court of Federal Claims Decision

The Court of Federal Claims granted the government's motion for summary judgment, thus upholding the validity of Treas. Reg. § 1.1502-20.⁵⁰ The court noted that the regulation was promulgated under the specific authority of section 1502 and thus was properly characterized as a legislative regulation. The court articulated the standard of review that legislative regulations are valid unless arbitrary, capricious, or manifestly contrary to the statute.⁵¹ The court concluded that Treas. Reg. § 1.1502-20 was not arbitrary, capricious, or manifestly contrary to the statute, stating that:

Regulation section 1.1502-20 appears to the court to fall well within the four corners of section 1502, affecting as it does the tax liability of the affiliated group with respect to a matter arising because of the disaffiliation of one of its members. The duplicated loss rule in the Regulation prohibits the opportunity that would

⁵⁰ Rite Aid Corp., 46 Fed. Cl. at 506. Although the parties also disputed the validity of the extraordinary gain and positive investment adjustment factors, the parties agreed at oral argument that the validity of these factors would be rendered moot if the court upheld the duplicated loss factor. Id. at 501, n.1.

⁵¹ Id. at 505.

exist – without the Regulation – for the affiliated group to recognize a loss on a sale of stock of a subsidiary and for the purchaser to recognize the same loss. By prohibiting the use of the same loss in the hands of both the seller and purchaser, the Regulation assists in achieving the purpose of all regulations issued under I.R.C. section 1502 “clearly to reflect the income-tax liability” of both members and former members of the affiliated group and to “prevent avoidance of such tax liability.”⁵²

Rite Aid made several arguments, which were rejected by the court. First, Rite Aid argued that the language of section 1502 contemplates that the delegation of regulatory authority will be limited by other provisions of the Code, including section 165.⁵³ Section 1502 grants authority to the Service to prescribe regulations to clearly reflect the “income tax liability” of consolidated groups and to prevent avoidance of “such tax liability.”⁵⁴ Rite Aid argued that the reference to “income tax liability” in section 1502 is to the tax liability imposed by the Code, not the consolidated return regulations, and the Service is without authority to derogate the Code’s provisions. Section 165 permits a deduction for a “loss sustained during the taxable year and not compensated for by insurance or otherwise.”⁵⁵ Because Treas. Reg. § 1.1502-20 disallows a loss that would otherwise be deductible under section 165, the Service exceeded its authority under section 1502 and, therefore, the regulation is invalid. The court rejected this argument, noting that Rite Aid could have structured the transaction in a way that would have

⁵² Id.

⁵³ Plaintiff’s Brief in Support of its Motion for Summary Judgment, pp. 14-15 (hereinafter “Plaintiff’s Brief”); Plaintiff’s Reply Brief in Further Support of its Motion for Summary Judgment and in Opposition to Defendant’s Motion for Summary Judgment, pp. 5-6 (hereinafter “Plaintiff’s Reply Brief”).

⁵⁴ I.R.C. § 1502.

⁵⁵ Id. § 165(a).

allowed Rite Aid to recognize its losses, such as an asset sale or a section 338(h)(10) election.⁵⁶

The court further noted that, because of the possible value of the losses to the buyer, the court did not believe that Rite Aid had not been compensated for its loss as contemplated by section 165.⁵⁷

Second, Rite Aid argued that the government's stated reason for the loss duplication factor – to prevent duplicate gain and loss recognition – was unsupported.⁵⁸ The government's historic effort to prevent duplicated losses is exemplified by the Supreme Court case of Charles Ifeld Co. v. Hernandez⁵⁹ and Treas. Reg. § 1.1502-32. However, those efforts disallowed a deduction to the consolidated group for a loss on the sale of stock that was attributable to other losses previously recognized by that consolidated group. In this case, the Rite Aid group had taken no prior deduction for the loss inherent in Encore and would receive no future deduction attributable to that loss. Therefore, Rite Aid argued, there was no duplicated loss. The court relied on the language of section 1502 – that the Service prescribe regulations to clearly reflect the tax liability of a consolidated group and each corporation in the group “both during and after the period of affiliation” – to conclude that the purpose of section 1502 is served by prohibiting group losses that otherwise might be taken both by the group and its former member.⁶⁰

⁵⁶ Rite Aid Corp., 46 Fed. Cl. at 505.

⁵⁷ Id. The court's belief seems flawed. If, as the court suggests, a portion of the consideration paid by the buyer was in exchange for Encore's tax attributes, such amount would already have increased the amount realized on the sale and therefore have been taken into account in computing Rite Aid's loss. There was, however, no dispute as to Rite Aid's calculation of its \$22.1 million loss.

⁵⁸ See Plaintiff's Brief, pp. 26-27; Plaintiff's Reply Brief, pp. 6-8.

⁵⁹ 292 U.S. 62 (1934).

⁶⁰ Rite Aid Corp., 46 Fed. Cl. at 506.

Third, Rite Aid argued that Court of Claims precedent limited the Service's authority under section 1502 to addressing the "special, myriad problems" that arise in determining the tax liability of consolidated groups.⁶¹ The duplicated loss problem that Treas. Reg. § 1.1502-20 attempts to fix also exists in the context of separate returns. Because the duplicated loss factor does not address a problem caused by the filing of consolidated returns, Rite Aid argued, it is arbitrary, capricious, and manifestly contrary to statute.⁶² The court distinguished American Standard, noting that in that case, the Service did not provide any statement of the basis and purpose for the regulations, whereas in the present case, the Service fully explained the rationale for the duplicated loss factor in numerous preambles.⁶³ The court further noted that the court in American Standard was particularly persuaded by the view that the regulation in issue frustrated a tax benefit that had been specifically provided by Congress as an inducement to American businesses.⁶⁴

⁶¹ See American Standard, Inc. v. United States, 602 F.2d 256 (Ct. Cl. 1979).

⁶² Plaintiff's Brief, pp. 17-18; Plaintiff's Reply Brief, pp. 9-10, 12-14.

⁶³ Rite Aid Corp., 46 Fed. Cl. at 506. We note that this distinction is not really relevant to the Rite Aid case. The regulation at issue in American Standard was invalidated on two grounds: (i) the regulation exceeded the scope of authority granted to the Service under section 1502; and (ii) the regulation violated the notice requirement of the Administrative Procedure Act. The lack of a statement of basis and purpose goes to the second ground, which was not at issue in Rite Aid. Although the court in American Standard mentioned the lack of a statement of basis and purpose in its discussion of the first ground, it was simply to note that the court was unaware of "any special factual or legal problem caused by the filing of consolidated returns with which the method adopted by the regulation meant to deal." Id. at 260.

⁶⁴ Id.

C. Court of Appeals for the Federal Circuit Decision

The Federal Circuit reversed the Court of Federal Claims' decision.⁶⁵ The Federal Circuit agreed with the Court of Federal Claims on the standard for review with respect to the validity of legislative regulations; i.e., that they are entitled to controlling weight unless arbitrary, capricious, or manifestly contrary to the statute.⁶⁶ The Federal Circuit did not address the arbitrary and capricious standard, but it concluded that Treas. Reg. § 1.1502-20 is manifestly contrary to the statute and is, therefore, invalid.⁶⁷

The court noted that a regulation is manifestly contrary to the statute if it is outside the scope of authority delegated under the statute.⁶⁸ Applying American Standard, the court held:

[I]n 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.⁶⁹

The Federal Circuit reasoned that realization of a loss by a subsidiary on the sale of its assets after the consolidated group realizes a loss on the sale of the subsidiary's stock is not a problem resulting from the filing of a consolidated return; it also arises in a separate return context. Congress has historically dealt with the problem by limiting the subsidiary's potential future

⁶⁵ Rite Aid Corp., 255 F.3d at 1358.

⁶⁶ Id. at 1359.

⁶⁷ Id. at 1360. See supra Part IV.B.1. for a discussion of the scope of the court's holding.

⁶⁸ Id. at 1359 (citing Rowan Cos., Inc. v. United States, 452 U.S. 247, 253 (1981)).

⁶⁹ Id. at 1359-60.

deduction,⁷⁰ not by limiting the parent's loss on the sale of the subsidiary's stock under section

165. The court therefore concluded:

[T]he duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions for the subsidiary's losses. Because the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute.⁷¹

D. Subsequent Procedural Developments

On August 20, 2001, the government filed a petition for rehearing en banc to the Federal Circuit, claiming that the test applied by the Federal Circuit – that the loss sustained by Rite Aid was not a problem created by the filing of consolidated returns and, therefore, the Service was without authority to change the application of other Code provisions – was flawed. The government argued that (i) the loss claimed by Rite Aid was, in fact, a product of its election to file consolidated returns, because the basis of the Encore stock used to compute the loss reflected a series of basis adjustments under Treas. Reg. § 1.1502-32, (ii) the duplicated loss rule is premised on the concept of clear reflection of income, and it carries out the objective of taking gains and losses of the group into account only once, and (iii) the Supreme Court's decision in Chevron U.S.A., Inc. v. Natural Resources Defense Council⁷² does not authorize the inquiry taken by the Federal Circuit regarding the presence or absence of a problem created from the

⁷⁰ See, e.g., I.R.C. §§ 382, 383.

⁷¹ Rite Aid Corp., 255 F.3d at 1360.

⁷² 467 U.S. 837 (1984).

filing of consolidated returns, and the Federal Circuit failed to undertake the two-step inquiry required by Chevron.⁷³

Rite Aid filed a response to the petition for rehearing, pointing out that American Standard, which has been the law in the Federal Circuit for twenty years, is entirely consistent with the decision in Chevron.⁷⁴

However, the Federal Circuit denied the government's petition for rehearing on October 3, 2001.

On August 30, 2001, the Service issued a Chief Counsel Notice⁷⁵ advising chief counsel attorneys that it disagrees with the Federal Circuit's decision. The Notice directing chief counsel attorneys to continue working with examining agents to "identify, develop and pursue [loss disallowance] issues without regard to the Rite Aid decision until further direction from this office or further judicial resolution."⁷⁶

On January 31, 2002, the Service announced that it would not file a petition for certiorari in the Rite Aid case, because it believed that the Supreme Court was unlikely to grant a petition for certiorari absent a split in the circuit courts of appeals. At the same time, the Service issued Notice 2002-11,⁷⁷ which set forth its intended course of action with respect to the loss disallowance rule of Treas. Reg. § 1.1502-20. In Notice 2002-11, the Service reiterated its

⁷³ See Appellee's Petition for Rehearing En Banc.

⁷⁴ See Appellant's Opposition to a Rehearing En Banc, pp. 1-7.

⁷⁵ CC-2001-42 (Aug. 30, 2001).

⁷⁶ Id.

⁷⁷ 2002-7 I.R.B. 1 (Jan. 31, 2002).

position that the Federal Circuit's holding in Rite Aid was incorrect, but announced that it would not continue to litigate the validity of the loss duplication factor. The Service also stated its position that the Rite Aid case implicates only the loss duplication factor of the loss disallowance rules. Nonetheless, because of the interrelationship in the operation of the loss duplication factor with the other loss disallowance factors, the Service announced that it would issue new rules governing the disallowance of losses on the sale of member stock. The Service intends to promulgate interim regulations that would require consolidated groups, on a prospective basis, to determine the allowable loss on a disposition of subsidiary stock under an amended Treas. Reg. § 1.337(d)-2 instead of under Treas. Reg. § 1.1502-20.

IV. ANALYSIS

A. Analysis of Federal Circuit Opinion in General

While we believe that the Federal Circuit arrived at the correct answer, the court's analysis is cursory and provides little guidance. As a result, it creates uncertainty about the reach of the court's holding and raises questions about the validity of many of the consolidated return provisions.

1. Support for Federal Circuit Decision

There is ample authority to support the Federal Circuit's conclusion that section 1502 does not authorize the Service to choose a method that imposes tax on income that would not otherwise be taxed.⁷⁸ Indeed, the Supreme Court has stated:

⁷⁸ See, e.g., Burnet v. Aluminum Goods Mfg. Co., 287 U.S. 544 (1933); Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954); Commissioner v. General Machinery Corp., 95 F.2d 759 (6th Cir. 1938); Corner Broadway-Maiden Lane, Inc. v. Commissioner, 76 F.2d 106 (1935); Int'l Paper Co. v. United States, 33 Fed. Cl. 384 (1995);

(Continued ...)

[N]o method of accounting, in calculating taxable income upon the consolidated return, can be upheld, which would withhold from the taxpayer all benefit of deduction for losses actually sustained and deductible under the sections governing the computation of taxable income, and which at the same time would not further, in some way, the very purpose for which consolidated returns are required. . . . While equitable principles of accounting applied to the calculation of the net income of the business unit do not permit deduction of the loss twice, they do require its deduction once.⁷⁹

The loss duplication factor contravenes the statutory provisions that permit shareholders to take a deduction for losses sustained on the disposition of their stock, thus taxing income that would remain untaxed in a separate return context.⁸⁰ Even though section 1502 grants the Service broad authority to promulgate regulations to clearly reflect the tax liability of consolidated groups and prevent tax avoidance, the Federal Circuit properly concluded that the loss duplication factor did not satisfy these standards. Rite Aid suffered an economic loss on its Encore stock – such loss was both realized and recognized. Denying a deduction for such loss can hardly be considered to clearly reflect the tax liability of the Rite Aid group. Moreover, such denial is not necessary to prevent tax avoidance. As the Federal Circuit noted, the potential for loss duplication also arises in the non-consolidated context where a corporate shareholder sells the stock of a non-consolidated subsidiary.⁸¹

Union Carbide Corp. v. United States, 612 F.2d 558 (Ct. Cl. 1979); American Standard, Inc., 602 F.2d at 262; Joseph Weidenhoff, Inc. v. Commissioner, 32 T.C. 1222 (1959).

⁷⁹ Aluminum Goods Mfg. Co., 287 U.S. at 549.

⁸⁰ I.R.C. §§ 165(a), (g)(3); 1001(c).

⁸¹ Rite Aid Corp., 255 F.3d at 1360.

2. Existence of Duplicated Loss

Nonetheless, the Federal Circuit gave short shrift to the Court of Federal Claims' decision. The Court of Federal Claims relied on the language of section 1502 that refers to the tax liability of "any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation."⁸² Thus, the court seemed to conclude that a loss that might be taken by both the group and its former member is a duplicated loss in the Ilfeld sense and that Treas. Reg. § 1.1502-20 achieves the purpose of section 1502 of preventing tax avoidance.⁸³

In so holding, the Court of Federal Claims attributes a new meaning to the term "duplicated." Webster's Dictionary defines "duplicate" as "to make double or twofold."⁸⁴ Thus, a deduction of a loss in the first instance cannot be a duplicated loss.⁸⁵

The approach of the Court of Federal Claims ignores the historic approach of both Congress and the Service in addressing duplicated loss concerns. Where the potential tax benefit of a loss may be realized by both the transferor and transferee of stock of a corporation, Congress has historically limited the benefit allowed to the transferee, not the transferor, who

⁸² Rite Aid Corp., 46 Fed. Cl. at 505 (emphasis added).

⁸³ Id.

⁸⁴ MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 359 (10th ed. 1994).

⁸⁵ See Charles Ilfeld Co., 292 U.S. at 68 ("The allowance claimed would permit petitioner twice to use the subsidiary's losses for the reduction of its taxable income"); Aluminum Goods Mfg. Co., 287 U.S. at 551 ("While equitable principles of accounting applied to the calculation of the net income of the business unit do not permit deduction of the loss twice, they do require its deduction once"); Textron, Inc. v. United States, 561 F.2d 1023, 1027 (1st Cir. 1977) ("Textron's deductions must have been proper at the time, for no 'double' deduction had yet been sought")

economically suffered the loss.⁸⁶ Similarly, the Service has, in the context of consolidated groups, historically limited the benefit of a loss or deduction only if such loss or deduction has already been used to offset income of the consolidated group. For example, a negative basis adjustment is made to stock of a subsidiary under the consolidated return regulations only if that subsidiary's losses are utilized by the group.⁸⁷

3. Single vs. Separate Entity Theories

The Federal Circuit decision also did not address the all-important question of single vs. separate entity theories of consolidated returns. Although the Federal Circuit's holding implicitly adopts the separate-entity approach, this fundamental difference between its holding and that of the lower court went unmentioned. In promulgating Treas. Reg. § 1.1502-20, the Service relied in part upon a shift, both statutory and regulatory, in favor of single-entity treatment of consolidated groups.⁸⁸ The government reiterated its argument in favor of single-entity treatment in its brief to the Federal Circuit:

The integrity of the single entity approach embodied in the relevant consolidated return provisions, however, depends upon treating the group as investing in the assets (not the stock) of the group members. . . . [T]he only value inherent in the group is the [assets] held by the subsidiary; the parent's stock in the subsidiary adds no independent value."⁸⁹

⁸⁶ See, e.g., I.R.C. §§ 269, 382, 383(b), 384; Treas. Reg. §§ 1.1502-21(c), -22(c), -15.

⁸⁷ Treas. Reg. § 1.1502-32(b)(3)(i).

⁸⁸ Preamble to Prop. Treas. Reg. § 1.1502-20, 55 Fed. Reg. at 49,079.

⁸⁹ Corrected Brief for the Appellee, the United States, p. 22.

The problem with the government's argument is that the consolidated return regulations have not consistently treated members of the consolidated group as a single entity – they represent a blend of single and separate-entity concepts. For example, the ability of a consolidated group to offset one member's losses against another member's income⁹⁰ and the treatment of intercompany obligations⁹¹ reflect the single-entity concept. On the other hand, the calculation of gain or loss and basis with respect to property sold in an intercompany transaction⁹² and the rules concerning methods of accounting of members of the group⁹³ reflect the separate-entity concept. Indeed, the computation of consolidated taxable income itself reflects both single and separate-entity concepts – separate taxable income is the starting point, but certain items of income and deduction are excluded from the computation of separate taxable income, because they are determined on a consolidated basis (e.g., net operating loss, dividends-received deduction).⁹⁴

Moreover, even the single-entity concepts do not ignore the separate identities of the members of the consolidated group and the existence of their stock. Far from disregarding member stock, the consolidated return investment adjustment rules carefully track and adjust the basis of member stock.⁹⁵ As another example, the regulations provide that a subsidiary must

⁹⁰ See Treas. Reg. §§ 1.1502-11(a)(1); -12.

⁹¹ See id. § 1.1502-13(g).

⁹² See id. § 1.1502-13(a)(2).

⁹³ See id. § 1.1502-17(a).

⁹⁴ See id. §§ 1.1502-11(a); -12(h)-(n).

⁹⁵ Id. § 1.1502-32.

recognize gain under section 311(b) upon the distribution of appreciated property notwithstanding single-entity concepts.⁹⁶ Courts have also supported the notion that members of a consolidated group retain their separate corporate identities. In Wolter Construction Co., Inc. v. Commissioner,⁹⁷ the court stated:

The consolidated return computations are not, however, based on a consolidated accounting of all income and capital items as though the properties of the subsidiaries were owned by the parent. Instead, for most items there are separate computations for each corporate entity. Actual consolidation of accounts is limited to certain specified items which are aggregated for all members. In this regard, the filing of a consolidated return is not the functional equivalent of a merger. The members of the affiliated group still retain their separate identities and still compute their income as if they were separate.

4. Problem Created by the Filing of Consolidated Returns

The Federal Circuit, relying on American Standard, held that in the absence of a problem created from the filing of consolidated returns, the Service is without authority to change the application of other Code provisions to consolidated groups.⁹⁸ This standard is suggested by the legislative history of section 1502:

⁹⁶ Id. § 1.1502-13(f)(2)(iii).

⁹⁷ 634 F.2d 1029, 1038 (6th Cir. 1980) (footnote omitted); see also American Standard, Inc., 602F.2d at 261 (stating that the consolidated return regulations “primarily deal with the affiliated corporations as separate corporate entities”).

⁹⁸ Rite Aid Corp., 255 F.3d at 1359-60; see also First Chicago Corp. v. Commissioner, 96 T.C. 421, 440 (1991), aff’d, 135 F.3d 457 (7th Cir. 1998) (stating that “[t]he power to promulgate consolidated regulations pursuant to section 1502 is the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns”).

Many difficult and complicated problems, however, have arisen in the administration of the provisions permitting the filing of consolidated returns. . . . The committee believes it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them.⁹⁹

This standard is also suggested by the Service in the preamble to the final regulations:

The essence of the Service's authority under sections 1502 and 337(d) is the authority to adapt Code provisions to solve problems resulting from the filing of consolidated returns.¹⁰⁰

The court did not, however, provide any further explanation of this standard. The whole point of the consolidated return regulations is to change the application of regular Code provisions to consolidated taxpayers.¹⁰¹ Thus, the court's holding appears to call into question many of the consolidated return regulations. Under the court's standard, the Service may change the application of the Code to consolidated taxpayers only if it is in response to a "problem created from the filing of consolidated returns." What does it mean to be created from the filing of consolidated returns?

Some guidance is provided by American Standard wherein the court stated that "[w]e are . . . unaware of any special factual or legal problem caused by the filing of

⁹⁹ S. REP. NO. 70-960, at 15 (1928).

¹⁰⁰ Preamble to Treas. Reg. § 1.1502-20, 56 Fed. Reg. at 47,382.

¹⁰¹ See Treas. Reg. § 1.1502-80(a) (stating that the Code or other law applies to consolidated groups to the extent the regulations do not exclude their application).

consolidated returns with which the method adopted by the regulation was meant to deal.”¹⁰² In concluding that Treas. Reg. § 1.1502-25 was invalid, the court stated:

It cannot seriously be contended that such a departure in methodology and resulting amount is merely a mechanical or technical method of adjusting individual returns to the consolidated return format. Critically, the regulation changes the conceptual basis upon which Congress permitted the deduction in section 922. We do not accept the view that this departure was within the Treasury’s power.

* * *

Sinclair Oil Corp.^[103] did not present a question of conforming the Code to consolidated returns but instead presented a question unique to consolidated returns. Nevertheless, the rationale is equally applicable because the WHTC deduction . . . , like the exclusion, is reserved for and for the benefit solely of WHTCs.¹⁰⁴

Thus, according to the American Standard court, a problem is created from the filing of consolidated returns if it either (i) requires a mechanical or technical adjustment of individual returns to the consolidated return format or (ii) presents a question unique to consolidated returns. The court cited as an example of the former type of problem the requirement that consistent accounting methods be used by all members of the consolidated group.¹⁰⁵ The court

¹⁰² American Standard, Inc., 602 F.2d at 260.

¹⁰³ Sinclair Oil Corp. v. United States, 183 Ct. Cl. 92 (1968). In Sinclair Oil Corp., the court dealt with the computation of the proper exclusion from consolidated taxable income of Western Hemisphere Trade Corporation (“WHTC”) and utility corporation income for purposes of the 2-percent add-on tax, which applied solely to consolidated returns. In American Standard, Inc., the court dealt with the allocation of consolidated taxable income to WHTCs and utilities for purposes of determining the special deductions allowed by sections 922 and 247.

¹⁰⁴ American Standard, Inc., 602 F.2d at 265, 266 (footnote omitted).

¹⁰⁵ Id. at 265, n.15 (citing Salem Packing Co. v. Commissioner, 56 T.C. 131 (1971)).

cited as an example of the latter type of problem the determination of the amount of income exempt from a penalty tax applicable only to consolidated groups.¹⁰⁶

The potential for loss duplication where stock of a subsidiary that has a built-in loss asset is sold at a loss is not unique to consolidated groups – it applies equally to non-consolidated subsidiaries. In addition, the disallowance of economic losses that could potentially be duplicated cannot be said to be a mechanical or technical method of adjusting individual returns to the consolidated return format. Thus, the loss duplication factor does nothing to conform the Code to the special, myriad problems resulting from the filing of consolidated income tax returns – it simply denies a tax benefit that is available to non-consolidated taxpayers solely because the taxpayer files a consolidated return. This was clearly not what Congress intended when it granted regulatory authority in section 1502.

B. Implications of Federal Circuit Opinion

1. Scope of Holding

There is legitimate concern regarding the scope of the Rite Aid decision. The Federal Circuit held that “[b]ecause the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute.”¹⁰⁷ Was the court referring to all of Treas. Reg. § 1.1502-20, or merely the duplicated loss factor in Treas. Reg. § 1.1502-20(c)(1)(iii)? Although the holding was broadly stated, it seems pretty clear from the parties’ arguments, the Federal Circuit’s analysis, and circumstances surrounding the decision of the Court of Federal Claims that the holding should be limited to the duplicated loss factor.

¹⁰⁶ Id. at 266.

¹⁰⁷ Rite Aid Corp., 255 F.3d at 1360 (emphasis added).

In their briefs filed with the Federal Circuit, the parties focused only on the duplicated loss factor. The analysis of the Federal Circuit notes that loss duplication is not a problem resulting from the filing of consolidated returns and that Congress has historically addressed the situation by limiting the subsidiary's potential future deduction. The court then states:

Rather than creating symmetry in the tax code, then, the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions for the subsidiary's losses. Because the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute.

Thus, even though the court's ultimate statement of its conclusion refers only to "regulation," it is clear that its reasoning relates only to the duplicated loss factor.

Further, in their briefs filed with the Court of Federal Claims, the parties disputed the validity of the extraordinary gain and positive investment adjustment factors in addition to the loss duplication factor. However, the parties agreed at oral argument that the validity of these factors would be rendered moot if the court upheld the duplicated loss factor.¹⁰⁸ The Court of Federal Claims upheld the duplicated loss factor:

Regulation section 1.1502-20 appears to the court to fall well within the four corners of section 1502, affecting as it does the tax liability of the affiliated group with respect to a matter arising because of the disaffiliation of one of its members. The duplicated loss rule in the Regulation prohibits the opportunity that would exist – without the Regulation – for the affiliated group to recognize a loss on a sale of stock of a subsidiary and for the purchaser to recognize the same loss. By prohibiting the use of the

¹⁰⁸ Rite Aid Corp., 46 Fed. Cl. at 501, n.1.

same loss in the hands of both the seller and purchaser, the Regulation assists in achieving the purpose of all regulations issued under I.R.C. section 1502 “clearly to reflect the income-tax liability” of both members and former members of the affiliated group and to “prevent avoidance of such tax liability.”¹⁰⁹

Thus, it also seems clear from the parties’ concession and the court’s articulation of its holding that it was limited to the loss duplication factor. As a result, the Federal Circuit had before it only the issue of the validity of the duplicated loss factor.

2. Effect on Other Consolidated Return Regulations

As discussed above, the standard applied by the Federal Circuit is that in the absence of a problem created from the filing of consolidated returns, the Service is without authority to change the application of other Code provisions to consolidated groups.¹¹⁰ Because many of the consolidated return regulations change the application of regular Code provisions to consolidated taxpayers,¹¹¹ the court’s holding appears to threaten many of the consolidated return regulations. Nonetheless, it appears that the vast majority of the consolidated return regulations should generally withstand scrutiny under Rite Aid, because they address problems created from the filing of consolidated returns. A few examples are discussed below.

For example, the investment adjustment rules of Treas. Reg. § 1.1502-32 modify the Code’s rules governing basis computations.¹¹² However, these rules address the problem of

¹⁰⁹ Id. at 505 (emphasis added).

¹¹⁰ Rite Aid Corp., 255 F.3d at 1359-60.

¹¹¹ See Treas. Reg. § 1.1502-80(a) (stating that the Code or other law applies to consolidated groups to the extent the regulations do not exclude their application).

¹¹² See, e.g., I.R.C. §§ 358; 1012; 1016.

how to prevent a consolidated group from recognizing gain or loss on the sale of a subsidiary that would duplicate income or deductions already claimed by that subsidiary and utilized in the group's consolidated return. The problem is illustrated by the following example:

Example 4. P owns all of the stock of S, and P and S file a consolidated return. P has a basis of \$500 in the stock of S. In Year 1, P has income of \$100 and S has an operating loss of \$40. The P group thus reports \$60 of consolidated taxable income. At the beginning of Year 2, P sells the S stock for \$460.

Without an adjustment to S's basis to reflect the loss utilized by the P group, P would recognize a \$40 loss on the sale of the S stock, in effect obtaining a double deduction for the same loss.

The problem arises solely because the consolidated return regulations permit P to offset its income by S's losses, which could not occur if P and S filed separate returns. Accordingly, the investment adjustment rules, which require a reduction in S's basis for the loss utilized by the P group,¹¹³ address a problem unique to, and created by, the filing of consolidated returns.

However, query whether a basis reduction for a distribution out of a subsidiary's pre-acquisition earnings and profits violates the Rite Aid standard.¹¹⁴

Similarly, the general intercompany transaction rules of Treas. Reg. § 1.1502-13 modify the Code's rules governing the timing and character of gain and loss recognition.¹¹⁵

However, without these rules, consolidated groups could utilize intercompany transactions to create, accelerate, avoid, or defer consolidated taxable income.¹¹⁶ Accordingly, the

¹¹³ Treas. Reg. § 1.1502-32(b)(2)(i), (b)(3)(i).

¹¹⁴ Treas. Reg. § 1.1502-32(b)(2)(iv) and (b)(3)(5) do not distinguish between distributions out of pre- and post-acquisition earnings and profits.

¹¹⁵ See, e.g., I.R.C. § 1001(c).

¹¹⁶ See Treas. Reg. § 1.1502-13(a)(1).

intercompany transaction rules also address a problem created by the filing of consolidated returns.

In addition, the separate return limitation year (“SRLY”) rules limit the use by a consolidated group of losses of a subsidiary that arose in separate return years.¹¹⁷ The rules prevent consolidated groups from acquiring subsidiaries with built-in losses in order to utilize such losses to offset the group’s built-in gains. This problem arises solely because the consolidated return regulations permit a subsidiary’s losses to offset income of other members of the consolidated group. Accordingly, the SRLY rules also address a problem created by the filing of consolidated returns.

However, certain consolidated return provisions would appear to be at risk under the Rite Aid standard. For example, Treas. Reg. § 1.1502-13(f)(6) permanently disallows a loss recognized by a member with respect to stock of the common parent. If the parent and subsidiary were not members of a consolidated group, such losses would not be disallowed. Thus, the provision does not appear to address a problem created by the filing of consolidated returns. In addition, Treas. Reg. § 1.1502-13(g)(4) turns off section 108(e)(4) and applies the deemed satisfaction and reissuance rules to obligations that become intercompany obligations, even though section 108(e)(4) would reach different results in the context of non-consolidated corporations. Similarly, Treas. Reg. § 1.1502-80 turns off certain Code provisions that do not appear to address problems created by the filing of consolidated returns (e.g., section 304 and 357(c)).

¹¹⁷ See id. §§ 1.1502-15; 1.1502-21(c); 1.1502-22(c).

Although these provisions were not at issue in Rite Aid and thus are not invalidated by that decision, if challenged, other courts could conceivably conclude that such provisions are invalid under the Rite Aid standard. Nonetheless, courts should be reluctant to hold legislative regulations invalid. Before extending the Rite Aid standard to these and other consolidated return regulations, a more careful analysis and a more clear statement of the standard should be made.

3. Effect on Other Taxpayers

What is the effect of the Rite Aid decision on other taxpayers? Because the Federal Circuit is a court of national jurisdiction, is Rite Aid the law of the land? Should taxpayers affected by the loss duplication factor amend their returns? What if a consolidated group elected to reattribute losses¹¹⁸ that would have been disallowed by reason of the loss duplication factor? Since the loss disallowance rule would not apply, such losses could not be reattributed – does that mean that a buyer could now claim that loss?

Given the Service's decision not to file a petition for certiorari and not to continue to litigate the validity of the loss duplication factor,¹¹⁹ taxpayers can likely rely on Rite Aid and file amended returns with respect to transactions for which the statute of limitations remains open. It remains to be seen, however, what the new loss disallowance rules will look like.

¹¹⁸ See id. § 1.1502-20(g).

¹¹⁹ See supra Part III.D.