ALI-ABA
Consolidated Tax Return Regulations

Cosponsored by the ABA Section of Taxation

October 5-6, 2006
Washington, D.C.

Acquisition and Separation Issues in Consolidation: Insolvent Corporations and No Net Value Regulations

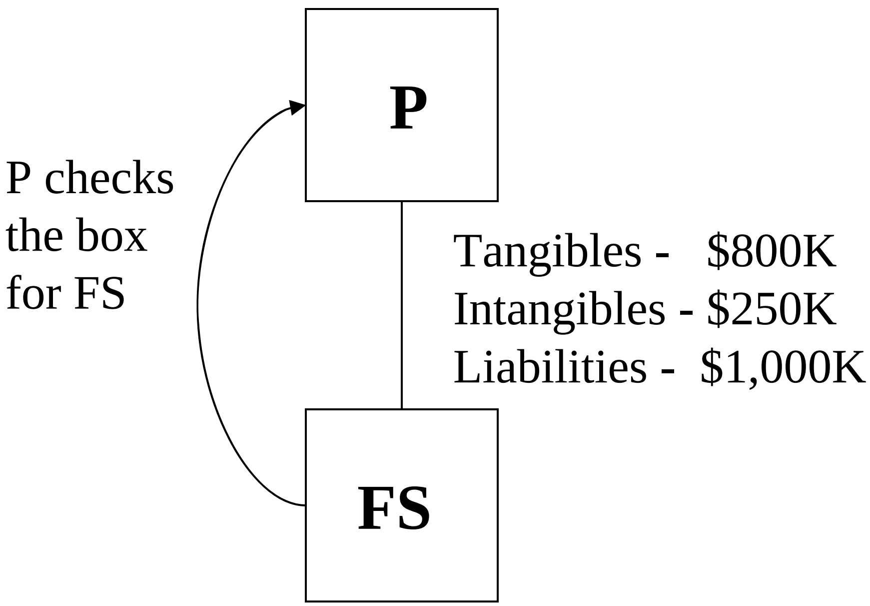
By

William Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service
Jerred Blanchard, Ernst & Young LLP
Joseph M. Pari, Dewey Ballantine LLP
Mark J. Silverman, Steptoe & Johnson LLP
Tom Wessel, KPMG LLP

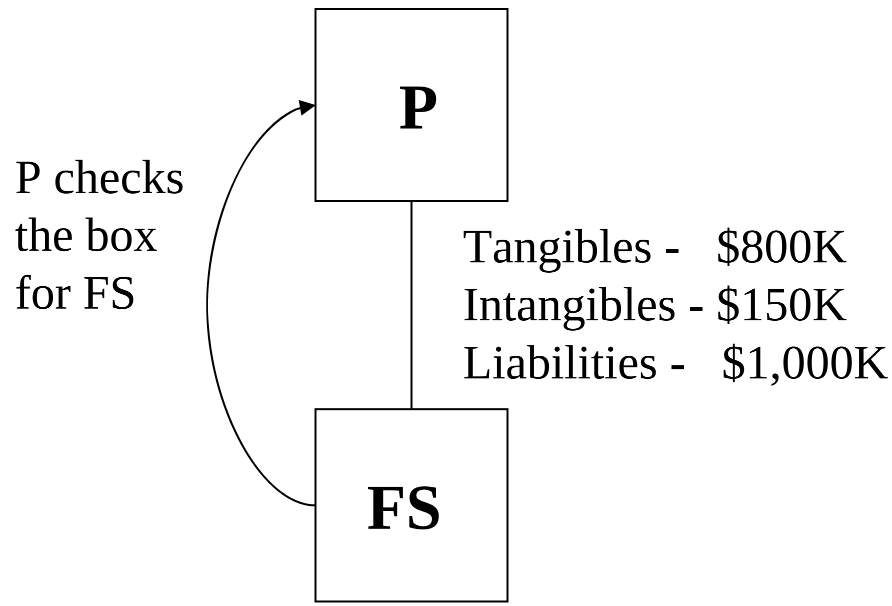
TROUBLED COMPANIES:
INSOLVENCY AND LIABILITY ISSUES

Rev. Rul. 2003-125

Situation 1



Situation 2



Situation 1: Corporation P owns 100 percent of the stock of Subsidiary FS, an entity organized under the laws of Country X that operates a manufacturing business. FS is an "eligible entity" under Treas. Reg. § 301.7701-3(a) and, prior to July 1, 2003, FS is treated as a corporation for federal tax purposes (under section 7701(a)(3)). On December 31, 2002, the stock of FS was not worthless. On July 1, 2003, P files a check-the-box election for FS, changing the classification of FS from a corporation to a disregarded entity for federal tax purposes effective as of that date. At the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, exceeds the sum of its liabilities. However, at that time, the fair market value of FS's assets, excluding intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities. After the change in entity classification election is effective, FS continues its manufacturing operations.

Situation 2: Same facts as in Situation 1, except that at the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities.

Rev. Rul. 2003-125 (Cont.)

Holding: When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under section 165(g) if the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities such that on the deemed liquidation of the entity the shareholder receives no payment on its stock.

Situation 1: Because the aggregate value of FS's tangible and intangible assets ($1,050,000) exceeds FS's liabilities ($1,000,000) immediately before the effective date of the P's check-the-box election for FS, the stock of FS is not worthless on that date. Accordingly, because P receives at least partial payment on its FS stock in the deemed liquidation of FS. As a result, section 332 applies to the deemed liquidation and no loss is allowable to P.

Situation 2: Because the aggregate value of FS's tangible and intangible assets ($950,000) does not exceed FS's liabilities ($1,000,000) immediately before the effective date of the P's check-the-box election for FS, the stock of FS is worthless. Accordingly, section 332 does not apply because P does not receive any payment on its FS stock in the deemed liquidation of FS. The deemed liquidation is an identifiable event that fixes P's loss with respect to the FS stock and, therefore, P is allowed a worthless security deduction under section 165(g) for its 2003 tax year. Also, depending on the facts, FS's creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under sections 165 or 166.

Rev. Rul. 2003-125 (Cont.)

Rev. Rul. 2003-125 clarifies that:

- Where a worthless stock deduction is claimed upon the liquidation of a corporation and the stock did not become worthless in a prior tax year, the standard for determining worthlessness is whether the shareholders receive payment for their stock. See H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).

- A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the fair market value of the corporation's assets is less than the corporation's liabilities.

- The value of intangible assets, including goodwill and going concern, is included in determining the fair market value of the entity's assets immediately before the deemed liquidation.

- Certain facts, such as (i) the continuation of the corporation's business after a liquidation without a substantial infusion of capital, and (ii) the revenues of that business following the liquidation exceed the amount required to service debt that existed immediately prior to the liquidation, may suggest that at the time of liquidation the fair market value of the liquidating entity's assets, including goodwill and going concern value, exceeded the sum of its liabilities.

Rev. Rul. 2003-125 (Cont.)

Rev. Rul. 2003-125 clarifies that (cont.):

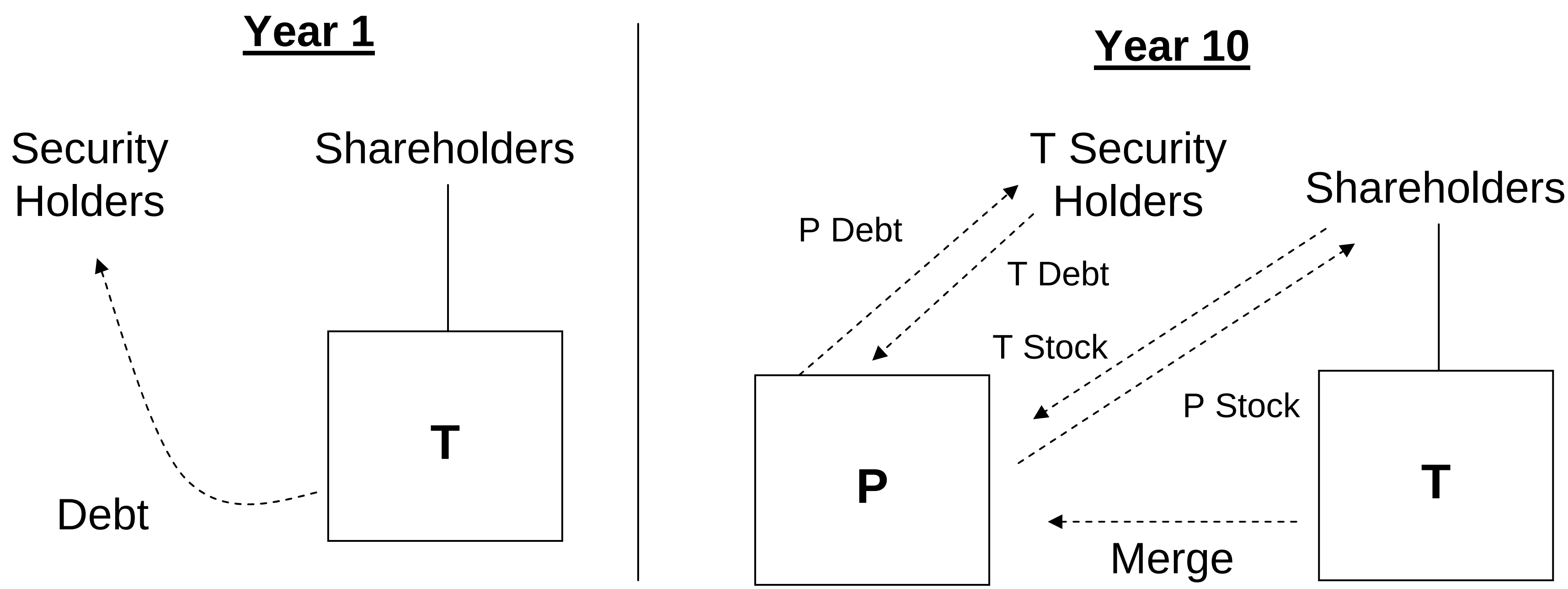
- Nevertheless, depending on the facts, the parent could claim a bad debt deduction and a worthless stock deduction where its wholly owned subsidiary owes a bona fide indebtedness to its parent corporation that exceeds the fair market value of its assets and the subsidiary transfers all of its assets to the parent in partial satisfaction of its indebtedness. This may be true even where the parent continues the business formerly conducted by the subsidiary. See Rev. Rul. 70-489, 1970-2 C.B. 53, *amplifying* Rev. Rul. 59-296, 1959-2 C.B. 87.

- If a shareholder receives no payment for its stock in a liquidation of the corporation, neither section 331 nor section 332 applies to the liquidation.

- The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that such shareholder's stock is worthless.

- The liquidation is an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g).

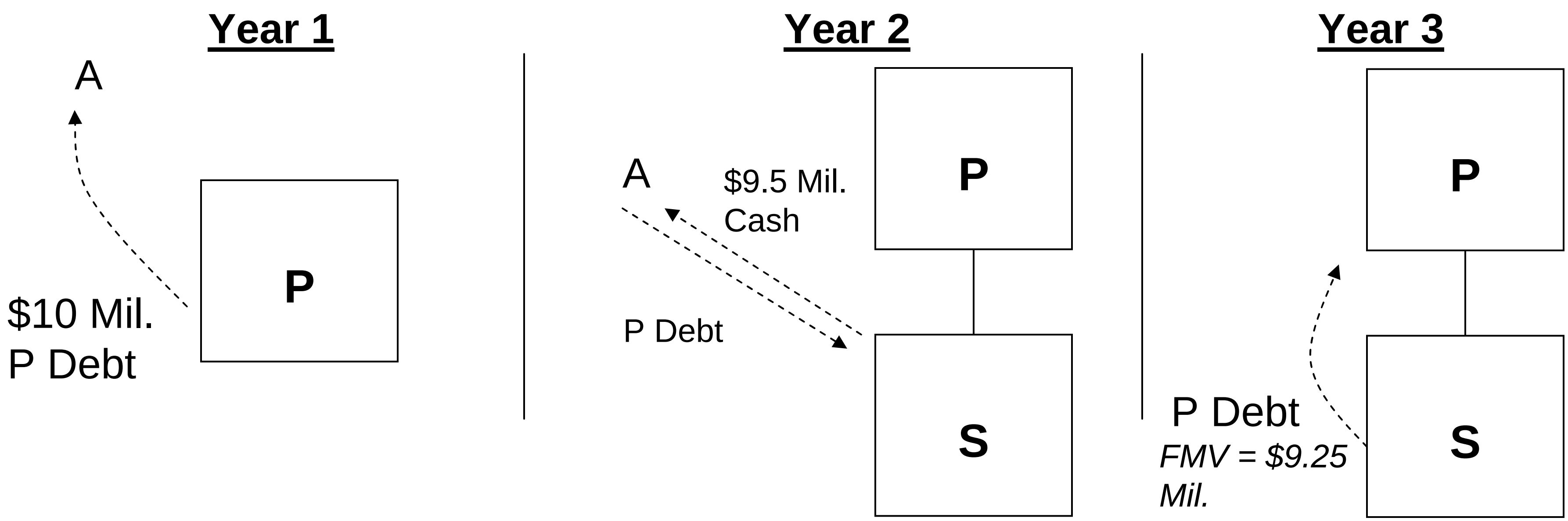
Definition of “Security”—
Rev. Rul. 2004-78



Facts: On January 1, year 1, T issues debt instruments with a stated maturity date of January 1, year 12. On the issue date, the debt instruments provide for a market rate of interest and are securities within the meaning of section 354. T has outstanding one class of common stock. On January 1, year 10, T merges into P in a transaction that qualifies as a reorganization under § 368(a)(1)(A). In the merger, T shareholders exchange their T stock for P stock. Also in the merger, the T security holders exchange their T securities for P debt instruments with terms identical to those of the T securities (including the maturity date), except that the interest rate is changed. The modification of the interest rate is a significant modification under Treas. Reg. § 1.1001-3.

Ruling: In Rev. Rul. 2004-78, the Service ruled that the P debt instruments issued by P in exchange for the T securities were securities under section 354. The Service acknowledged that the P debt with a term of two years generally would not qualify as a security. However, because the P debt instruments were issued in the reorganization in exchange for T securities and bore the same terms (other than interest rate) as the T securities, the P debt instruments represented a continuation of the T security holder’s investment in T in substantially the same form. Therefore, the P debt instruments exchanged for T securities were securities under section 354.

Acquisition of Related Party Indebtedness—Rev. Rul. 2004-79: Situation 1



Facts: On January 1, Year 1, P issued debt that provides for monthly interest payments of $80,000 payable at the end of each month and a principal payment of $10,000,000 on its stated maturity date of December 31, Year 4. The $80,000 monthly interest payments are qualified stated interest payments within the meaning of Treas. Reg. § 1.1273-1(c). S has only one class of stock outstanding, all of which is owned by P. On January 1, Year 2, S purchases all of the P indebtedness from A, an individual not related to S under Treas. Reg. § 1.108-2(d)(2), for cash in the amount of $9,500,000. On that date, the adjusted issue price of the P indebtedness is $10,000,000. On January 1, Year 3, S distributes all of the P indebtedness it holds to P. At the time of this distribution, the fair market value of the P indebtedness is $9,250,000. During Year 3, S makes no other distributions to P. P and S do not join in filing a consolidated return for Years 1 through 3. At all times, the fair market value of P's assets exceeds the amount of its liabilities. At the end of Year 3, S has earnings and profits in the amount of $20,000,000.

Rev. Rul. 2004-79: Situation 1, continued

- Analysis
  - Under section 108(e)(4), S's purchase of the P indebtedness is treated as P's acquisition of that indebtedness because P and S have a relationship specified in section 267(b)(3). Thus, S's acquisition of the P indebtedness results in the realization by P of income from the discharge of indebtedness. P realizes $500,000 of income from the discharge of indebtedness (the adjusted issue price of the indebtedness ($10,000,000) less S's basis in the indebtedness on the acquisition date ($9,500,000)).
  - The P indebtedness is treated as new indebtedness issued by P to S in year 2. The new indebtedness is deemed issued with an issue price equal to S's adjusted basis in the indebtedness ($9,500,000). The $500,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its deemed issue price ($9,500,000) is OID.
  - The P indebtedness is property for purposes of the corporate distribution provisions. Therefore, S's distribution of the P indebtedness to P is a distribution of property described in section 301. The amount of such distribution is the fair market value of the property distributed, $9,250,000. The distribution in its entirety is treated as a dividend to P because as of the end of Year 3 S has earnings and profits in excess of the amount of the distribution.
  - Additionally, because the distribution of the P indebtedness to P extinguishes the indebtedness, it is repurchased within the meaning of Treas. Reg. § 1.61-12(c)(2), and P is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness, $9,250,000. Accordingly, under Treas. Reg. § 1.61-12(c)(2)(ii), P realizes income from the discharge of indebtedness in an amount equal to $397,868, the excess of the adjusted issue price of the P indebtedness ($9,647,868) over the amount of the distribution ($9,250,000).
  - Under section 311(a), S does not recognize the loss inherent in the P indebtedness on the distribution of the P indebtedness. As a result of the distribution, pursuant to section 312(a), S's earnings and profits are reduced by its adjusted basis in the P indebtedness distributed, $9,647,868.

Rev. Rul. 2004-79: Situation 2

Facts: Same facts as situation 1, except that at the time S distributes the P indebtedness to P, the fair market value of the P indebtedness is $10,050,000.

Analysis: In Situation 2, the tax consequences of S's purchase of the P indebtedness are generally the same as in Situation 1.

In Year 3, the amount of the distribution of the P indebtedness determined pursuant to section 301(b) and treated as a dividend under section 301(c) is $10,050,000.

Additionally, P is treated as having repurchased its indebtedness for the same amount.

Under Treas. Reg. § 1.163-7(c), P is generally entitled to an interest deduction in an amount equal to the $402,132 excess of the amount of the distribution ($10,050,000) over the adjusted issue price of the P indebtedness ($9,647,868).

Under section 311(b), S recognizes gain as if it sold the indebtedness to P for an amount equal to its $10,050,000 fair market value. Thus, S recognizes gain in an amount equal to $402,132, the excess of the fair market value of the indebtedness distributed ($10,050,000) over S's adjusted basis in the indebtedness distributed ($9,647,868).

Under sections 312(a) and (b), S's earnings and profits must be increased by $402,132, the excess of the fair market value of the indebtedness distributed ($10,050,000) over S's adjusted basis in the indebtedness distributed ($9,647,868), and reduced by the fair market value of the indebtedness distributed, $10,050,000.

TROUBLED COMPANIES:
LIQUIDATIONS AND UPSTREAM MERGERS

In General

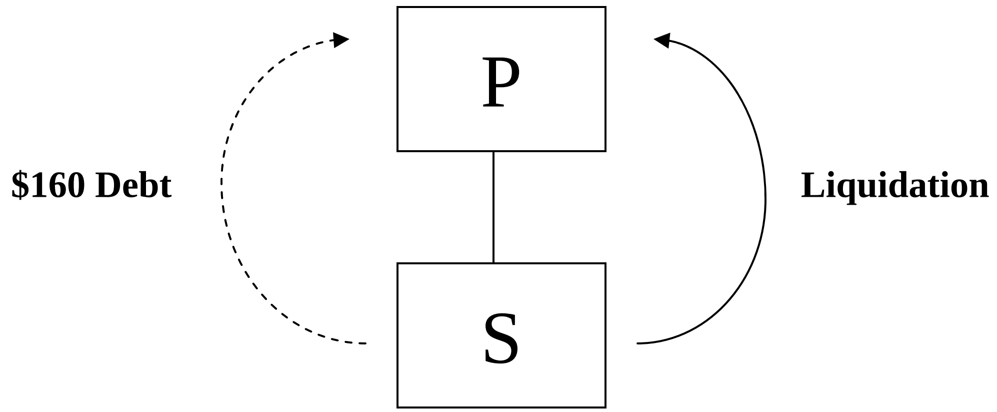
- Section 332 - A liquidation is not taxable to a corporate shareholder if the corporate shareholder owns at least 80 percent (by vote and value) of the stock of the liquidating subsidiary. Section 337 shields the liquidating company from tax.
  – If the requirements of section 332 are not satisfied, a liquidation is taxable to the liquidating corporation and its shareholders under sections 331 and 336.
- Treas. Reg. §1.332-2(b) – Section 332 applies only where the parent receives at least partial payment for its stock.
  – This requirement has been held to apply to section 331 liquidations as well. See Braddock Land Co. v. Commissioner, 75 T.C. 324 (1980); Jordan v. Commissioner, 11 T.C. 914 (1948).
  – Section 332 requires a distribution in cancellation or redemption of *all* of the stock of the liquidating company. Thus, a distribution that is sufficient to redeem only the company's preferred stock is not a liquidation. See Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693 (2d Cir. 1958); H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).
- Therefore, section 332 does not apply when a parent liquidates an insolvent subsidiary, and the parent can recognize loss on its sub stock under section 165(g). Iron Fireman Mfg. Co. v. Commissioner, 5 T.C. 452 (1945); H.G. Hill Stores, Inc. v. Commissioner, 44 B.T.A. 1182 (1941); Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying, Rev. Rul. 59-296, 1959-2 C.B. 87.

In General

- Proposed No Net Value Regulations – The proposed regulations retain the partial payment rule of the current regulations and provide new rules with respect to liquidations involving multiple classes of stock. Prop. Treas. Reg. §1.332-2(b).
  - If partial payment is not received for *every* class of stock but is received for at least one class, the proposed regulations look separately to each class of stock to determine the tax consequences.
  - With respect to those classes of stock for which no payment is received, the proposed regulations refer to section 165(g) worthless stock deductions.
  - With respect to those classes of stock for which payment is received, the proposed regulations refer to section 368(a)(1) regarding a potential reorganization or to section 331 if the distribution does not qualify as a reorganization.

- The Service also takes the position that an upstream merger cannot qualify as a tax-free A reorganization. Rev. Rul. 70-489. But see Norman Scott, Inc., 48 T.C. 598 (noting that unlike the requirement for a liquidation that there be a payment in cancellation or redemption of stock, there is no such requirement for a statutory merger to qualify under section 368(a)(1)(A)).

Liquidations vs. Upstream Merger

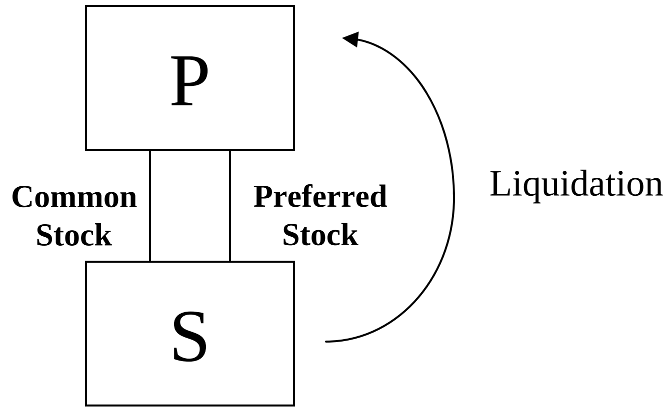


Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. S adopts a plan of liquidation, and distributes all of its assets to P.

Result: The transaction does not qualify as a section 332 liquidation under either current law or the proposed regulations. Instead, S should be treated as transferring its $100 of assets in satisfaction of its $150 debt to P, and P should be entitled to a worthless stock deduction of $100 and a bad debt deduction of $50.

What if S merged upstream into P? See Norman Scott, Inc., 48 T.C. 598. But see Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying, Rev. Rul. 59-296, 1959-2 C.B. 87. Could the liquidation be treated as an upstream C reorganization?

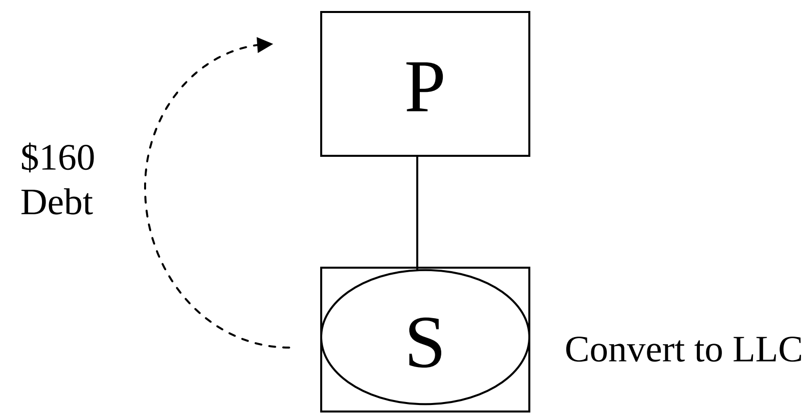
Liquidation with No Payment on Common Stock



Facts: P owns all of the common and preferred stock of S. The preferred stock has a liquidation preference of $200. S has assets worth $100 and no liabilities. S adopts a plan of liquidation, and distributes all of its assets to P.

Result: The transaction does not qualify as a section 332 liquidation under either current law or the proposed regulations, because P did not receive any payment on its common stock. See Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693 (2d Cir. 1958); H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986); Prop. Treas. Reg. §1.332-2(b), (e), Ex. 2. Thus, P is entitled to a worthless stock deduction for its common stock under section 165(g). Under the proposed regulations, the transaction may qualify as a reorganization with respect to P's preferred stock, since it received partial payment on that. If the transaction does not qualify as a reorganization, then P would recognize gain or loss on the preferred stock under section 331.

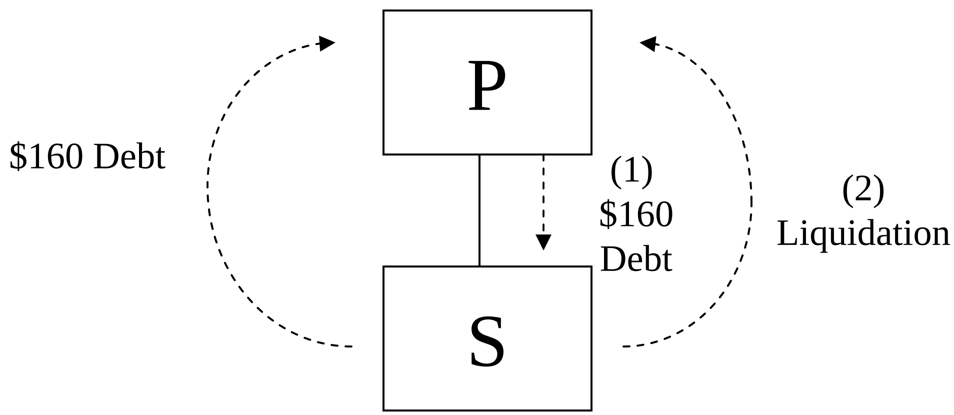
Deemed Liquidation



Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. S converts into a single-member LLC pursuant to state law.

Result: The conversion into a single-member LLC results in a deemed liquidation under Treas. Reg. §301.7701-3(g)(1)(iii). However, because S is insolvent, the deemed liquidation does not qualify as a section 332 liquidation under either current law or the proposed regulations. The deemed liquidation is considered an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g). Rev. Rul. 2003-125, 2003-52 I.R.B. 1 (reversing the result in F.S.A. 200226004 (Mar. 7, 2002)). Thus, P should be entitled to worthless stock and bad debt deductions, even though P continues the business formerly conducted by S. Id.; see also Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying Rev. Rul. 59-296, 1959-2 C.B. 87.

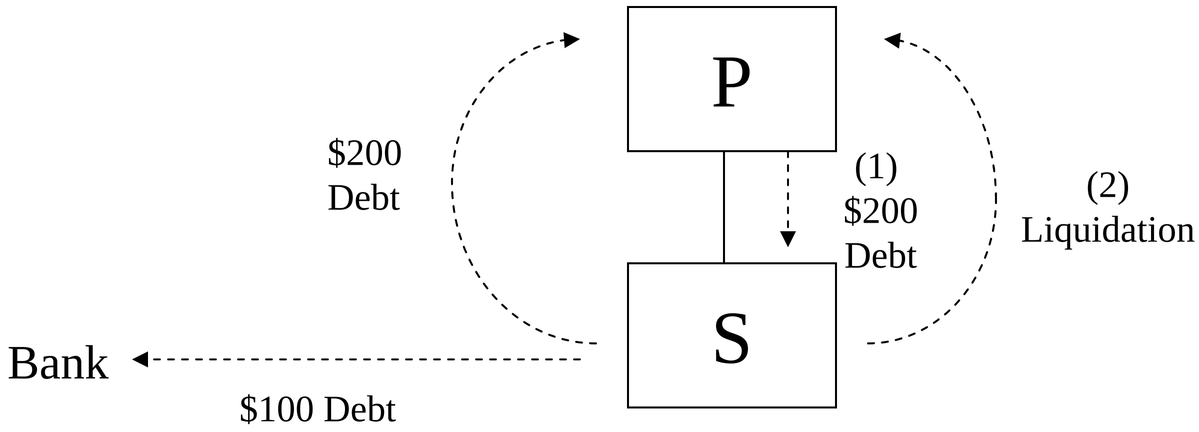
Revenue Ruling 68-602



Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. P cancels the $160 debt by contributing it to S's capital. S then adopts a plan of liquidation, and distributes all of its assets to P.

Result: In Rev. Rul. 68-602, 1968-2 C.B. 135, the Service ruled that the debt cancellation was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of S's net operating loss carryover. Therefore, the Service regarded the cancellation as transitory and disregarded it. Cf. Rev. Rul. 78-330, 1978-2 C.B. 147 (respecting debt cancellation immediately before a sideways merger because such cancellation had independent economic significance). As a result, the liquidation in this example does not qualify as a section 332 liquidation, and the result is the same as in the prior two examples. The proposed regulations do not change this result.

Revenue Ruling 68-602 - Variation



Facts: P owns all of the stock of S. S has assets worth $150 and is indebted to P in the amount of $200 and to the bank in the amount of $100. P cancels the $200 debt by contributing it to S's capital. S then adopts a plan of liquidation, repaying the bank debt in full and distributing the remaining assets (i.e., $50) to P.

Result: Absent the debt cancellation, 1/3 of S's assets (i.e., $50) would have gone to the bank, and 2/3 (i.e., $100) would have gone to P. Arguably, in these circumstances, the debt cancellation has independent economic significance and Rev. Rul. 78-330, not Rev. Rul. 68-602, should apply. Query whether the cancellation has independent economic significance only to the extent of $150, the value of S's assets available to repay its outstanding debt.

TROUBLED COMPANIES:
SECTION 351 INCORPORATIONS

In General

- Section 351 – No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of such corporation.

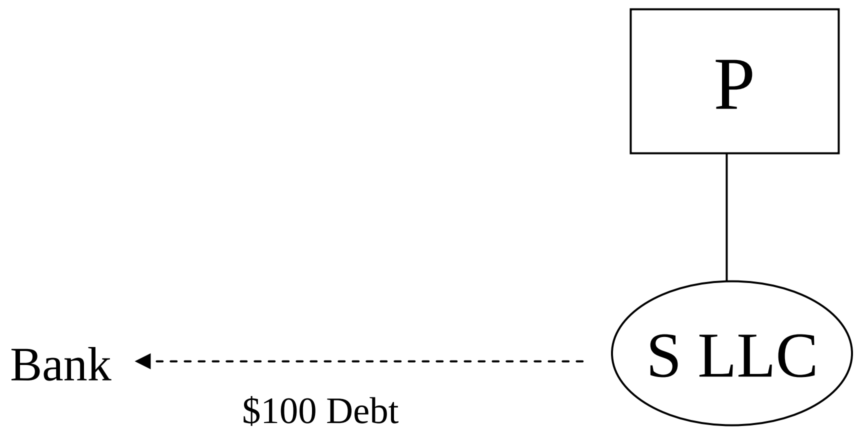
- Where the transferor of property is the sole shareholder of the transferee corporation, issuance of new stock is not necessary, because it would be a meaningless gesture. See Lessinger v. Commissioner, 85 T.C. 824 (1985), aff'd, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 CB 138.

- In Rosen v. Commissioner, 62 T.C. 11 (1974), the taxpayer transferred the assets and liabilities of a sole proprietorship to a newly formed corporation. At the time of the transfer, the liabilities exceeded the value of the assets, and the corporation was insolvent. The court held that the taxpayer realized gain under section 357(c) to the extent the liabilities assumed exceeded the adjusted basis of the assets transferred. See also Focht v. Commissioner, 68 T.C. 223 (1977); G.C.M. 33,915 (Aug. 26, 1968). But see DeFelice v. Commissioner, 386 F.2d 704 (10th Cir. 1967) (rejecting the taxpayer's argument that section 357(c) did not apply, because he was insolvent; the court found that the taxpayer failed to prove he was insolvent).

In General

- Proposed No Net Value Regulations - The proposed regulations provide that stock will not be treated as issued for property if either (i) the fair market value of the transferred property does not <u>exceed</u> the sum of the amount of liabilities of the transferor that are assumed by the transferee in connection with the transfer and the amount of money and fair market value of any other property received by the transferor in connection with the transfer (i.e., the transferor does not transfer net value), or (ii) the fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer (i.e., the transferee is insolvent). Prop. Treas. Reg. §1.351-1(a)(1)(iii).
  - For purposes of (i), any liability of the transferor to the transferee that is extinguished in connection with the transfer is treated as a liability assumed by the transferee.

Insolvent Subsidiary

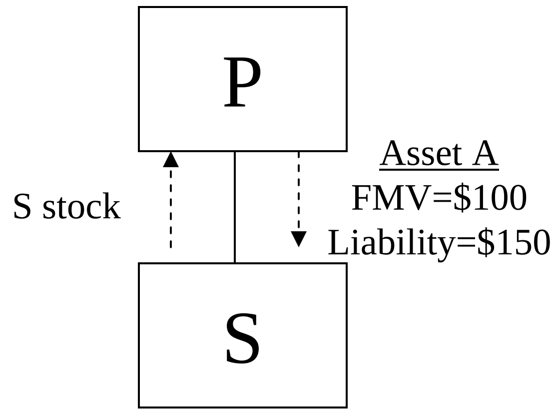


Facts: P owns all of the interests of S LLC, which is disregarded for tax purposes. S has assets worth $50 and is indebted to the bank in the amount of $100. S LLC checks the box and elects to be taxed as a corporation. The bank debt remains outstanding.

Result: Under the check-the-box regulations, P is deemed to contribute all of the assets and liabilities of S LLC to a newly formed corporation in exchange for stock of such corporation. Treas. Reg. §301.7701-3(g)(1)(iv). The transaction arguably qualifies under section 351 under current law. See Rosen, 62 T.C. 11, Focht, 68 T.C. 223; G.C.M. 33,915 (Aug. 26, 1968). But see DeFelice, 386 F.2d 704. However, under the proposed regulations, the transaction would not qualify, because P does not transfer net value and the transferee is insolvent immediately after the transfer. Prop. Treas. Reg. §1.351-1(a)(1)(iii).

What if P agrees to satisfy S LLC's obligation to Bank? See section 357(d).

Underwater Property

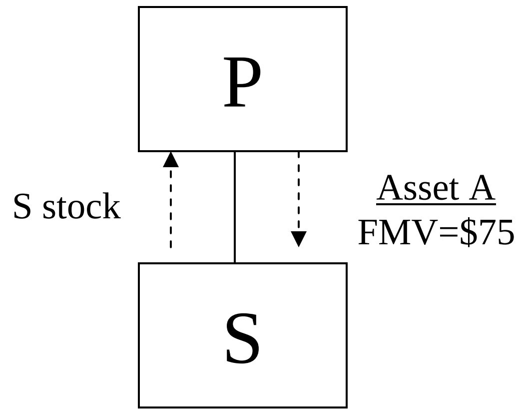


Facts: P owns all of the stock of S. S has assets worth $500 and liabilities of $200. P contributes Asset A to S, which is worth $100, but is subject to a nonrecourse liability of $150.

Result: The transaction arguably qualifies under section 351 under current law. See Rosen, 62 T.C. 11, Focht, 68 T.C. 223; G.C.M. 33,915 (Aug. 26, 1968); *cf*. section 301(b)(2) (amount of distribution reduced, but not below zero, for liabilities assumed or to which property is subject); section 311(b)(2) (fair market value of property received in distribution not less than amount of liability assumed or to which the property is subject); section 336(b) (same). But see DeFelice, 386 F.2d 704. However, under the proposed regulations, the transaction would not qualify, because P does not transfer net value. Prop. Treas. Reg. §1.351-1(a)(1)(iii).

What if, in addition to Asset A, P transfers Asset B, which is unencumbered and has a value of $75?

Transfer to Make S Solvent



Facts: P owns all of the stock of S. S has assets worth $100 and liabilities of $150. P contributes Asset A to S, which is worth $75.

Result: The transaction should qualify under section 351 under either current law or the proposed regulations.

TROUBLED COMPANIES:
TAX-FREE REORGANIZATIONS

Debtor Consequences

- If the debtor issues stock or securities to a creditor, it will not recognize gain or loss. Section 1032(a).

- If a debtor corporation transfers its assets to another corporation in an asset reorganization, including an A, C, D, or G reorganization, solely in exchange for stock or securities of the acquiring corporation, the debtor will not recognize gain or loss. Section 361(a).

- Where property other than stock or securities (i.e., “boot”) is received, gain must be recognized, unless the debtor distributes the boot to its shareholders or creditors. Section 361(b)(1), (3).

Debtor Consequences

- In general, the assumption of a liability of the debtor corporation by the acquiror will not be treated as boot. Section 357(a). However, in the case of a divisive D reorganization or section 351 transaction, the debtor must recognize gain to the extent the liabilities assumed exceed the debtor’s basis in the transferred assets. Section 357(c)(1).

- The acquiror succeeds to the tax attributes enumerated in section 381(c).
  - Section 382 may apply to limit the use of the corporation’s NOLs after the acquisition.

Creditor Consequences

- If the creditor is a security holder, it will not recognize gain or loss when it exchanges its securities for stock or securities of the debtor corporation pursuant to a recapitalization under section 368(a)(1)(E) or for stock or securities of the acquiror pursuant to a reorganization under section 368. Section 354(a)(1).

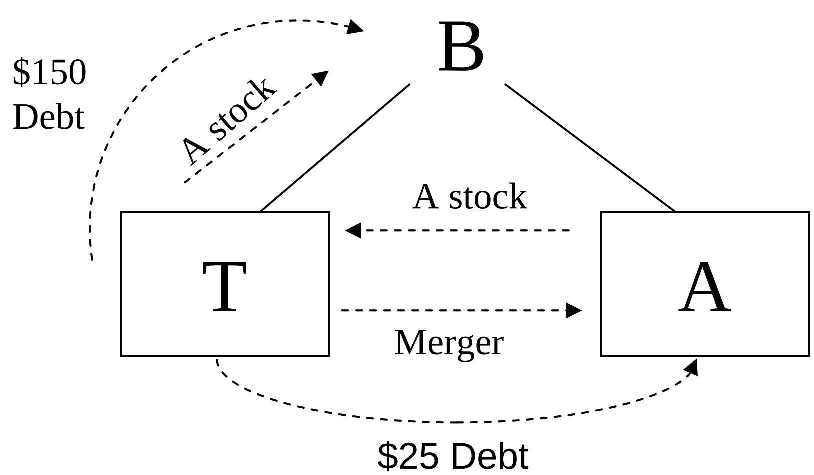
- However, the creditor recognizes gain currently with respect to any property other than stock or securities (i.e., boot) received in the exchange. Section 356(a), (c).
  - In addition, if the principal amount of the security received in the exchange exceeds the principal amount of the security surrendered, then gain will be recognized to the extent of the excess. Sections 354(a)(2)(A); 356(d)(2)(B).

Creditor Consequences

- Basis – The creditor's basis in the new security will equal its basis in the old security, increased by any gain recognized and reduced by the FMV of any boot received. Section 358.

- Holding Period – The creditor's holding period in the new security will include its holding period in the old security. Section 1223(1).

Norman Scott, Inc. Case



Facts: Individual B owns all of the stock of A and T. T has assets worth $100 and is indebted to B in the amount of $150 and to A in the amount of $25. A is solvent. T merges into A, with B receiving additional A stock in the merger.

Result: The transaction should qualify as a tax-free A reorganization under current law. See Norman Scott, Inc. v. Commissioner, 48 T.C. 598 (1967), acq. in result only, AOD 1967-104 (Dec. 7, 1967); Rev. Rul. 54-610, 1954-2 C.B. 152; see also G.C.M. 33,859 (June 25, 1968).

Norman Scott, Inc. Case

- IRS Argument: Because the target was insolvent, any stock that the shareholder exchanged was worthless; therefore, the shareholder could not obtain a proprietary interest in the acquiror.
  - The Tax Court rejected this argument, concluding that the COI requirement was satisfied because the shareholders received a proprietary interest in the acquiror either as a shareholder or as a creditor.
  - In G.C.M. 33,859 (June 25, 1968), the IRS analyzed the Tax Court's decision.
    - The IRS disagreed with the court's broad conclusion, taking the position that unless affirmative steps are taken by the creditors to assert their proprietary interest, the shareholders remain the equity holders of the corporation.
    - Nonetheless, the IRS concluded that because the of the significant overlap between the shareholders and creditors, the shareholders satisfied the COI requirement in their capacity as shareholders, and their status as creditors did not affect that proprietary interest. See Seiberling Rubber Co. v. Commissioner, 189 F.2d 595 (6th Cir. 1948), and Rev. Rul. 54-610.

Norman Scott, Inc. Case

- Alternative IRS Argument: Since the acquiror was also a substantial creditor of the target, the merger was in reality a satisfaction of indebtedness (citing Rev. Rul. 59-296, 1959-2 C.B. 87).
  - The Tax Court disagreed, distinguishing Hill Stores, Inc. v. Commissioner, 44 B.T.A. 1182 (1941), on which Rev. Rul. 59-296 relied. Hill Stores held that section 332 did not apply to the liquidation of an insolvent corporation, because there could be no distribution of assets in cancellation or redemption of the parent's stock. By contrast, there is no specific requirement in section 368(a)(1)(A) that there must be a cancellation or redemption of stock to qualify for a statutory merger.
  - The IRS also disagreed with this holding, arguing that sections 354 and 361, the operative reorganization provisions, require that there be an exchange of property *solely for stock or securities* of the transferee corporation. A discharge of debt is insufficient to satisfy this standard. However, the IRS conceded that the upstream merger involved in Rev. Rul. 59-296 was distinguishable from a brother-sister merger.

Proposed No Net Value Regulations

- On March 10, 2005, Treasury and the IRS issued proposed regulations regarding corporate formations, reorganizations, and liquidations of insolvent corporations. The proposed regulations generally require the exchange (or, in the case of a section 332 liquidation, the distribution) of net value for the nonrecognition rules of sections 332, 351, and 368 to apply. Thus, the proposed regulations would reverse the result in Norman Scott, Inc.

- For tax-free reorganizations under section 368, the proposed regulations require that there be both a surrender and a receipt of net value. Prop. Treas. Reg. §1.368-1(f)(1).
  - Whether net value is surrendered is determined by reference to the assets and liabilities of the target corporation.
  - Whether net value is received is determined by reference to the assets and liabilities of the issuing corporation.

Proposed No Net Value Regulations

- **Asset Reorganizations**
  - There is a surrender of net value if the FMV of the property transferred by the target exceeds the sum of (i) the target liabilities assumed by the acquiror in connection with the exchange and (ii) the amount of money and the FMV of any other property received by the target in connection with the exchange. Prop. Treas. Reg. §1.368-1(f)(2)(i).
    - Any liability that the target owes the acquiror that is extinguished in the exchange is treated as assumed in connection with the exchange.
  - There is a receipt of net value if the FMV of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(2)(ii).

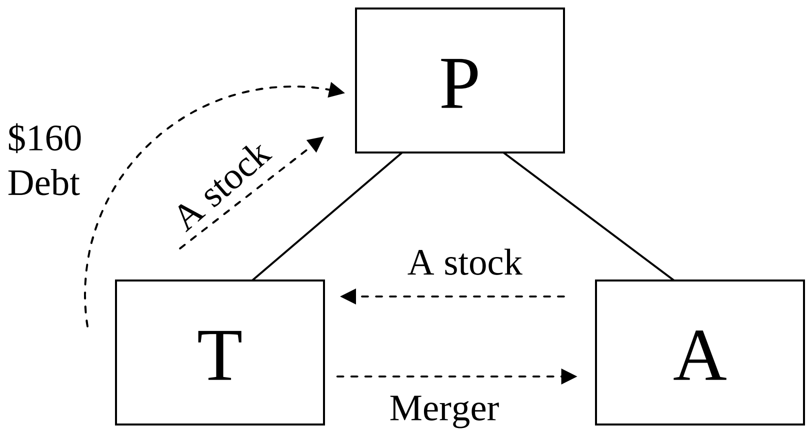
Proposed No Net Value Regulations

- **Stock Reorganizations**
  - There is a surrender of net value if the FMV of the assets of the target *exceeds* the sum of (1) the amount of the target liabilities immediately prior to the exchange and (ii) the amount of money and the FMV of any other property received by the target shareholders in connection with the exchange. Prop. Treas. Reg. §1.368-1(f)(3)(i).
    - Assets of the target that are not held immediately after the exchange and liabilities of the target that are extinguished in the exchange are disregarded.
  - There is a receipt of net value if the FMV of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(3)(ii).

Proposed No Net Value Regulations

- **Exceptions**
  - The net value requirement does not apply to E and F reorganizations. Prop. Treas. Reg. §1.368-1(b)(1).
  - The net value requirement does not apply to acquisitive D reorganizations, provided the FMV of the property transferred to the acquiror by the target exceeds the amount of target liabilities immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the FMV of the assets of the acquiror equals or exceeds the amount of its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(4); see also Rev. Rul. 70-240.

Sideways Asset Reorganization
Parent Debt

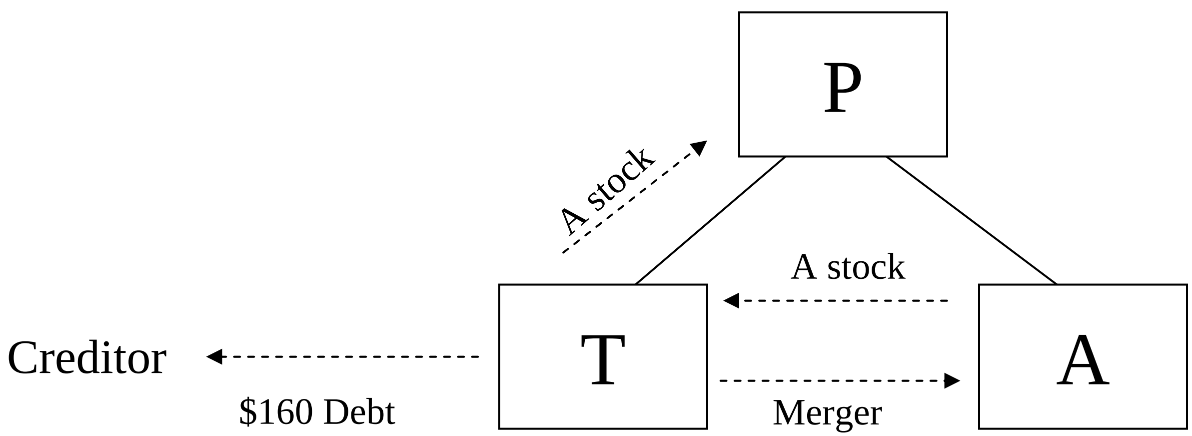


Facts: P owns all of the stock of T and A. T has assets with a fair market value of $100 and liabilities of $160, all of which are owed to P. T merges into A, with P receiving $100 worth of additional A stock in exchange for its T debt. A is solvent both before and after the merger.

Result: The transaction should qualify as a tax-free A reorganization under current law. See Norman Scott, Inc., 48 T.C. 598; Rev. Rul. 54-610, 1954-2 C.B. 152; see also G.C.M. 33,859 (June 25, 1968). The result is the same under the proposed no net value regulations, because (i) T surrendered net value in that the FMV of the property transferred by T ($100) exceeds the sum of the liabilities assumed by A ($0) and the amount of money and fair market value of other property received by T in connection with the exchange ($0), and (ii) T received net value in that the FMV of A's assets exceeds its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(2), (f)(5), Ex. 2.

What if A issues no stock to P in the reorganization? Compare Laure v. Commissioner, 653 F.2d 253 (6th Cir. 1981) and Rev. Rul. 64-155, 1964-1 C.B. 138 with Warsaw Photographic Associates, Inc. v. Commissioner, 84 T.C. 21 (1985); see also Prop. Treas. Reg. §1.368-1(f)(5), Exs. 2 & 3.

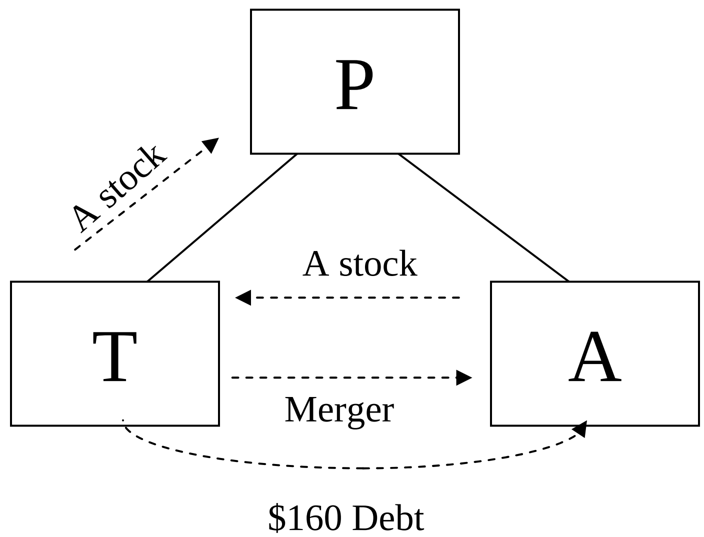
Sideways Asset Reorganization
Third-Party Debt



Facts: P owns all of the stock of T and A. T has assets with a fair market value of $100 and liabilities of $160, all of which are owed to Creditor. T merges into A, with P receiving $100 worth of additional A stock. A is solvent both before and after the merger.

Result: The transaction is distinguishable from Norman Scott, Inc., but it should qualify as a tax-free A reorganization under the IRS's reasoning in G.C.M. 33,859 (June 25, 1968) that because Creditor had not taken affirmative steps to assert its proprietary interest, P remains the holder of the proprietary interest. However, the merger does not satisfy the net value requirement of the proposed regulations, because T does not surrender net value—the FMV of the property transferred by T ($100) does not exceed the sum of the liabilities assumed by A ($160) and the amount of money and fair market value of other property received by T in connection with the exchange ($0). Prop. Treas. Reg. §1.368-1(f)(2)(1).

Sideways Asset Reorganization
Brother-Sister Debt

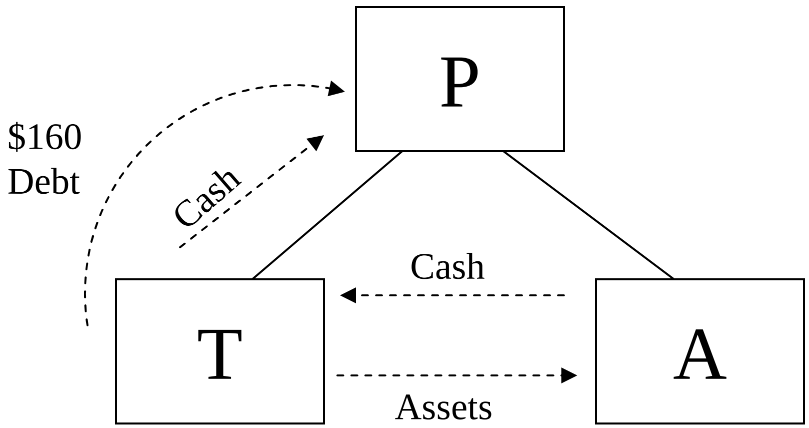


Facts: P owns all of the stock of T and A. T has assets with a fair market value of $100 and liabilities of $160, all of which are owed to A. T merges into A, with P receiving $100 worth of additional A stock. Assume further that the T debt is worth $100, and A has other assets worth $400, so A is solvent both before and after the merger.

Result: The transaction should qualify as a tax-free A reorganization under current law. See Norman Scott, Inc., 48 T.C. 598; G.C.M. 33,859 (June 25, 1968). However, the merger does not satisfy the net value requirement of the proposed regulations, because T does not surrender net value. The proposed regulations treat debt owed by the target to the acquiring corporation that is extinguished in an exchange as if it were assumed by the acquiring corporation. Prop. Treas. Reg. §1.368-1(f)(2)(i). Thus, the FMV of the property transferred by T ($100) does not exceed the sum of the liabilities assumed by A ($160) and the amount of money and fair market value of other property received by T in connection with the exchange ($0). Prop. Treas. Reg. §1.368-1(f)(2)(1).

What if the direction of the merger were reversed, so that A merged into T? See Prop. Treas. Reg. §1.368-1(f)(5), Ex. 6

Sideways Asset Reorganization
D Reorganization



Facts: P owns all of the stock of A and T. T has assets worth $100 and is indebted to P in the amount of $160. A is solvent. T transfers all of its assets and liabilities to A in exchange for $100 cash. T distributes the cash to P in complete liquidation.

Result: The transaction should be a tax-free D reorganization under current law. See Rev. Rul. 70-240, 1970-1 C.B. 81; Rev. Rul. 2004-83, 2004-32 I.R.B. 157. Although the proposed regulations exclude D reorganizations from the net value requirement, they do so only if the target is solvent immediately before the exchange and the acquiror is solvent immediately after. Because T is insolvent before the exchange, the exclusion does not apply. The transaction would not qualify as tax free, because T does not surrender net value – the FMV of the property transferred by T ($100) does not *exceed* the sum of the liabilities assumed by A ($0) and the amount of money and fair market value of other property received by T in connection with the exchange ($100). Prop. Treas. Reg. §1.368-1(f)(2)(1); see Prop. Treas. Reg. §1.368-1(f)(5), Ex. 8.

Creditor Continuity of Interest

- General Rule – In order to have a tax-free reorganization, there must be a continuity of interest ("COI") on the part of those "persons who, directly or indirectly, were the owners of the enterprise prior to" the reorganization. Treas. Reg. §1.368-1(b).
  - For advance ruling purposes, the IRS requires that the former owners receive stock of the acquiring corporation equal to 50 percent of the value of the formerly outstanding stock of the acquired corporation. Rev. Proc. 77-37, 1977-2 C.B. 568.

- In Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), the Supreme Court held that creditors of an insolvent corporation would be treated as equity holders for purposes of the COI requirement.
  - The Court held that the creditors stepped into the shoes of the shareholders at the time they instituted bankruptcy proceedings, because from that time on, they had effective command over the disposition of the property. See also Palm Springs Holding Corp. v. Commissioner, 315 U.S. 185 (1942); G.C.M. 33,859 (June 25, 1968).

- In determining whether the 50% COI threshold is met, begin with the most senior class of creditors that actually receive stock in the reorganization and end with the last group of creditors or shareholders to receive any consideration in the reorganization. H.R. Rep. No. 96-833, at 31-32 (1980); S. Rep. No. 96-1035, at 36 (1980); Atlas Oil & Refining Corp. v. Commissioner, 36 T.C. 675 (1961), acq., 1962-2 C.B. 3.

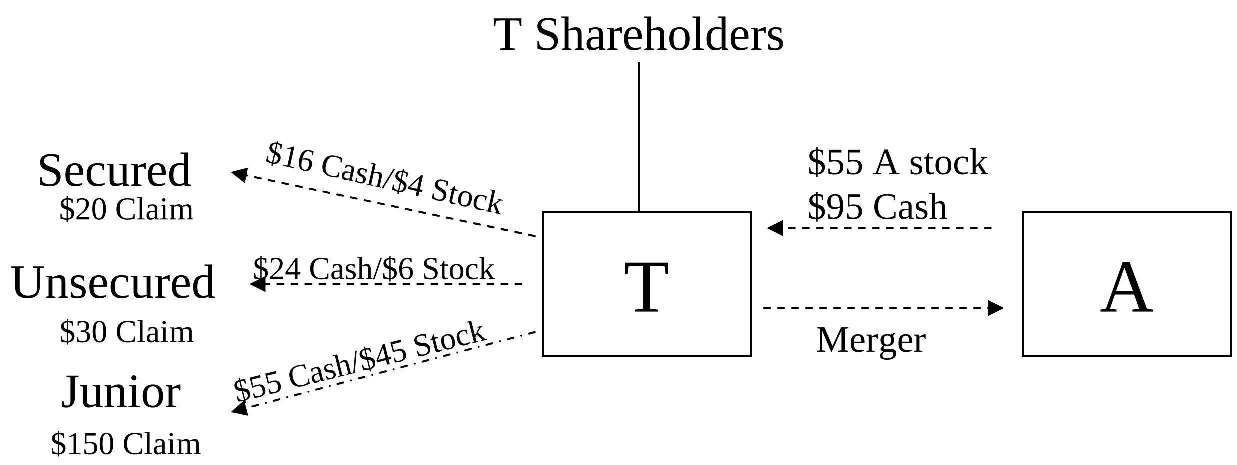
Creditor Continuity of Interest

- Proposed Creditor Continuity Regulations – Along with the no net value regulations proposed on March 10, 2005, Treasury and the IRS proposed rules regarding creditor COI.
  – Treating Creditors' Claims as Proprietary Interest
    - The proposed regulations treat a creditor's claim against a target corporation as a proprietary interest if (i) the target is in a title 11 or similar case, or (ii) the target is insolvent immediately before the reorganization. In such cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, then every claim of that class of creditors and every claim of all equal and junior classes of creditors is a proprietary interest in the target corporation. Prop. Treas. Reg. §1.368-1(e)(6)(i).
    - Shareholders retain their proprietary interest in the target corporation notwithstanding that creditors are treated as having a proprietary interest. Prop. Treas. Reg. §1.368-1(e)(6)(iv).
  – Measuring COI
    - Senior Creditors – The claims of the most senior class of creditors to receive a proprietary interest and all other equal creditors (together the "senior creditors") represent, in part, a creditor claim and, in part, a proprietary interest. The portion of the claim treated as a proprietary interest is equal to (Prop. Treas. Reg. §1.368-1(e)(6)(ii)(B)):

$$\text{FMV of creditor's claim} \times \frac{\text{FMV of proprietary interests issued to senior creditors}}{\text{Total consideration paid to senior creditors}}$$

    - Junior Creditors – The claims of the junior creditors are treated as a proprietary interest in full. Prop. Treas. Reg. §1.368-1(e)(6)(i).

Creditor Continuity of Interest



Facts: T is in bankruptcy and has assets with a fair market value of $150 and liabilities of $200. T has three classes of creditors: senior secured with claims of $20, senior unsecured with claims of $30, and junior unsecured with claims of $150. Pursuant to the plan of reorganization, T transfers its assets to A in exchange for A stock worth $55 and $95 cash. T distributes $16 cash and $4 stock to the senior secured creditors; $24 cash and $6 stock to the senior unsecured creditors; and $55 cash and $45 stock to the junior unsecured creditors. T's shareholders receive nothing.

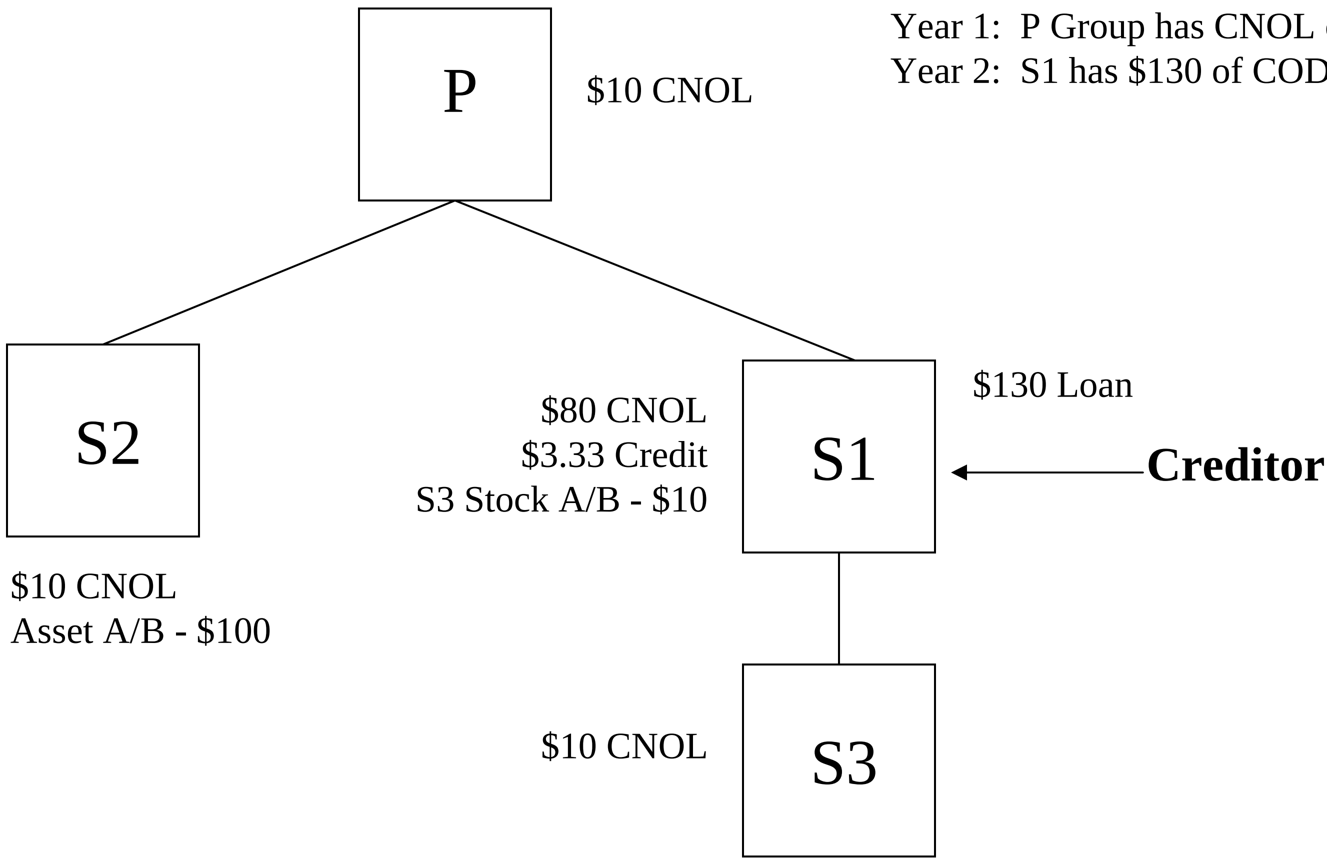
Result: Applying current law, the most senior class of creditors to receive stock is the senior secured and the most junior class to receive any consideration is the junior unsecured creditors, so all classes count toward COI. The COI requirement is likely not satisfied because only $55 out of the total $150 consideration, or 36.6%, consisted of A stock.

Under the proposed regulations, the senior creditors together receive $40 cash and $10 in A stock. The value of their proprietary interest is $10 (i.e., $50 value of claims x ($10 stock received by senior creditors ÷ $50 total consideration). The value of the junior creditors' claims is $100. The COI requirement is satisfied, because A is treated as acquiring $55 of the total $110 claims , or 50%, in exchange for stock. See Prop. Treas. Reg. §1.368-1(e)(7), Ex. 10.

CANCELLATION OF INDEBTEDNESS

Insolvency Example

Year 1: P Group has CNOL of $110.
Year 2: S1 has $130 of COD income.



Facts: In Year 1, Creditor lends $130 to S1, and the P group incurs a $110 consolidated net operating loss (“CNOL”) that is carried over to Year 2 and attributed to each member of the P group as described above under the principles of Treas. Reg. § 1.1502-21. In Year 2, as a result of S1 becoming insolvent, Creditor discharges S1 from its obligation to repay the loan, which causes S1 to realize $130 of COD income. S1 excludes the COD income from its gross income under section 108(a)(1)(B) since S1 remains insolvent after the discharge. At the end of Year 2, in addition to the CNOL, S1 has a $10 basis in the stock of S3 and a $3.33 general business credit carryover. S2 also has a $100 basis in depreciable property. No member makes an election under section 108(b)(5).

Insolvency Example (continued)

Results under the final regulations: Treas. Reg. §§ 1.1502-28, 1.1502-19, 1.1502-21, 1.1502-32.

- **First Step - Separate Entity Determination.** Apply the section 108(a)(1)(B) insolvency exception to the debtor member taking into account only the debtor member's assets and liabilities. This results in the exclusion of all of S1's $130 COD income from gross income. See Treas. Reg. § 1.1502-28(a)(1).
- **Second Step – Reduce Attributes of Debtor Member.** Reduce the tax attributes of the debtor member, including consolidated tax attributes attributable to the debtor member, by the amount of the debtor member's excluded COD income. With respect to S1, this reduces the following attributes in the following order: (i) $80 CNOL, (ii) $3.33 general business credit carryover, and (iii) $10 adjusted basis in S3 stock. Note that an ELA attributable to S3 stock cannot be created under these rules. Overall in this step, $100 of the $130 excluded COD income is applied to reduce tax attributes and, therefore, is taken into account for purposes of adjusting P's basis in S1 stock. However, note that the reduction in the $3.33 general business credit carryover causes $10 of the excluded COD income to be treated as tax-exempt income, but the reduction of the credit carryover itself does not constitute a noncapital, nondeductible expense. See Treas. Reg. § 1.1502-28(a)(2), Treas. Reg. §§ 1.1502-32(b)(3)(ii)(C)(1), (3)(iii)(A).
- **Third Step – Reduce Attributes of Debtor Member Subsidiaries.** To the extent the debtor member reduced its basis in the stock of a subsidiary in the second step, such subsidiary is treated as realizing excluded COD income but only for purposes of the tax attribute reduction rules. Since S1's basis in S3 stock was reduced by $10, S3 is treated as realizing excluded COD income of $10 but only for purposes of the tax attribute reduction rules. The deemed excluded COD income of $10 reduces the $10 CNOL attributable to S3. The realization of the deemed excluded COD income and the absorption of the $10 CNOL are not taken into account for purposes of adjusting S1's basis in S3 stock or P's basis in S1 stock. Overall in this step, $0 of the actual $130 excluded COD income is applied to reduce tax attributes. See Treas. Reg. § 1.1502-28(a)(3), Treas. Reg. §§ 1.1502-32(b)(3)(ii)(C)(1), (3)(iii)(A).

Insolvency Example (continued)

- **Fourth Step – Reduce Attributes of Members Other Than Debtor Member.** To the extent of any remaining excluded COD income, apply such remaining amount to reduce the consolidated tax attributes attributable to members other than the debtor member. The remaining $30 of excluded COD income is applied to reduce the consolidated tax attributes (to the extent they remain) attributable to P, S2, or S3. The $10 CNOL attributable to P and the $10 CNOL attributable to S2 are reduced to $0. Although $10 of excluded COD income remains, it does not reduce S2's basis in its depreciable property, since Treas. Reg. § 1.1502-28 does not permit the reduction of asset basis of members other than the debtor member (and subsidiary members of the debtor member under the third step). Thus, the remaining $10 of excluded COD income does not reduce tax attributes of any member of the group. Overall in this step, $20 of the $130 excluded COD income is applied to reduce tax attributes and, therefore, is treated as tax-exempt income of S1 for purposes of adjusting P's adjusted basis in S1 stock. The reduction of the $10 CNOL attributable to S2 is treated as a noncapital, nondeductible expense of S2 for purposes of determining P's basis in S2 stock. <u>See</u> Treas. Reg. § 1.1502-28(a)(4), Treas. Reg. §§ 1.1502-32(b)(3)(ii)(C)(1), (3)(iii)(A).

History of Consolidated Section 108

- Prior to the issuance of regulations, it was unclear how section 108 applied to members of a consolidated group. The primary question was whether excludable COD income could reduce the CNOLs attributable to other members of the consolidated group – that is, whether a separate entity approach or a consolidated approach was appropriate.
  - Arguments for a separate entity approach
    - Section 108(b), on its terms, refers to the "tax attributes of the taxpayer."
    - ELA rules provide an appropriate backstop to consolidated attribute reduction.
    - Consolidated attribute reduction appears inconsistent with section 1017(b)(3)(D).
    - Existence of only a single CNOL does not resolve determination of "tax attributes of taxpayer."
    - If there were consolidated attribute reduction, it would still be necessary to know to whom the reduced CNOL is attributable. Thus, although the single CNOL is indivisible until an apportionment event, absorption or reduction determined on a member-by-member basis is required to ensure correct amount available for apportionment
    - PLR 9121017, FSA 199912007 and ILM 200149008.
  - Arguments for a consolidated approach
    - Treas. Reg. § 1.1502-6 holds the debtor member liable for the consolidated tax of the group.
    - The Supreme Court confirmed in *United Dominion* that there is no such thing as a "separate NOL"; thus, the CNOL is the only identifiable "tax attribute of the taxpayer."
    - The separate entity approach would have been "inconsistent with Congressional intent that income realized from a debt discharge generally be deferred and not permanently eliminated."

History of Consolidated Section 108 (continued)

- On August 29, 2003, the IRS and Treasury issued temporary regulations (TD 9089) (the “first temporary regulations”) addressing the application of section 108 to members of a consolidated group. Proposed regulations (68 FR 52542) accompanied the first temporary regulations.
  - Temp. Reg. § 1.1502-28T was added which provided guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes COD income that is excluded from gross income and the method for reducing those attributes.
    - The four-step approach outlined in Temp. Reg. § 1.1502-28T is the identical approach adopted in the final regulations.
  - The first temporary regulations added temporary guidance under Treas. Reg. § 1.1502-19 (regarding ELAs), Treas. Reg. § 1.1502-21 (regarding NOLs), and Treas. Reg. § 1.1502-32 (regarding investment basis adjustments).
  - The first temporary regulations were effective for discharges of indebtedness arising after August 29, 2003.

History of Consolidated Section 108 (continued)

- On December 11, 2003, the IRS and Treasury issued temporary regulations (TD 9098) (the "second temporary regulations") amending the first temporary regulations. Proposed regulations (68 FR 69062) accompanied the second temporary regulations.
  - The IRS and Treasury were concerned that the first temporary regulations did not provide for the reduction of all of the attributes that are in fact available to the debtor member.
  - Therefore, the second temporary regulations included among the tax attributes that are subject to reduction tax attributes attributable to members other than the debtor member that arose in a separate return year (or are treated as arising) to the extent that no SRLY limitation applies to the use of such attributes.
    - The amended attribute reduction rule does not permit a reduction in the basis of non-debtor assets
    - The amended attribute reduction rule applies after the application of Temp. Reg. §1.1502-28T(a)(2) (reduction in the attributes of the debtor-member) and Temp. Reg. §1.1502-28T(a)(3) (reduction in the attributes of subsidiaries of the debtor-member).
  - The amended attribute reduction rule in the second temporary regulations is effective for discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the return of which is due (without regard to extensions) after December 10, 2003.

History of the Consolidated Section 108 (continued)

- On March 12, 2004, the IRS and Treasury issued temporary regulations (TD 9117) (the "third temporary regulations") that amended Temp. Reg. § 1.1502-28T and Treas. Reg. § 1.1502-13. Proposed regulations (69 FR 12091) accompanied the third temporary regulations.
  - The IRS and Treasury became aware of several technical issues arising under the first and second temporary regulations.
  - In particular, the third temporary regulations sought to correct the following three technical issues:
    - When the look-through rule applied to reduce the basis in a subsidiary member's assets, the stock of the subsidiary and the assets would be treated as section 1245 property and, thus, an inappropriate amount of ordinary income could result.
    - If the debtor-member is also a creditor to an intercompany obligation then the intercompany transaction rules of Treas. Reg. § 1.1502-13 can be interpreted to exclude from gross income any income attributable to the application of excluded COD income to reduce the basis of the intercompany obligation.
    - Because the ELA income triggered by excludable COD income is included in the taxable year that includes the date on which the excluded COD income was realized, there is a potential for circular calculations.
- On March 21, 2005, the IRS and Treasury issued the final regulations which adopt the substance of the prior temporary and proposed regulations but include several modifications intended to address certain issues arising under the prior temporary and proposed regulations.

Changes in the Final Regulations

- **Apportionment of NOLs** – The final regulations clarify the timing of the recomputation of the percentage of a CNOL attributable to a member when a portion of the loss is carried back to a separate return year or is reduced in respect of excluded COD income, or when a member departs. See Treas. Reg. § 1.1502-21(b)(2)(iv)(B).
  - Under the final regulations, the recomputed percentage of the CNOL attributable to each member shall equal the "unabsorbed CNOL" attributable to the member at the time of the recomputation divided by the sum of the "unabsorbed CNOL" attributable to all of the members at the time of recomputation.
- **Timing of Asset Basis Reduction –** The final regulations clarify that basis of property is subject to reduction pursuant to the rules of sections 108 and 1017 and Treas. Reg. § 1.1502-28 after the determination of tax for the year during which the member realized excluded COD income (and any prior years) and coincident with the reduction of other attributes pursuant to section 108 and Treas. Reg. § 1.1502-28. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is available for reduction. See Treas. Reg. § 1.1502-28(b)(3).
- **Elimination of Circular Stock Basis on Disposition of Member Stock –** The final regulations modify the method under Treas. Reg. § 1.1502-11 for limiting the actual reduction of attributes in connection with a disposition of member stock during the same taxable year in which a member realizes excluded COD income. See Treas. Reg. § 1.1502-28(b)(7) and Treas. Reg. § 1.1502-11(c).
  - Specifically, the final regulations change the limitation to the amount of attributes available for reduction after the computation of tax rather than after the computation of taxable income.

Changes in the Final Regulations (continued)

- **Application of Look-Through Rule** – The final regulations clarify when the "look-through" rule applies. In general the look-through rule requires that if a debtor member reduces the basis in stock of a lower-tier member, then the lower-tier member must reduce its attributes in a corresponding amount. Under the final regulations, the look-through rule applies if the basis of stock of a corporation (the lower-tier member) that is owned by another corporation (the higher-tier member) is reduced, and both corporations are members of the same consolidated group on the last day of the higher-tier member's taxable year that includes the date on which the excluded COD income is realized or the first day of the higher-tier member's taxable year that follows the taxable year that includes the date on which the excluded COD income is realized. See Treas. Reg. § 1.1502-28(a)(3).
- **Intragroup Reorganizations and Group Structure Changes –** The final regulations provide that, if the taxable year of a member during which such member realizes excluded COD income ends prior to the last day of the consolidated return year and, on the first day of that member's next taxable year such member has a successor member (determined by reference to section 381), the successor member is treated as if had realized the excluded COD income. Thus, all attributes of the successor member listed in section 108(b)(2) are subject to reduction prior to the attributes of other members of the group. See Treas. Reg. §§ 1.1502-28(b)(9)(i),(ii), 1.1502-28(b)(10).
- **Application of the Next Day Rule –** The final regulations clarify that the next day rule cannot be applied to treat excluded COD income as realized in the beginning of the day following the day on which it was realized. See Treas. Reg. § 1.1502-28(b)(11).

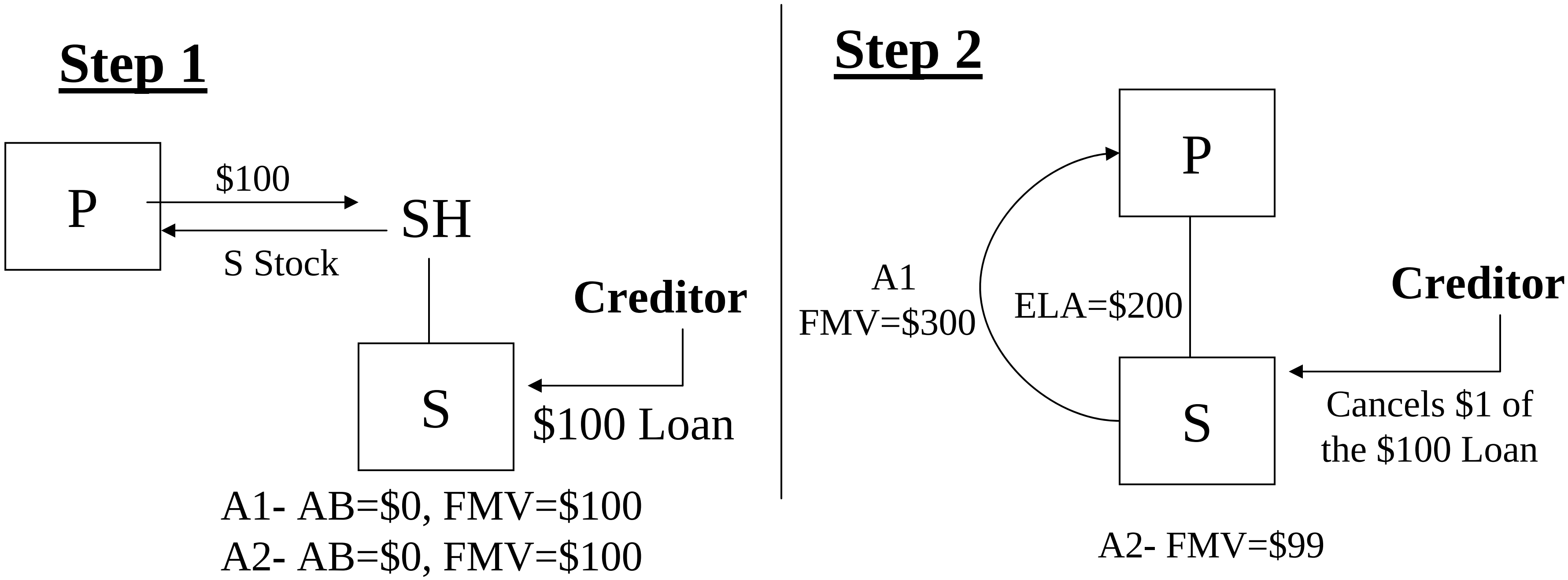
Changes in the Final Regulations (continued)

- **Timing of Investment Adjustments –** The final regulations clarify that basis adjustments under Treas. Reg. § 1.1502-32 resulting from the realization of excluded COD income and from the reduction of attributes in respect thereof are made immediately after the determination of tax for the group for the consolidated return year during which the excluded COD income is realized (and any prior years) and are effective immediately before beginning of the day following the day a member departs from the group. See Treas. Reg. § 1.1502-32(b)(1)(ii).
  - As a result, if the departing member becomes a member of another group, the adjustments to the basis of the departing member's stock in respect of the excluded COD income should not cause basis adjustments in the new group.
- **Attributes Available for Reduction on Departure of Debtor Member –** The final regulations confirm that the tax attributes that remain after the determination of the tax imposed on the group that belong to members of the group are available for reduction when the member that realizes the excluded COD income leaves the group or the assets of that member are acquired by a corporation that is not a member of the group in a section 381(a) transaction occurring prior to the last day of the consolidated return year during which the excluded COD income is realized. See Treas. Reg. §1.1502-28(b)(8)

New Final Regulations

- No Anti-abuse rule
  - The preamble to the final regulations stated that the IRS and Treasury did not deem it necessary to provide for an anti-abuse rule because both the IRS and Treasury continue believe that general principles (including the step transaction doctrine) could be applied to disregard certain transactions that have the effect of changing the result of the application of the attribute reduction rules.
- Retroactive Application
  - Generally, the portion of regulations finalizing the rules contained in Treas. Reg. § 1.1502-28T apply to discharges of indebtedness arising after March 21, 2005. However, a consolidated group may apply those rules in whole, but not in part, to discharges of indebtedness that occur on or before March 21, 2005 and after August 29, 2003. See Treas. Reg. § 1.1502-28(d).
  - Furthermore, these regulations also permit groups to retroactively apply a special rule added in the March 15, 2004 temporary and proposed regulations that prevented the potential duplication of ordinary income recapture under section 1245. Under the final regulations, a group can apply this rule retroactively to discharges of indebtedness that occur on or before August 29, 2003, in cases in which section 1017(b)(3)(D) was applied. See Treas. Reg. § 1.1502-28(d).

The Effect of COD on ELAs



Facts: P purchases 100 percent of the stock of S for $100, and S becomes part of P's consolidated group. At the time S is acquired, S has two assets: (i) asset A1, which has an adjusted basis of zero and a FMV of $100, and (ii) asset A2, which has an adjusted basis of zero and a FMV of $100. S has no tax attributes, and $100 debt (owed to Creditor), for which A2 has been pledged as security. Subsequent to P's acquisition of S, S distributes A1 to P, at a time when the value of A1 has increased to $300. This results in an ELA of $200. At the same time, the value of A2 has decreased to $99, and creditor agrees to cancel $1 of the $100 debt owed by S.

Result: The $1 of COD would be excluded under the insolvency exception, and $1 of the $200 ELA would be triggered since the excluded COD does not reduce attributes (Treas. Reg. § 1.1502-19(c)(1)(iii)(B); Treas. Reg. § 1.1502-19(b)(1)(ii)). Prior to Treas. Reg. § 1.1502-19(b)(1)(ii) (and the prior temporary regulations), the entire $200 ELA was triggered under these circumstances.

The Effect of COD on ELAs (continued); Income Issue

- The final regulations adopt the approach of the second temporary regulations with respect to the timing of the inclusion of an ELA required to be taken into account and adopt the approach of the proposed regulations accompanying the second temporary regulations with respect to determining whether an ELA account is to be taken into account is made.
  - **Timing of ELA inclusion:** The amount of ELA triggered is included in the group's tax return for the taxable year that includes the date on which the subsidiary realizes excluded COD income. Treas. Reg. § 1.1502-28(b)(6)(ii).
  - **Determination of ELA inclusion:** The determination of whether any portion of the ELA must be included in income is made (i) after the determination of taxable income (or loss) for the year during which the member realizes excluded COD income (without regard to whether any portion of an ELA in a share of the subsidiary is required to be taken into account) and any prior years to which the deductions or losses of the subsidiary may be carried, (ii) after the reduction of tax attributes (under sections 108, 1017, and Treas. Reg. § 1.1502-28), and (iii) after the adjustment of the basis of the share of subsidiary stock pursuant to Treas. Reg. § 1.1502-32. Treas. Reg. § 1.1502-28(b)(6)(i).

The Effect of COD on ELAs (continued); Income Issue

• May assets be contributed to an insolvent member of a consolidated group to provide basis reduction and avoid triggering an ELA? See FSA 200135002; PLR 9650019.

• Does reduction of credit under section 108(b) trigger ELA?

⇒ ELA is triggered to extent COD is excluded from gross income and is not tax-exempt income.

⇒ Pursuant to Treas. Reg. § 1.1502-32(b)(3)(ii)(C)*(1)* , excluded COD that reduces credits is tax-exempt income despite the fact that it does not result in a negative basis adjustment. Prior rules did not treat excluded COD that reduces credits as tax-exempt income.

• Basis Reduction Rule:

Under Temp. Treas. Reg. § 1.1502-35T(f), if a subsidiary (i) leaves the group and does not exist after leaving the group, or (ii) becomes worthless (Treas. Reg. section 1.1502-80(c)), then any consolidated NOL or capital loss attributable to such subsidiary is treated as absorbed immediately prior to such event, and any deemed absorption under Temp. Treas. Reg. § 1.1502-35T(f) causes a downward basis adjustment with respect to subsidiary stock (and stock of higher-tier members).

Which Comes First: NOL Carryback or Attribute Reduction?

Restructuring Facts:

- $50 of COD income, of which
  - $40 is excludable due to insolvency,
  - $10 is includible
- Remaining liabilities: $60
- Tax attributes: $25 of current year NOLs
  $70 of basis (non-depreciable)
- Issue: Assume that the debtor had in its prior taxable year reported $11 of taxable income upon which it paid tax. Can it carry back the $15 remaining NOL before applying the attribute reduction?

	Carryback First	Reduce Attributes First
Refund:	**All**	**None**
Attributes Reduced Due to COD:	**$4 NOLs** **$10 Basis**	**$15 NOLs** **$10 Basis**

Which Comes First: NOL Carryback or Attribute Reduction? (continued)

- § 108(b)(1) provides for the reduction of any NOL "for the taxable year of the discharge," as well as NOL carryovers. Same rule applies for capital losses.
- § 108(b)(4)(A) provides that the reduction of attributes (other than basis) "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge."
- Legislative history does not directly address this question, but basic policy of the exclusion of COD income is that the COD should only affect a debtor's cash position on a going-forward basis.

Which Comes First: NOL Carryback or Attribute Reduction?

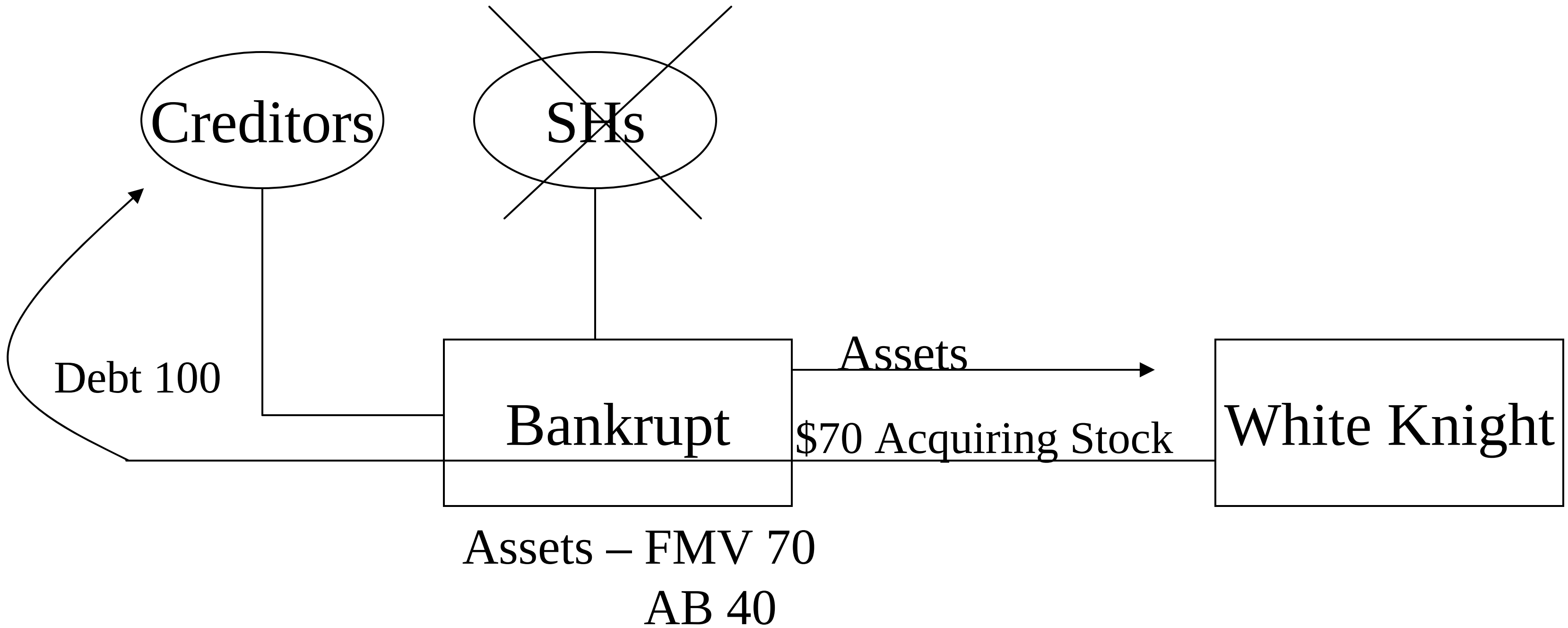
- Examples of where current year taxes are *actually* affected by carrybacks include the carry back of a capital loss that frees up a prior NOL carryforward. *See* Reg. § 1.1212-1(a)(3) and -1(a)(3)(iv), Example 5.

	Year 1	Year 2	Year 3
Operating income/(loss)	($100)	--	$100
Capital gain/(loss)	--	$120	($120)
Excluded COD			$100

Which Comes First:
NOL Carryback or Attribute Reduction?

- Effective for debt discharges occurring after July 17, 2003, Temp. Treas. Reg. § 1.108-7T(b) provides that a taxpayer is required to reduce the tax attributes listed in Section 108(b)(2) only after the taxpayer has determined its federal income tax liability for the year of discharge and any preceding year. These temporary regulations were finalized on May 10, 2004 without substantial modification.
- Thus, a taxpayer is permitted to carry back any loss or credit from the year of discharge without first reducing such loss or credit under Section 108(b) and Temp. Treas. Reg. § 1.1502-28.

Basis Reduction – "G" Reorganizations



- Bankrupt's only tax attribute is its adjusted basis in its assets
- Is the basis in assets subject to attribute reduction?
  - Section 108(b)(5)(E) and 1017 – reduce basis at beginning of year following year of discharge
  - FSA 200145009 – Basis in assets not subject to attribute reduction because not held by Bankrupt at the time of transfer
  - Legislative history to Bankruptcy Tax Act of 1980 suggests the opposite
  - PLR 9409037 (basis reduced)/PLR 9629016 (less clear)/ PLR 8503064 (no opinion)

Basis Reduction – “G” Reorganizations

- On July 17, 2003, the IRS issued Treas. Reg. § 1.108-7T(c) providing that, in the case of a Section 381(a) transaction that ends a taxable year in which the distributor or transferor corporation excludes COD income under Section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by Section 108(b). For this purpose, all attributes listed in Section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in Section 381(a), but after the determination of tax for the year of discharge, including basis of property, shall be available for reduction under Section 108(b)(2). See also Temp. Treas. Reg. § 1.1017-1T(b)(4).
- On May 10, 2004, the IRS issued final regulations clarifying that attribute reduction applies when COD income is realized either during or after the taxable year in which the taxpayer distributor or transferor of assets in a section 381(a) transaction. The final regulations are effective for COD income realized on or after May 10, 2004.
- Thus, Bankrupt’s basis in its assets is subject to attribute reduction.