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THE REGULATIONS GOVERNING INTERCOMPANY TRANSACTIONS WITHIN CONSOLIDATED GROUPS

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I. INTRODUCTION

A. In General

1. On July 18, 1995, the Internal Revenue Service (the "Service") published final regulations that revise the manner in which consolidated groups account for transactions occurring between members of the group (the "current rules"). T.D. 8597, 60 Fed. Reg. 36,671 (Jul. 18, 1995). The current rules contain various changes from the proposed regulations published in 1994 (the "proposed rules"). Notice of Proposed Rulemaking, CO-11-91, 59 Fed. Reg. 18,011 (Apr. 15, 1994).

2. In addition to revising the rules for intercompany transactions, the current rules make minor conforming revisions to the regulations under § 108(b) (attribute reduction for debt discharge of an insolvent corporation), § 460 (accounting for long-term contracts) and § 469 (applying passive loss rules to consolidated groups). The current rules also include extensively revised regulations under § 267(f) (loss deferral on property sales between members). In addition, the Service simultaneously published temporary and proposed regulations governing the treatment of sales of stock of the common parent by consolidated group members. Temp. Treas. Reg. § 1.1502-13T, 60 Fed. Reg. 36,669 (Jul. 18, 1995); Prop. Treas. Reg. § 1.1502-13(f)(6), 60 Fed. Reg. 36,755 (Jul. 18, 1995). These regulations were finalized on March 14, 1996. T.D. 8660, 61 Fed. Reg. 10,447 (March 14, 1996).

3. The purpose of this outline is to describe the current rules, including any changes made to the proposed rules, and to contrast them to the old rules addressing the treatment of intercompany transactions.[1] The outline is intended to be an overview of the current rules and is not an exhaustive discussion of every aspect of the current rules.

B. Summary of the Current Intercompany Transaction Rules

1. **In general**. The current rules extend the application of the single-entity theory to intercompany transactions, including intercompany transactions

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[1]The following secondary sources were consulted in the preparation of this outline: Jerred G. Blanchard, Intercompany Transactions During Consolidated Return Years: A Big Step For Neutrality (unpublished, July 1994); Lawrence M. Axelrod, The Proposed Consolidated Return Intercompany Transaction Regulations: Clearly Reflecting Income Is Clearly Not Simple, Practicing Law Institute (August, 1994); American Bar Association, Comments on Proposed Intercompany Transaction Regulations, submitted April 27, 1995, reprinted in 95 Tax Notes Today 93-22 (May 12, 1995) (hereinafter "ABA Comments"). This outline makes use of numerous examples, many of which are drawn from the proposed and final regulations and some of which are drawn from these secondary sources.

involving stock or other obligations of members. Thus, whereas the amount and location of items with respect to intercompany transactions continue to be accounted for on a separate-entity basis, attributes, holding periods, timing, source, and character are redetermined as necessary to produce the effect of treating the selling and buying members as divisions of a single entity. Treas. Reg. § 1.1502-13(a)(2).

2. **Avoid specific mechanical rules**. The approach of the current rules represents a significant departure from that of the old rules, in that the current rules eschew specific mechanical rules in favor of broad rules that can only be applied with a view to the purposes of the intercompany transaction rules and the single-entity theory.

3. **Eliminate distinction between deferred and non-deferred intercompany transactions**. The current rules eliminate the distinction between "deferred" and "non-deferred" intercompany transactions, and between transactions unrelated to the corporate/shareholder relationship and those that are incident to this relationship. The current rules analyze all transactions under the same general principles.

4. **Outline of regulations**. Paragraph (a) of Treas. Reg. § 1.1502-13 discusses the purpose and theory underlying the current rules, as well as the status of the timing rules as a method of accounting. Paragraph (b) of Treas. Reg. § 1.1502-13 provides definitions of certain key terms and concepts. The primary rules that achieve single-entity treatment under Treas. Reg. § 1.1502-13, however, are the "matching rule" of paragraph (c) and the "acceleration rule" of paragraph (d). Paragraph (e) provides simplifying rules for certain transactions. Paragraphs (f) and (g) provide special rules for transactions involving member stock and member obligations, respectively. Paragraphs (h) and (j) provide anti-avoidance rules and miscellaneous operating rules, respectively. Paragraph (k) makes cross-references to certain other applicable provisions of the Code or regulations. Paragraph (l) contains the effective date rules, including a special anti-avoidance rule. Paragraph (i) is reserved.

5. **Fundamental principles**. The fundamental principle of the current regulations is reflected in the matching rule, which requires the selling member to take intercompany items into account as the buying member takes into account corresponding items from the intercompany transaction. The selling member must take its intercompany items into account at the time and in the manner consistent with treating the selling and buying members as divisions of a single entity. See Treas. Reg. § 1.1502-13(c). The acceleration rule requires items deferred under the matching rule to be taken into account when it first becomes clear that it is no longer possible to achieve single-entity treatment under the matching rule, generally when the selling or buying member leaves the group. See Treas. Reg. § 1.1502-13(d).

C. Summary of the Old Intercompany Transaction Rules

1. **In general**. The prior intercompany transaction rules were found at Treas. Reg. §§ 1.1502-13 and 1.1502-14 and Temp. Reg. §§ 1.1502-13T and 1.1502-14T (the "old rules"). These rules continue to be generally effective for transactions occurring during tax years beginning prior to July 12, 1995. Thus, the old rules continue to be effective in most instances for transactions occurring during 1995.

2. **Transactions covered by old rules**. The old rules defined intercompany transactions as transactions during the consolidated taxable year between corporations that were members of the same group immediately after the transaction. The old rules distinguished between transactions involving members acting in an unrelated capacity (for example as buyer and seller of property) and transactions between members acting in their corporate/shareholder capacities. The former (unrelated transactions) were governed by the rules of Prior Treas. Reg. § 1.1502-13, while the latter transactions were governed by Prior Treas. Reg. § 1.1502-14. Prior Treas. Reg. § 1.1502-18 contained rules for inventory transactions.

3. **Distinction between deferred and non-deferred intercompany transactions**. The old rules distinguished between "deferred intercompany transactions" and intercompany transactions that were not "deferred." Deferred intercompany transactions generally included only sales of property and intercompany transactions involving expenditures that were capitalized. Thus, the general rules did not apply to many transactions involving intercompany debt or stock. Special rules were provided for such transactions. See, e.g., Prior Treas. Reg. §§ 1.1502-14 and -14T.

4. **Generally redetermine only the timing of transactions**. Under the old rules, sales or exchanges of property that were intercompany transactions were treated as "deferred." The amount, location, character, and source of items arising from intercompany transactions were determined as if separate returns were filed; i.e., on a separate-entity basis. However, the time at which intercompany items were taken into account was deferred until the occurrence of a triggering event that would cause the item to be restored. There were three general restoration rules.

    a. First, gain or loss was restored to the selling member in proportion to depreciation, amortization, or depletion deductions taken by the buying member with respect to the property. Prior Treas. Reg. § 1.1502-13(d).

    b. Second, in the case of an installment obligation sold between members, gain was restored as the obligation was satisfied. Prior Treas. Reg. § 1.1502-13(e).

5. Third, the balance of any deferred gain or loss was restored when the property was disposed of outside the group or when the selling or buying member ceased to be a member of the consolidated group. Prior Treas. Reg. § 1.1502-13(f).

II. Definitions

A. Denomination of Selling and Buying Member

1. **Selling member**. For purposes of simplicity under the current rules, the company transferring the property, or performing the services in connection with an intercompany transaction, is uniformly denominated as "S." Treas. Reg. § 1.1502-13(b)(1)(i).

2. **Buying member**. The company paying for the property or services in connection with an intercompany transaction is uniformly denominated as "B." Treas. Reg. § 1.1502-13(b)(1)(i).

B. Definition of an Intercompany Transaction

1. **General definition**. A transaction is only subject to the current regulations if it is an "intercompany transaction," defined as any transaction between corporations that are members of the same consolidated group immediately after the transaction. Treas. Reg. § 1.1502-13(b)(1)(i).

2. **Time of transaction**. If a transaction occurs in part while the corporations are both members of the same group and in part while they are not, the transaction is treated as taking place at the earliest of (1) when performance by either corporation takes place, or (2) when payment for performance would be taken into account under the current rules if the transaction were an "intercompany transaction." Treas. Reg. § 1.1502-13(b)(1)(ii).

3. **Separate transactions**. Each transaction must be analyzed separately and different transactions may not be "netted." For example, if S simultaneously sells appreciated property to B at a gain and depreciated property to B at a loss, it is not appropriate to net the results of the two transactions. Each is treated as a separate and independent transaction. Treas. Reg. § 1.1502-13(b)(1)(iii). Thus, the following generally are separate transactions: (1) each accrual of interest on a loan; and (2) each payment under a notional principal contract. Accrual of premium on a loan is treated either as a separate transaction or as an offset to accrued interest, whichever is appropriate to achieve single-entity treatment.

C. Intercompany Items and Corresponding Items

1. **Attributes**. An item's attributes include all of the characteristics necessary to determine the item's effect on taxable income (and tax liability), except amount, timing, and location. For example, attributes include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as a built-in gain or loss under § 382(h) or § 384. In contrast, characteristics of property such as its holding period or the fact that the property is included in inventory are not attributes, although these characteristics might affect the determination of the attributes of an item. For example, holding period is not an attribute, because it may have no effect on taxable income (or tax liability) in many instances. In certain cases, however, holding period may determine the character of gain or loss, which is an attribute. See Treas. Reg. § 1.1502-13(b)(6).

2. **Intercompany items**

   a. **In general**. The transferor's (S's) items of income, gain, deduction, or loss are its "intercompany items." For example, if S sells appreciated property to B at a gain, the gain is intercompany gain. An item is an intercompany item whether it arises directly or indirectly from an intercompany transaction. Treas. Reg. § 1.1502-13(b)(2)(i).

   b. **Related costs or expenses**. S's costs or expenses related to an intercompany item are included in determining its intercompany items. Generally, any costs or expenses that are related to the intercompany item that would not be capitalized under S's separate method of accounting are included in the determination of the intercompany item. For example, if S sells appreciated inventory property to B, S's intercompany gain is determined by including direct and indirect costs properly includible under § 263A. Deductions for employee wage costs are included in determining intercompany income items from the performance of services for B. Depreciation costs are included in the determination of intercompany income from renting property to B. See Treas. Reg. § 1.1502-13(b)(2)(ii).

   c. **Amounts not yet recognized or incurred**. S's intercompany items may be taken into account even if S has not yet taken them into account under its separate-entity method of accounting. If S is a cash method taxpayer, S may be required take intercompany items into account under the current rules even if S has not received the cash. Treas. Reg. § 1.1502-13(b)(2)(iii). For example, if S, a cash method taxpayer, has sold property to B but has not yet received the cash, and B leaves the consolidated group,

the acceleration rule may require S to take its intercompany gain or loss into account even though it would not have taken it into account under its separate-entity method of accounting. Thus, the current rules may operate to accelerate recognition of items relative to the time an item would have been taken into account on a separate-company basis.

3. **Corresponding items**

a. **In general**. The transferee's (B's) items of income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are B's "corresponding items." Treas. Reg. § 1.1502-13(b)(3)(i). For example, if S sells appreciated property to B, S has an item of intercompany gain. When B subsequently disposes of the property, B's gain or loss on the disposition is B's corresponding item.

b. **Disallowed or eliminated amounts**. B's corresponding items include amounts that are permanently disallowed or eliminated, directly or indirectly, under other provisions of the Code or regulations; i.e., an item is not disregarded for purposes of applying the current rules merely because a provision of the Code or regulations otherwise prevents B from taking the item into account. For example, B's corresponding items include amounts disallowed under § 265 (expense related to tax-exempt income) and amounts not recognized under § 311(a) (nonrecognition of loss on distributions), § 332 (nonrecognition on liquidating distributions), or § 355(c) (certain distributions of stock of a subsidiary). Treas. Reg. § 1.1502-13(b)(3)(ii).

By contrast, an amount not recognized is not treated as a corresponding item to the extent B receives a "successor asset" in the nonrecognition transaction. Treas. Reg. § 1.1502-13(b)(3)(ii). Successor assets generally include any asset whose basis in B's hands is determined in whole or in part by intercompany property. See Treas. Reg. § 1.1502-13(j)(1). In effect, this rule prevents duplication of corresponding items that could trigger S's intercompany items, which will be taken into account only by reference to the successor property.

4. **Recomputed corresponding items**. In order to determine the time that S will take its intercompany items into account under the matching rule (described more fully below) it is also necessary to determine the "recomputed corresponding item." This is the amount or item that would have been taken into account if S and B had been divisions of a single corporation. Treas. Reg. § 1.1502-13(b)(4). Thus, the term is somewhat

of a misnomer since the item is not, in fact, a recomputation of B's corresponding item so much as a hypothetical single-entity item.

EXAMPLE 1 -- Items

Facts: S holds investment property with a basis of $100 and a fair market value of $200. In Year 1, S sells the property to B for $200. B holds the property for investment with a basis of $200. In Year 3, B sells the property to X, a nonmember, for $300.

Results: S's sale to B is an intercompany transaction, because it involves a transfer of property between corporations that are members of the same consolidated group immediately after the transaction. S's $100 gain is its intercompany item ($100 intercompany gain). B's gain with respect to the property from the sale to X is its corresponding item ($100 corresponding gain). If S and B were divisions of a single corporation, that hypothetical corporation would ignore the transfer between its divisions for tax purposes and would keep S's original basis of $100 in the property; the hypothetical single corporation would realize an amount of $300 upon the sale to X. Thus, if S and B were merely divisions of a single corporation, the hypothetical corporation would recognize $200 of gain in Year 3 on the sale to X. The recomputed corresponding item is, therefore, a $200 recomputed gain.

5. **Elimination of deemed items**. The proposed rules contained rules regarding "deemed items," which generally were adjustments reflected in basis or as a carryover that were substitutes for an intercompany item or corresponding item. Many commentators felt that the concept was confusing and duplicative, because in most instances the general rules would reach the problems intended to be addressed by the concept of "deemed items." See, e.g., ABA Comments at 2311. Accordingly, the deemed item rules have been eliminated in the final regulations. Preamble to the final regulations, 60 Fed. Reg. at 36,674. However, because the deemed item rules overlapped with the more general rules, this should have no effect on the results.

D. Timing Rules As a Method of Accounting

The timing rules are a method of accounting for intercompany transactions that is to be applied by each member in addition to the member's other methods of accounting. See Treas. Reg. §§ 1.1502-13(a)(3); -17. For example, if S sells property to B in exchange for B's note, the timing rules apply rather than the installment sale rules of § 453. This clarifies uncertainty that had arisen from conflicting authorities and positions of the Service concerning whether the old timing rules were a method of accounting. Compare P.L.R. 9002006 (Sept. 30, 1989) (ruling that the deferral and restoration adjustments required by the old rules were not a method of accounting), with General Motors Corp. v.

Commissioner, 112 T.C. 270 (1999) (rejecting the Service's argument that the old rules were a method of accounting). In response to questions raised by commentators when this rule was introduced in the proposed rules, the Service added a technical provision granting automatic consent under § 446(e) to any change in the method of accounting made necessary by joining or leaving a consolidated group. Such a change in accounting method is to be effected on a cut-off basis. However, this does not address concerns expressed by commentators over the complexity created by treating the timing rules as a method of accounting; e.g., whether it requires groups to obtain consent to correct an erroneous application of the current rules.

III. The Matching Rule

A. In General

1. The heart of the current regulations is the matching rule contained in Treas. Reg. § 1.1502-13(c). The matching rule seeks to achieve single-entity treatment by prescribing a treatment that matches the consequences that would obtain if the transaction had been undertaken between divisions of a single corporation. Thus, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring). For example, S's sale of property to B for cash is not disregarded but is treated as an exchange for cash between divisions. If S sells property to B in exchange for B's stock, S will be treated as owning the B stock, even though a division of corporation could not issue stock. See Treas. Reg. § 1.1502-13(c)(3).

2. Although treated as divisions of a single corporation for most purposes, S and B are treated as:

    a. Operating separate trades or businesses. See, e.g., Treas. Reg. § 1.446-1(d) (permitting different accounting methods to be applied by a taxpayer in its separate and distinct trades or businesses), Treas. Reg. § 1.1502-13(c)(3)(i); and

    b. Retaining any special status that they have under the Code as separate entities. For example, if B has status as a bank under § 581, a domestic building and loan association defined in § 7701(a)(19), or an insurance company to which § 801 or 831 applies, it will be treated as such under the matching rule, despite the fact that B will generally be treated as a division of a single corporation. Treas. Reg. § 1.1502-13(c)(3)(ii). Holding property for sale to customers in the ordinary course of business, however, is not a special status for this purpose.

3. The matching rule applies to timing and attributes, but not to amount or location of items, which is determined on a separate-entity basis.[2] See Treas. Reg. § 1.1502-13(a)(2). The application of the matching rule involves three general rules: (1) matching of timing; (2) holding period aggregation; and (3) redetermination of other attributes. There are also a number of operational rules. However, the aim of the current rules is to avoid the mechanical rules imposed by prior law. As a result, the current rules are frequently somewhat vague and can only really be understood in conjunction with the stated purposes of the current rules and specific examples. Fortunately, the current rules provide numerous examples to illustrate their application, many of which are reproduced below.

B. Timing under the Matching Rule

1. **B's timing**. B is generally required to determine the timing of corresponding items as it would under its accounting method on a separate-entity basis, subject to any impact the redetermination of the attributes of those corresponding items may have on B's timing. As described below, attributes may be redetermined so as to achieve the effect of treating S and B as divisions of a single corporation. Thus, while B's timing will not generally be affected by the current rules, it may be affected in a few instances. For example, if S's activities turn what normally would be a capital asset in the hands of B into dealer property, this may prevent B from taking the income into account under the installment sale method of § 453(b), thereby affecting the timing of B’s recognition of income. Treas. Reg. § 1.1502-13(c)(2)(i).

2. **S's timing**. S is required to redetermine the timing of its intercompany items to reflect the difference for the year between B's corresponding items taken into account and B's recomputed corresponding items (the items that B would have taken into account for the year if B and S were divisions of the same corporation). Treas. Reg. § 1.1502-13(c)(2)(ii). In effect, the concept of the “recomputed corresponding item” merely provides a mechanical means to effect the requirement that S's timing be redetermined to achieve single-entity treatment. To the extent items taken into account by B differ from items that would have been taken into account by a single entity, S “makes up the difference.”

EXAMPLE 2 -- Timing of Realization

Facts: S holds investment property with a basis of \$40 and a fair market value of \$100. In Year 1, S sells the property to B for \$100. B holds the

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[2]Treatment as a separate entity means treatment without application of the rules for intercompany transactions, but with application of the other rules applicable to consolidated returns. Treas. Reg. § 1.1502-13(b)(5).

property for investment with a basis of $100. In Year 3, B sells the property to X, a nonmember, for $200.

Results: S has a $60 intercompany gain (the difference between its basis of $40 and amount realized of $100). B has a corresponding gain of $100 (the difference between B's basis of $100 and amount realized of $200). If S and B were divisions of a single corporation, the gain realized by B upon the sale of the property in Year 3 would be the amount realized of $200 less the original basis of $40, or $160 (which, therefore, is the recomputed corresponding item). Under the matching rule, in any given tax year, S is required to take into account the difference between B's corresponding item and the recomputed corresponding item. In Year 1, S's intercompany gain is $60, which is deferred. B has no corresponding item until Year 3, and if S and B were divisions of the same corporation, no gain would have been realized or recognized until Year 3. Accordingly, the corresponding and recomputed corresponding items are zero until Year 3. Thus, S is not required to take any portion of its intercompany item into account until Year 3. In Year 3, the difference between B's corresponding gain of $100 and the recomputed corresponding gain of $160 is taken into account by S. Thus, S takes $60 of gain into account in Year 3.

EXAMPLE 3 -- Timing on Sale of Depreciable Property

Facts: S acquires a depreciable machine with a 10-year life on January 1 of Year 1 for $100. S depreciates the machine using the straight-line method, giving rise to annual depreciation deductions of $10. On January 1 of Year 5, S sells the machine to B for $100. S realizes $40 of gain. Because S and B are related, B is required under § 168, in effect, (i) to bifurcate the basis subject to depreciation into an amount equal to $60 that is depreciated as if it had a remaining useful life of six years, and (ii) an amount equal to $40 that has a remaining useful life of ten years. Therefore, during Year 6, B has a depreciation deduction of $10 with respect to the $60 basis and $4 with respect to the $40 basis. In the aggregate, B depreciates the machine at a rate of $14 in Years 5 through 10, and at a rate of $4 in Years 11 through 14.

Results: The example involves facts that may require redetermination of attributes and character. These issues are discussed below, but are ignored here for simplicity. The timing of recognition is determined as follows. S has an intercompany gain of $40 realized at the beginning of Year 5. In Year 5, B has a corresponding depreciation deduction of $14. However, if S and B had been divisions of a single corporation, the depreciation deduction would have been only $10. Therefore the recomputed corresponding item is a $10 depreciation deduction. S is required to take into account an amount equal to the difference between the corresponding item of $14 and the recomputed corresponding item of $10; i.e., S must

take $4 of its intercompany gain into account in Year 5. Similarly, S will take $4 into account in Years 6 through 10. In Years 11 through 14, a hypothetical single entity would not have been entitled to any amount of depreciation. Therefore, the recomputed corresponding item for these years is zero while the corresponding item is $4. Thus, S must take $4 of gain into account in Years 11 through 14.

C. Holding Period Aggregation

1. **Current rules**. Under the current rules, S and B are required to account for transactions as if they were divisions of a single corporation. If S and B were divisions of a single corporation, that corporation's holding period would include both S's and B's holding periods. Accordingly, the current rules provide that the holding period of property transferred from S to B is the aggregate of the separate entity holding periods in most situations. Treas. Reg. § 1.1502-13(c)(1)(ii). However, if the basis of the property transferred in an intercompany transaction is determined by reference to the basis of any other property, the property's holding period is determined by reference to the holding period of the other property. In other words, carryover basis under another provision of the Code or regulations also requires carryover of the holding period, without regard to the aggregation otherwise required by the matching rule.

2. **Old rules**. Under the old rules, B's holding period did not include S's holding period. Prior Treas. Reg. § 1.1502-13(g). Thus, if S sold investment property that it had held for seven months to B, and B sold the property, which it held for investment, seven months later to X, B's holding period was measured from the time of the intercompany sale. Both S and B were treated as having a holding period of only seven months.

EXAMPLE 4 -- Holding Period Aggregation

Facts: On January 1 of Year 1, S acquires property for $40, which it holds for investment. On March 1 of Year 1, S sells the appreciated property to B for $100. B holds the property for investment. On January 2 of Year 2, B sells the property for $200 to X, a nonmember.

Results: S has a $60 intercompany gain (the difference between its basis of $40 and amount realized of $100). B has a corresponding gain of $100 (the difference between B's basis of $100 and amount realized of $200). If S and B were divisions of a single corporation, the gain realized upon the sale of the property in Year 2 would be the amount realized of $200 less the original basis of $40, or $160 (the recomputed corresponding gain). Under the old rules, the character of S's gain and B's gain would have been determined without regard to the holding period of the other member. Under the current rules, however, the holding periods are tacked together.

Therefore, both S and B are treated as having a holding period of 1 year, and their items of gain are treated as long-term capital gain.

EXAMPLE 5 -- Holding Period Aggregation

Facts: S holds all of the stock in a subsidiary, T, for a period of ten years. On January 1 of Year 11, S distributes all of the T stock to B in a transaction to which § 355 applies. B holds the stock for six months, during which time it appreciates in value significantly. On July 1 of Year 11, B sells the T stock to X, a nonmember.

Results: Under § 358, B's basis in the T stock would be an allocable portion of B's basis in the stock of S. Therefore, B's holding period in the distributed T stock is determined by B's holding period in the stock of S and does not include S's holding period for the T stock. See Treas. Reg. § 1.1502-13(c)(1)(ii).

D. Redetermination of Other Attributes

1. **Current rules**. The current rules require group members to redetermine separate-entity attributes of intercompany items and corresponding items to the extent necessary "to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation." Treas. Reg. § 1.1502-13(c)(1)(i). This rule is simply stated, but may well be extremely complicated to apply in practice.

2. **Old rules**. The old rules deferred recognition of gain or loss on certain intercompany transactions, but this did not affect other attributes, which were determined on a separate-entity basis. For example, if S held appreciated investment property for two years and sold the property to B, which held it for sale to customers in the ordinary course, the old rules required S and B to determine the character of their items with respect to the property without regard to the other member's activities. Prior Treas. Reg. §§ 1.1502-13(c)(4) and 1.1502-13(m)(1).

EXAMPLE 6 -- Character (Dealer Property)

Facts: S owns undeveloped lots that S has held for two years for sale to customers in the ordinary course. In Year 1, S sells the lots to B for $200. S has a basis of $100 and the gain realized by S is, therefore, $100. B holds the lots for investment and sells to X, a nonmember, in Year 3 for $250. B's basis is $200 and gain to B is, therefore, $50.

Results: S's intercompany item is the $100 gain. B's corresponding item is the $50 gain upon sale of the lots to X in Year 3. If S and B were divisions of the same corporation, the corporation would have a basis of $100 and gain of $150 when B sells to X. The recomputed corresponding

gain is, therefore, $150 in Year 3. S is required to recognize the $100 intercompany gain when B sells the property. The character of S's intercompany item and B's corresponding item are determined as if both were divisions of a single corporation. Thus, the character of the gain is based on the activities of both S and B. See Treas. Reg. § 1.1502-13(c)(7)(ii), Ex. 2. This is in contrast to the old rules where S's gain and B's gain were bifurcated and the character of each determined on the basis of separate-entity principles. Determining the character of the property in the hands of a putative single entity presumably involves issues of "dual purpose" in cases such as this where S's purpose for holding the property is demonstrably different from B's purpose. Resolving the conflict would require the taxpayer to determine which was the "primary" purpose based on all the facts and circumstances. See, e.g., Malat v. Riddell, 383 U.S. 569 (1966) (holding that, as used in § 1221(1), "primarily" means "of first importance" or "principally").

E. Conflict or Allocation of Attributes

1. **In general**. Special rules are provided for situations where there is a conflict between the separate-entity attributes of S's and B's items.

2. **Offsetting amounts**

   a. **General rule for offsetting amounts**. To the extent B's corresponding item offsets S's intercompany item in amount, the attributes of B's corresponding item, determined based on both S's and B's activities, control the attributes of S's offsetting intercompany item. Treas. Reg. § 1.1502-13(c)(4)(i)(A).

EXAMPLE 7 -- Attributes on Sale of Depreciable Property

Facts: S acquires a depreciable machine with a 10-year life on January 1 of Year 1 for $100. S depreciates the machine using the straight-line method, giving rise to annual depreciation deductions of $10. On January 1 of Year 5, S sells the machine to B for $100. S realizes $40 of gain. Because S and B are related, B is required under § 168, in effect, to bifurcate the basis subject to depreciation into (i) an amount equal to $60 that is depreciated as if it had a remaining useful life of six years, and (ii) an amount equal to $40 that has a remaining useful life of ten years. Therefore, during Year 5, B has a depreciation deduction of $10 with respect to the $60 basis and $4 with respect to the $40 basis. In the aggregate, B depreciates the machine at a rate of $14 in Years 5 through 10, and at a rate of $4 in Years 11 through 14.

Results: The rules regarding the timing of S's intercompany gain are discussed in more detail above, but are generally ignored here for simplicity. Assume that in each of Years 5 through 10, B takes a

depreciation deduction in the aggregate amount of $14, while S is required to recognize $4 of its intercompany gain. It is not really possible to redetermine both S's and B's separate-entity attributes based on the aggregation of the activities of S and B. The addition to depreciable basis by B is inherently incompatible with the activities of such a hypothetical single entity. Instead, the conflicting attributes of either S or B must give way to ensure that one offsets the other and achieves a result compatible with single-entity treatment. The rule for offsetting amounts generally provides that B's attributes govern to the extent of a conflict. Thus, because B's $14 depreciation deduction is ordinary and entirely offsets S's gain, S's gain is treated as ordinary gain.

b. **Redetermination where general rule is unreasonable**. To the extent the general rule for offsetting amounts would achieve results that are inconsistent with treating S and B as divisions of a single corporation, the offsetting amounts must be redetermined in a manner consistent with single-entity treatment. Treas. Reg. § 1.1502-13(c)(4)(i)(B). However, to the extent B's corresponding item is excluded from gross income, is a noncapital, nondeductible amount, or is otherwise permanently disallowed or eliminated, B's corresponding item always controls the attributes of S's intercompany item.

3. **Allocation**

a. **In general**. To the extent B's corresponding item does not offset S's intercompany item in amount, the attributes redetermined to achieve single-entity treatment must be allocated between S and B in a "reasonable" manner.

b. **Reasonable allocation**. An allocation method must be reasonable based on all the facts and circumstances, taking into account the purposes of the current rules and any other rules affected by the redetermination. An allocation method is per se unreasonable if it is not applied consistently from year to year. See Treas. Reg. § 1.1502-13(c)(4)(ii). Reasonable allocation might include, for example, allocating the § 1245 recapture income based on the percentage of the original basis depreciated by each. See ABA Comments at 2311.

EXAMPLE 8 -- Attributes on Sale of Depreciable Property

Facts: S acquires a depreciable machine with a 10-year life on January 1 of Year 1 for $100. S depreciates the machine using the straight-line method, giving rise to annual depreciation deductions of $10. On January 1 of Year 5, S sells the machine to B for $100. S realizes $40 of gain. Because S and B are related, B is required under § 168, in effect, to

bifurcate the basis subject to depreciation into (i) an amount equal to $60 that is depreciated as if it had a remaining useful life of six years, and (ii) an amount equal to $40 that has a remaining useful life of ten years. Therefore, during Year 5, B has a depreciation deduction of $10 with respect to the $60 basis and $4 with respect to the $40 basis. B depreciates the machine at a rate of $14 in Years 5 and 6. On January 1 of Year 7, B sells the machine to X, a nonmember, for $110.

Results: In each of Years 5 and 6, B takes a depreciation deduction in the aggregate amount of $14, while S is required to recognize $4 of its intercompany gain. S is required to take the balance of its intercompany gain ($32) into account in Year 7 when B sells the machine. B's gain on the sale is $38, of which $28 would § 1245 ordinary "recapture" income and $10 would be § 1231 capital gain on a separate-entity basis. S's and B's intercompany and corresponding items do not offset each other in amount. If S and B had been divisions of a single corporation, the hypothetical single entity would have recognized a gain of $70 of which $60 would have been § 1245 ordinary income and $10 would have been § 1231 capital gain. On a separate-entity basis, no amount of S's gain would be § 1231 capital gain, while $10 of B's gain would be § 1231 gain. Therefore, all of the § 1231 gain is allocated to B. See Treas. Reg. § 1.1502-13(c)(7), Ex. 4(e) (for circumstances where it is reasonable to allocate the entire § 1231 gain to S).

F. Special Status

1. **Special rule**. Notwithstanding the general rule that attributes must be redetermined to achieve the effect of treating S and B as divisions of a single corporation, to the extent that an item's attributes are permitted or not permitted to a member under the Code or regulations by reason of that member's special status, the attributes required by the special status apply to that member, but not to the other member. Treas. Reg. § 1.1502-13(c)(5).

EXAMPLE 9 -- Special Status and Attribute Redetermination

Facts: S is a Bank, which holds appreciated securities for investment. On January 1 of Year 1, S sells the appreciated securities to B (a nonbank). B holds the securities for investment. On July 1 of Year 2, B sells the securities, which have further appreciated, to X, a nonmember.

Results: S has an intercompany gain. B has a corresponding gain. S recognizes the intercompany gain in Year 2 when B sells the securities to X. Under the general matching rule, S and B are required to redetermine the attributes of the intercompany and corresponding items to achieve the same effect as if they were divisions of a single corporation. Since both B and S held the securities for investment, under the general principles, the

gain would be capital gain, because their holding period would be aggregated. However, because S is a bank, its special status trumps this redetermination. S's gain is ordinary gain under § 582(c) (bank gain or loss on the disposition of securities not treated as capital). However, B's gain is not affected; i.e., it is treated as capital gain if this is the result of redetermining the corresponding item as required to achieve single-entity treatment.

G. Limitation on exclusion of intercompany gain

1. **General problem** Redetermining attributes of intercompany items and corresponding items under the current rules to achieve single-entity treatment may result in S's intercompany items being treated as excluded from gross income or as a noncapital, nondeductible amount. For example, if S sells property to B at a $10 gain, and B later distributes the property to a nonmember shareholder at a $10 loss, § 311(a) precludes recognition of the loss by B. Under the general principles of single-entity treatment, one would expect that B or S should redetermine the attributes of their items to achieve single-entity treatment. Because the amount of B's corresponding loss offsets S's intercompany gain, B's attributes would control. Thus, to achieve single-entity treatment, S's gain would be redetermined under generally applicable principles to be excluded from gross income. See Treas. Reg. §§ 1.1502-13(b)(6) (definition of attributes); -13(c)(1)(i) (redetermination to achieve single-entity treatment); -13(c)(4) (conflict or allocation of attributes). In other cases, however, B's loss may, in effect, be deferred rather than entirely disallowed. Permitting S to exclude its gain could result in an unintended tax benefit, particularly if the property has left the group and B's subsequent recognition of the loss will not trigger recognition of S's gain. Therefore, special rules permit S to treat its gain as excluded from gross income in only limited cases.

2. **Gain not loss exclusion limited**. Treas. Reg. § 1.1502-13(c)(6)(ii) limits the exclusion of gain. The rule does not limit exclusion of S's loss. It provides that S's intercompany gain or income may be excluded from gross income only to the extent one of the following applies:

   a. **Corresponding disallowed loss**. Gain may be excluded to the extent B's corresponding item is a deduction or loss that is permanently and explicitly disallowed by a provision of the Code or regulations, rather than deferred. See, e.g., I.R.C. § 265. This rule is intended to be one of administrative convenience to avoid the need to trace deferred tax attributes associated with items indefinitely. See Preamble to proposed rules, 59 Fed. Reg. at 18,013. Deductions or losses are not considered permanently and explicitly disallowed if:

(i) the amount is not recognized under the Code or regulations, but is not permanently and explicitly disallowed, for example, as under §§ 332 or 355(c);

(ii) disallowance is not permanent because a related amount might be taken into account by B, for example, as under § 280B (demolition costs recoverable as capitalized amount);

(iii) disallowance is not permanent because a related amount might be taken into account by a related person, for example, as under § 267(d) (disallowed loss may result in nonrecognition of gain by a related person);

(iv) a related amount may be taken into account as a deduction or loss, including as part of a carryforward (whether or not the carryforward expires in the later year); or

(v) the amount is reflected in the computation of any credit against (or other reduction of) federal income tax (whether allowed or carried forward).

b. **Corresponding loss not recognized under § 311(a)**. Gain may be excluded to the extent B's corresponding item is a loss that is realized but not recognized under § 311(a).

c. **Other eliminated loss identified by Commissioner**. Gain may be excluded to the extent B's corresponding item is otherwise limited, eliminated, offset, or has no effect on the computation of taxable income under any provision identified by the Commissioner.

EXAMPLE 10 -- Exclusion of Gain

Facts: S sells investment property with a $100 basis and a $200 value to B at a $100 gain. The value of the property depreciates in B's hands to $150. B has an unrealized built-in loss of $50 on the property. B distributes the loss property to X, a nonmember shareholder. B recognizes no loss on the distribution under § 311(a).

Results: B's disallowed loss of $50 is a corresponding item. Treas. Reg. § 1.1502-13(b)(3)(ii). Under the matching rule, S's gain is taken into account to reflect the difference between B's corresponding item and B's recomputed corresponding item. The recomputed corresponding item is a gain of $50. The corresponding item is a disallowed loss of $50. Thus, S must take $100 of gain into account. Because the corresponding loss is eliminated, single-entity treatment requires redetermination of the attributes. Such redetermination generally requires $50 of S's gain to be redetermined as excluded from gross income in the absence of a

limitation. Treas. Reg. § 1.1502-13(c)(6). Where the corresponding item is a loss realized but not recognized under § 311(a), S is permitted to permanently exclude the gain.

EXAMPLE 11 -- Exclusion of Loss

Facts: S sells property to B at a $100 loss. The value of the property depreciates further in B's hands. B distributes the loss property to X, a nonmember shareholder.
Results: Under the matching rule, S's loss is taken into account to reflect the difference between B's corresponding items and the recomputed corresponding item. Under § 311(a), B has not recognized a disallowed corresponding loss upon distribution of the property to X. The loss would not be recognized under § 311(a) if S and B were divisions of a single corporation. Thus, the recomputed corresponding loss is zero. S may not recognize any amount of the loss upon the distribution of the property, because S's loss is redetermined to be a noncapital, nondeductible expense. Treas. Reg. § 1.1502-13(c)(6) offers no relief, because it does not limit the exclusion of S's loss.

H. Additional Examples Illustrating the Matching Rule

EXAMPLE 12 -- Items

Facts: S, a general contractor, builds a building for B, receiving a fee of $200 from B. S incurs $150 of expenses in performing the services for B, all of which are currently deductible under S's separate accounting method. B is required to capitalize the fee into its basis in the building and depreciate the fee over the life of the building. Assuming the depreciable life of the building is 20 years, B will deduct $10 per annum with respect to the this amount of basis.

Results: Under the old rules, S could defer recognition of $200 fee income, taking it into account as B depreciated the building. It was unclear whether the expenses associated with the income could be immediately deducted by S or also had to be deferred. To the extent the expenses could be deducted immediately by S, S enjoyed an unintended tax benefit. Under the current rules, both the $200 fee income and the $150 of related costs are taken into account in determining S's intercompany items. Treas. Reg. § 1.1502-13(b)(2)(ii). The net intercompany item is $50 of intercompany income. Thus, under the current rules, S cannot currently deduct $150 of expenses while deferring $200 of fee income. See Treas. Reg. § 1.1502-13(c)(7), Ex. 7.

Timing. S will take its net intercompany income item of $50 into account as B recovers its additional basis in the building. If S and B were divisions of a single corporation, the corporation would have a basis of

$150 determined by its cost in the building and would recover $7.50 as annual depreciation. Therefore, the recomputed corresponding item is a $7.50 deduction. B's corresponding item is the $10 depreciation deduction it will take on the building. Therefore, S must recognize as income the difference of $2.50 when B deducts $10 of depreciation.

Character. S's net income will be ordinary, because it offsets B's additional (ordinary) depreciation deduction.

EXAMPLE 13 -- Capitalized Depreciation

Facts: S sells a machine to B at the end of Year 1 for $100, recognizing $100 of § 1245 recapture gain and no amount of § 1231 capital gain. B holds the machine as inventory. In Year 2, the machine produces $20 of depreciation that B is required to capitalize and add to the basis of the inventory under § 263A. The inventory is sold to X, a nonmember, on January 1 of Year 3 for a gross profit of $40. The gross profit would have been $60 absent capitalization of the depreciation.

Results: Both B's $20 capitalized depreciation deduction and its $20 reduction in gross income (higher basis) on the inventory sale are corresponding items of B. Under the matching rule, however, no gain will be recognized by S in Year 2. The matching of B's reduction in inventory gain (recovery of capitalized basis) in future periods with S's intercompany gain is more consistent with single-entity theory. See Treas. Reg. § 1.1502-13(j)(3).

Timing: No part of S's $100 intercompany item is taken into account until Year 3 when the inventory into which B's depreciation has been capitalized is sold. B's recomputed corresponding gross profit item is $60. B's corresponding item is $40 (actual gross profit). S must include the $20 difference in income in Year 3 when the inventory is sold and the capitalized depreciation is recognized.

Character: S's $20 intercompany item will be ordinary, because it offsets B's additional reduction in gross profits (a reduction in ordinary income). Treas. Reg. § 1.1502-13(c)(1)(i) and (c)(4)(i).

EXAMPLE 14 -- § 1031 Exchange Outside the Group

Facts: In Year 1, S sells property A with a basis of $10 and fair market value of $100 to B for $100, recognizing a gain of $90. In Year 3, B transfers property A to X, a nonmember, in exchange for property B. The exchange satisfies the requirements of § 1031.

Results: Under the old rules, the exchange would accelerate all of S's $90 gain, because the property had been transferred outside the group.

However, this is inconsistent with single-entity treatment, because a single corporation would not be required to recognize its gain in a § 1031 exchange. Therefore, the current rules reach a different result. Under the matching rule, S is only required to recognize intercompany gain to the extent of the difference between B's corresponding item and the recomputed corresponding item. Here, the recomputed corresponding item is zero gain, because a single entity would substitute basis under § 1031. Since B's corresponding item is also zero, S recognizes no gain. B takes a substituted basis in the property B. Therefore, under Treas. Reg. § 1.1502-13(j)(1), the property B is a successor asset. S's items will be taken into account based on subsequent events with respect to property B.

EXAMPLE 15 -- Installment Sale

Facts: S is a dealer and is not eligible to use the installment method. B is not a dealer. S sells property with a basis of $50 to B for $150, recognizing $100 of gain. B subsequently sells the property to X, a nonmember, in exchange for X's note payable in two equal installments in the principal amount of $160 and bearing interest at a rate in excess of the applicable federal rate.

Results: The old rules would have permitted S to report its gain of $100 as B received payments on the installment note. This led to inappropriate results where a single entity consisting of divisions S and B would not have been entitled to use the installment method. The old rules were then amended to restore all of S's gain when the property was sold outside the group, ignoring the installment note. The current rules apply the single-entity theory more consistently to installment transactions. Treas. Reg. § 1.1502-13(c)(2) requires S to recognize as income only the difference between B's recomputed corresponding items and its corresponding items. Thus, if the activities of S and B as divisions of a single entity would preclude use of the installment method, S will recognize the gain immediately when the property is sold outside the group. If the single corporation consisting of S and B would be entitled to the installment method, S will recognize its income only as B receives payments under the installment note.

EXAMPLE 16 -- § 475

Facts: S, a dealer in securities within the meaning of § 475(c), purchases a security for $100. The security is held for sale to customers and is not identified under § 475(b) as within an exception to the mark-to-market rules, and S recognizes $30 of net mark-to-market decreases before Year 1. On July 1 of Year 1, S sells the security to B for $100. B is not a dealer and holds the security for investment. On December 31 of Year 1, the fair market value of the security is $100. On July 1 of Year 2, B sells the security to X for $110.

Treatment as a single corporation: Under § 475, a dealer in securities can treat a security as within an exception to the mark-to-market rules under § 475(b) only if it identifies the security on the day of its acquisition. S's intercompany gain is taken into account by treating § 475 as applying to S and B as a single corporation that is a dealer with respect to securities as a result of S's activities. Thus, B's recomputed items are determined by B's continuing to treat the security as not within an exception to the mark-to-market rules. However, under § 475(d)(3), it is possible for the character of S's intercompany items to differ from the character of B's corresponding items.

Timing and attributes: S has a $30 gain when it disposes of the security by selling it to B. This gain is intercompany gain that is taken into account in Year 1 to reflect the $30 difference between B's $0 gain taken into account and its recomputed $30 gain that would be taken into account as a result of marking to market under § 475. Under § 475(d)(3), S's gain is ordinary income. B has a $10 gain as a result of its sale to X, and this gain is taken into account in Year 2. Under § 475(d)(3), B's gain is capital gain.

EXAMPLE 17 -- Source of Items from a § 863 Sale

Facts: S manufactures inventory in the United States that it sells to distributors for resale to customers. B is a distributor with a foreign branch in country Y that purchases and resells the inventory outside the United States. During Year 1, S manufactures inventory, sells it to B's country Y branch at an arm's-length price, and has $75 of income. There is no independent factory or production price for the sale. Also during Year 1, B's country Y branch resells the inventory to X, an unrelated foreign person, with title passing abroad. B recognizes $25 of income. S's United States manufacturing assets have a value of $900, and B's country Y branch assets have a value of $100.

Timing: S's $75 of intercompany income is taken into account in Year 1 to reflect the difference between B's $25 of corresponding income taken into account and its $100 of recomputed income.

Attributes: The attributes of S's intercompany income and B's corresponding income are determined as if S and B were divisions of a single corporation. Thus, § 863 applies to S's intercompany sale as if S and B were divisions of a corporation manufacturing in the United States and selling in country Y. Two steps are required to source S's $75 of income and B's $25 of income. First, the sourcing rules of § 863 are applied on a single-entity basis to divide the $100 of combined income into foreign and U.S. source income portions. Of the combined income, $50 is sourced based on the aggregate asset values of S and B, with $45 of

the $50 treated as U.S. source income ($50 multiplied by $900/$1,000) and $5 treated as foreign source income ($50 multiplied by $100/$1,000). The remaining $50 of combined income is treated as foreign source income, based on the passage of title to X outside the United States. See Treas. Reg. § 1.863-3T(b), Ex. 2. Thus, $55 of the $100 of combined income is treated as foreign source income and $45 is treated as U.S. source income. Second, the sourcing rules are applied on a separate-entity basis, and the amount that must be redetermined to treat S and B as divisions of a single corporation is allocated between S and B using a reasonable method. Treas. Reg. § 1.1502-13(c)(4)(ii). It is reasonable to allocate the attributes based on the percentage each corporation's income bears to the total consolidated income from inventory production and sale.

IV. The Acceleration Rule

A. General Rule

To the extent S's and B's items "cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation," they are taken into account under the acceleration rule. Treas. Reg. § 1.1502-13(d). The most common situation in which the acceleration rule applies is when S or B cease to be a member of the group. As the term "acceleration rule" suggests, the timing consequences of the acceleration rule are relatively straightforward. The complexity arises primarily in determining attributes, and indeed, in ascertaining whether the acceleration rule applies in the first place. For example, if X acquires both S and B, which accordingly become members of the X group and cease to be members of the P group, the general language of the acceleration rule suggests that it should not apply. There is nothing evident from the rule itself that prevents the S and B subgroup from continuing to be treated as divisions of a single corporation. It appears clear from the examples, however, that subgroup principles do not apply in this context. See, e.g., Treas. Reg. § 1.1502-13(d)(3), ex. 1(g) (no subgroups). In other words, the acceleration rule is applied when it becomes impossible to treat S and B as divisions of a single corporation within the P group. In effect, the acceleration rule forces S (but generally not B) immediately to recognize an item to the extent it becomes clear that the matching rule would cause results inconsistent with the policy underlying deferral of items from intercompany transactions. The acceleration rule applies differently to S and B, both in terms of timing and its effect on the redetermination of attributes.

B. Application of the Acceleration Rule to S's Items

1. **Timing**. S takes its intercompany items into account when, and to the extent, they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation under the matching rule. The items must be taken into account immediately before it first becomes

impossible to achieve this effect.[3] Treas. Reg. § 1.1502-13(d)(1)(i). For this purpose, "the effect cannot be achieved" in the following situations:

a. To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or tax liability) under the matching rule. For example, the acceleration rule applies if S or B ceases to be a member of the group, or if S's intercompany item is no longer reflected in the difference between B's basis in property (or an equivalent) and the basis (or an equivalent amount) the property would have had if S and B were divisions of a single corporation. Treas. Reg. § 1.1502-13(d)(1)(i)(A). The latter, somewhat cryptic language, refers to the fact that, under the matching rule, S generally takes its intercompany item into account when B recovers the basis attributable to the intercompany item. In other words, at any given moment the amount of S's intercompany item should generally equal the difference between B's corresponding items (including basis) and the recomputed corresponding items.

b. To the extent a nonmember reflects, directly or indirectly, any "aspect" of the intercompany transaction (e.g., if B's cost basis in property acquired from S is reflected by a nonmember under § 362 following a contribution of the property to a nonmember corporation in a transaction described in § 351). The latter example, provided by the regulations, is considerably more instructive than the language of the rule itself, as it is unclear what it means to reflect, directly or indirectly, any "aspect" of an intercompany transaction. Unlike "basis," "aspect" is not a tax law term of art. The rule can only be applied with a view to its purpose; i.e., as a catch-all provision.

2. **Attributes**. S's attributes are determined differently depending on whether or not the intercompany transaction giving rise to the item was an intercompany sale, exchange, or distribution, or whether it was some other type of transaction. Moreover, different rules apply even to sales or exchanges of property depending on the nature of the sale.

a. **Sale, exchange, or distribution**. If the intercompany transaction giving rise to S's item was a sale, exchange, or distribution, S's attributes are determined under the principles of the matching rule as if B sold the property (at the time the intercompany item is taken into account under the acceleration rule) for cash in an

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[3] However, whether S takes its intercompany items into account also depends on the regulations under § 267, which may operate to further defer recognition of these items. See Reg. § 1.267(f)-1.

amount equal to B's basis in the property; i.e., at no net gain or loss to B. Treas. Reg. § 1.1502-13(d)(1)(ii)(A). In other words, the event triggering recognition of the intercompany item is deemed to be a hypothetical sale of the property by B and the matching rule is applied. The deemed buyer in this hypothetical transaction depends on whether the property leaves the group.

(i) **Property leaves the group**. If the property is owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to that nonmember. However, for purposes of other provisions of the Code or regulations, if the nonmember is related "to any party to the intercompany transaction (or a related transaction) or to the common parent," the nonmember is treated as related to B at the time of the hypothetical sale. Treas. Reg. § 1.1502-13(d)(1)(ii)(A)(1). For example, if the nonmember is related to P for purposes of § 1239(b), the deemed sale is treated as one described in § 1239(a) (recapture of depreciation). But see Treas. Reg. § 1.1502-13(j)(6) (property not treated as owned by a nonmember when owned by common parent as last remaining group member).

(ii) **Property does not leave the group**. If the property is not owned by a nonmember immediately after S is required to recognize the intercompany item by the acceleration rule, the hypothetical sale is treated as one to a nonmember affiliate. Treas. Reg. § 1.1502-13(d)(1)(ii)(A)(2).

b. **All other transactions**. In the case of all other transactions, S's attributes are determined on a separate-entity basis. Treas. Reg. § 1.1502-13(d)(1)(ii)(B). For example, if the intercompany transaction involved income from S's services capitalized by B, S determines the attributes of the income as if the original transaction had been with a nonmember.

C. Application of the Acceleration Rule to B's Items

1. **Attributes**. The attributes of B's corresponding items continue to be determined under the matching rule, but with certain adjustments.

a. **S and B continue as members of same group**. If S and B continue to join with each other in filing a consolidated return, the attributes of B's corresponding items (and applicable holding periods) are determined as if S and B were divisions of a single corporation. Treas. Reg. § 1.1502-13(d)(2)(i)(A). This could arise, for example, if the acceleration rule is triggered because a

nonmember reflects B's cost basis in the property or if S and B are both acquired by a new group; i.e., as a subgroup. For this attribute rule to apply, it is not necessary that S and B continue to join in filing the P group's return. See Treas. Reg. § 1.1502-13(d)(3), Ex. 1(g).

b. **S and B cease to be members of the same group**. Once S and B no longer join with each other in filing a consolidated return, the attributes of B's corresponding items are determined as if the single entity transferred the S division, but not the B division, to an unrelated person. In other words, S's activities (and any applicable holding period), before the deemed transfer continue to be taken into account in determining attributes (or holding period), but its activities thereafter do not affect the determination of B's attributes. Treas. Reg. § 1.1502-13(d)(2)(i)(B).

2. **Timing**. B continues to take corresponding items into account under its separate method of accounting. However, to the extent timing under this method is determined by an attribute of B that must be redetermined under the rules discussed above (Treas. Reg. § 1.1502-13(d)(2)), timing of the corresponding item may be affected. Treas. Reg. § 1.1502-13(d)(2)(ii).

D. Exception for Acquisition of Entire Group

1. As mentioned above, subgroup principles generally do not apply in determining whether S's intercompany items are accelerated. Thus, the sale of both S and B to a new consolidated group will accelerate S's intercompany items. However, Treas. Reg. § 1.1502-13(j)(5) provides that if (i) another consolidated group acquires the stock or assets of the former common parent, or (ii) the termination of the old group results from of a reverse acquisition described in Treas. Reg. § 1.1502-75(d)(2) or (3), then the surviving group is treated as the terminating group with respect to subsidiaries that remain members of the surviving group.

2. Treas. Reg. § 1.1502-13(j)(6) provides that if the P group terminates because the common parent is the sole remaining corporation, the common parent succeeds to the treatment of the terminating group.

EXAMPLE 18 -- Acquisition of entire group

Facts: S sells appreciated property to B in Year 1. B holds the property for investment. In Year 3, a nonmember, X, acquires all the stock of P.

Results: Absent an exception, S would be required to recognize the intercompany gain, because P, S, and B would be treated as joining a new group with X as the common parent. Under the exception of paragraph (j)(5), however, the event will not accelerate S's gain.

E. Acceleration Rule Examples

1. Acceleration rule's effect on timing

EXAMPLE 19 -- Deconsolidation (Timing)

Facts: S owns land with a basis of $70. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P sells 60% of S's stock to X, a nonmember, for $60. As a result of the sale, S becomes a nonmember.

Results: Under the matching rule, S's $30 intercompany gain is not taken into account in Years 1 through 3, because there is no difference between B's corresponding item and its recomputed item. Under the acceleration rule, S's $30 gain is taken into account immediately before the treatment of S and B as divisions of a single corporation becomes impossible by reason of S's deconsolidation. Thus, S takes the gain into account in Year 3 immediately before the event that causes this effect; i.e., the sale of the S stock. P's basis in the S stock is increased immediately before the sale of that stock under Treas. Reg. § 1.1502-32. B continues to take its corresponding items into account under its own separate accounting method. The same result would be reached if P had sold 60% of B's stock instead of S's stock (although, obviously, P's basis in the B stock would not be affected by gain recognized by S) or if the P group receives permission under Treas. Reg. § 1.1502-75(c) to cease to file a consolidated return. (The result is the same even if S's sale to B were an installment sale under § 453, because the recognition of S's gain must be determined under the intercompany transaction rules rather than other provisions. See Treas. Reg. § 1.1502-13(a)(3).)

EXAMPLE 20 -- Subgroup Deconsolidation (Timing)

Facts: S owns land with a basis of $70. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P sells all of the stock of S and B to X, a nonmember. As a result of the sale, S and B cease to be members of the P group and become members of the X group.

Results: Under the matching rule, S's $30 intercompany gain is not taken into account in Years 1 through 3, because there is no difference between B's corresponding item and its recomputed item. Under the acceleration rule, it might seem that the effect of treating S and B as divisions of a single corporation has not become impossible by reason of the deconsolidation of a subgroup. However, subgroup principles do not apply. See Treas. Reg. § 1.1502-13(d)(3), Ex. 1(g). Thus, the effect of treating S and B as divisions of a single corporation is impossible to achieve, because the item will not be reflected in the P group's

consolidated taxable income. See Treas. Reg. § 1.1502-13(d)(1)(i)(A). Recognition of S's intercompany gain is thus accelerated.

EXAMPLE 21 -- § 351 Exchange at a Gain (Timing)

Facts: In Year 1, S sells property to B that has a basis of zero and fair market value of $100, recognizing gain of $100. In Year 2, B transfers the land to X, a nonmember, in exchange for $100 worth of X stock, which constitutes one percent of X's stock outstanding immediately after the transaction. B recognizes no gain or loss, because the transaction is subject to § 351 (i.e., B is part of a control group for purposes of § 351). X is not eligible to join the group.

Results: No gain would be recognized by S under the matching rule. Under § 351, B's corresponding item is zero and the recomputed item is also zero. However, the acceleration rule requires S's $100 intercompany gain to be taken into account when the land is transferred to X by B, because a nonmember has reflected B's cost basis in the property. See Treas. Reg. § 1.1502-13(d)(1)(i)(B). The same result would obtain if B transferred the property to a partnership, rather than to a corporation, to the extent the partnership's basis in the property was determined under § 723. Under the successor rules, discussed later in this outline, B's new stock in X is treated as successor property. See Treas. Reg. § 1.1502-13(j)(1). Thus, the current rules could have elected to continue to apply the matching rule and determine the timing of S's recognition based on B's recognition of the indirect corresponding item associated with the X stock. Presumably, application of the acceleration rule in this context reflects a policy judgment that this would give taxpayers too much latitude to defer intercompany gain indefinitely by disposing of the intercompany property in nonrecognition transactions.

EXAMPLE 22 -- Transfer of Partnership Interest (Timing)

Facts: S owns a 20-percent profits and capital interest in a general partnership. S has a basis of zero in the partnership interest, and the fair market value of the interest is $100. S sells the interest to B for $100. An election under § 754 is in effect and B increases the basis in the underlying partnership assets by $100 to reflect its outside basis, under § 743(b).

Results: B's increase in the basis of the underlying assets will not be treated as a recognition event by B equivalent to the sale of the assets outside the group. S's gain is not accelerated, because the § 743(b) adjustment to B's basis is "solely with respect to B and therefore no nonmember reflects any part of the intercompany transaction." See Treas. Reg. § 1.1502-13(c)(7), Ex. 9(b). S's items and B's items are taken into account under the matching rule.

2. **Acceleration rule's effect on attributes**

EXAMPLE 23 -- Deconsolidation (Attributes)

Facts: S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to B for $100. B holds the land for sale to customers in the ordinary course and expends resources developing the land. On July 1 of Year 3, before B has sold any of the improved land, P sells 60% of S's stock to X, a nonmember, for $60. As a result of the sale, S becomes a nonmember.

Results: (1) **S's items**. Under the acceleration rule, the attributes of S's intercompany gain are redetermined under the principles of the matching rule. Because the intercompany transaction that gave rise to S's gain was a sale, exchange, or distribution, the general principles of the matching rule are applied as if B had resold the land for an amount equal to B's adjusted basis in the land. Because the property is not owned by a nonmember immediately after S's gain is taken into account, the sale is deemed to be to a nonmember affiliate. Thus, the character of the gain will be determined based on the activities of both S and B. See Treas. Reg. § 1.1502-13(d)(1)(ii).

(2) **B's items**. Because S and B no longer join in filing a consolidated return, the attributes of B's corresponding items are redetermined under the matching rule as if the hypothetical single entity had sold the S division to X, an unrelated nonmember, at the time of P's sale of S's stock. Thus, B continues to take into account S's activities before the intercompany transaction in determining the attributes of its corresponding items. (These rules apply solely to redetermine attributes and have no effect on timing, see Treas. Reg. § 1.1502-13(d)(2).) The results would be the same if P sold 60% of B's stock instead of S's stock.

EXAMPLE 24 -- Sale of Depreciable Property (Attributes)

Facts: S holds depreciable property with an adjusted basis of $70. The adjusted basis reflects prior depreciation of $30. On January 1 of Year 1, S sells the depreciable property to B for $110. (On a separate-entity basis, S would have $30 of § 1245 ordinary gain and $10 of § 1231 capital gain.) On January 1 of Year 2, P sells 60% of S, and S ceases to be a member of the P group.

Results: Under the acceleration rule, S is required to take its intercompany gain into account immediately before it becomes a nonmember of the P group. As discussed in the previous example, S's attributes are redetermined under the principles of the matching rule as if B sold the property to a nonmember affiliate. Accordingly, under § 1239, all of S's gain is redetermined to be ordinary gain, because under the

matching rule, the hypothetical single entity would not have any amount of § 1231 capital gain.

EXAMPLE 25 -- Intercompany Transaction Was Not A Sale, Exchange, or Distribution (Attributes)

Facts: During Year 1, S performs services for M, a member of the group, in exchange for $10 from M. M capitalizes the cost of these services under § 263 as part of M's cost to acquire real property from X, a nonmember. S incurs $8 of expense in connection with the performance of the services. M holds the real property for investment. On July 1 of Year 5, P sells all of S's stock to X, and S, therefore, becomes a nonmember.

Results: S has a net $2 intercompany income item determined by taking into account the related expenses. A single entity would have had a cost basis of $8 rather than $10. Under the acceleration rule, $2 of S's intercompany income is taken into account immediately before S leaves the group. Because the intercompany income is not from the sale, distribution, or exchange of property within the group, S's attributes are determined on a separate-entity basis. Therefore, S's intercompany gain is recognized in Year 5 as ordinary income.

3. **Other applications of the acceleration rule**

EXAMPLE 26 -- Installment Sale

Facts: S owns land with a basis of $70. On January 1 of Year 1, S sells the land to B for B's $110 note. The note bears interest equal to the applicable federal rate and provides for principal payments of $55 in Year 4 and $55 in Year 5. On July 1 of Year 3, S sells B's note to X for $110.

Results: The intercompany transactions rules trump § 453. S's sale of the B note does not result in S's intercompany gain being taken into account, for example, under § 453B. Rather, the timing of recognition of S's intercompany items continue to be taken into account using the matching rule or acceleration rule based on subsequent events such as B's sale of the land. Of course, if B had intercompany items with respect to the note, these items might be taken into account as a result of the sale of the note. As described below, other special rules apply to intercompany obligations. See Treas. Reg. § 1.1502-13(g).

EXAMPLE 27 -- Cancellation of Debt

Facts: S's sole asset is land held for investment with a basis of zero and value of $100. On January 1 of Year 1, S sells the land to B for $100. B also holds the land for investment. During Year 3, B becomes insolvent

and B's creditors agree to discharge $60 of the $100 debt that B owes them. The discharge of indebtedness is excluded from gross income under § 108 by reason of B's insolvency. However, B is required under §§ 108(b) and 1017 to reduce its basis in the land by $60.

Results: S has an intercompany gain of $100. B's insolvency does not give rise to any corresponding item or recomputed corresponding item, because B continues to own the land. However, because $60 of the potential corresponding gain is eliminated, the acceleration rule requires S to take into account $60 of its intercompany gain when B reduces its basis. Otherwise, this amount of S's intercompany gain would never be taken into account under the matching rule. See Treas. Reg. § 1.1502-13(d)(3), Ex. 4.

Analysis: This rule arguably reaches the wrong result if S and B are both insolvent. The sale generates basis that will be eliminated, at the cost of an intercompany gain that is taxed to S. If S and B were divisions of a single entity, the entity would be insolvent; i.e., it would exclude $60 of COD income and would have no attributes to reduce because inter-division transfers would not generate basis. (On the other hand, P's basis in S and B stock is increased under Treas. Reg. § 1.1502-32 when S takes the gain into account, although in light of the loss disallowance rules of Treas. Reg. § 1.1502-20, this is likely to be of limited consolation to the P group.) Cf. Treas. Reg. § 1.1502-13(d)(3), Ex. (4)(c) (clarifying that purchase price adjustments, which are excluded from gross income under generally applicable principles of § 108(e)(5), result in elimination of S's intercompany gain without recognition).

V. Simplifying Exceptions

A. Dollar-Value LIFO Inventory Methods

1. **General rule**. If S or B uses a dollar-value LIFO inventory method to account for its intercompany transactions, the current rules permit aggregation of individual intercompany transactions in applying the matching rule using one of the prescribed methods applied consistently. Treas. Reg. § 1.1502-13(e)(1)(i).

2. **B uses dollar-value LIFO**. If B uses dollar-value LIFO to account for its inventory purchases and includes all inventory costs in its costs of good sold for the year, then S may take all of its intercompany inventory items for that year into to account. If B includes less than all of its inventory costs in cost of goods sold, a percentage of S's net intercompany inventory income or loss is not taken into account. The percentage not taken into account is determined under the increment average method or the increment valuation method. Separate computations are made for each

pool of B that receives intercompany purchases from S. Treas. Reg. § 1.1502-13(e)(1)(ii).

3. **S uses dollar-value LIFO**. If S uses dollar-value LIFO inventory method, S can use any reasonable method of allocating its LIFO inventory costs to intercompany transactions. LIFO inventory costs include costs of prior layers if a decrement occurs. Treas. Reg. § 1.1502-13(e)(1)(iii).

4. **Other reasonable methods**. S or B can use other methods that will reasonably take into account intercompany items and corresponding items from intercompany inventory sales. However, if the other method results in amounts not taken into account by S that significantly exceed amounts that would not be taken into account under the prescribed methods, then S must take that excess into account. Treas. Reg. § 1.1502-13(e)(1)(iv).

B. **Reserve Accounting and Similar Items.** Special simplifying rules apply to additions to or reductions of reserves maintained by banks and thrifts or insurance companies. See Treas. Reg. § 1.1502-13(e)(2). These rules generally require the institution to account for such additions or reductions on a separate-entity basis, with the exception of intercompany reinsurance transactions.

C. **Consent to Treat Intercompany Transactions on a Separate-Entity Basis.** Treas. Reg. § 1.1502-13(e)(3) provides rules by which the common parent may request consent to take items into account on a separate-entity basis. Consent is not available for intercompany transactions with respect to member stock or member obligations. If such consent were granted under the old rules (and is in effect as of the first day of the first consolidated taxable year beginning on or after July 12, 1995), consent will generally be deemed to have been granted under the current rules. See Treas. Reg. § 1.1502-13(e)(3)(iv).

VI. Special Rules for Member Stock

A. **§ 301 Distributions.** Special rules apply to intercompany distributions to which § 301 applies. Treas. Reg. § 1.1502-13(f)(2).

1. **Distributee member**. The distributee member is not required to include the distribution in gross income to the extent there is a corresponding negative adjustment in its basis in the stock under Treas. Reg. § 1.1502-32. This includes negative adjustments giving rise to excess loss accounts ("ELAs") under Treas. Reg. § 1.1502-19. In other words, consistent with single-entity treatment, no distinction is made between a distribution that is a dividend and a distribution that is a return of capital. Both reduce basis in the stock of the subsidiary. To the extent the distribution is not excluded from the distributee's gross income under this rule, the rules of Treas. Reg. § 1.1502-26(b), regarding the application of the dividends-received deduction to distributions not excluded from gross income (such

as a distribution by common parent on its stock owned by a subsidiary), may apply. Treas. Reg. § 1.1502-13(f)(2)(ii).

2. **Distributing member**. The distributing member must apply the principles of § 311(b) to both its losses and gains from intercompany distributions of property. Thus, the distributing member's loss is recognized under the matching rule if the property is subsequently sold to a nonmember. § 311(a) continues to apply, however, to distributions to nonmembers. Treas. Reg. § 1.1502-13(f)(2)(iii).

3. **Entitlement rule**. For all federal income tax purposes, the entitlement rule applies to determine the time when a distribution is deemed to occur. Under the entitlement rule, a distribution is deemed to be received when the distributee becomes entitled to the distribution (generally on the record date) and not when the distribution is actually received. Treas. Reg. §§ 1.1502-13(f)(2)(i) and 1.1502-13(f)(2)(iv). If it is subsequently established that the distribution will not be made, the initial taking into account is reversed through appropriate adjustments. Adjustments must also be made to prevent the acceleration of the distribution to members from affecting distributions to any nonmember minority shareholders of the distributing corporation.

EXAMPLE 28 -- § 301 Distributions (Gain)

Facts: S owns land with a $70 basis and a $100 value. On January 1 of Year 1, P's basis in S's stock is $100. During Year 1, S declares and makes a dividend distribution of the land to P. Under § 311(b) S's gain is $30. Under § 301(d), P's basis in the land is $100. P is required to reduce its basis in S to zero. On July 1 of Year 3, P sells the land to X, a nonmember, for $110.

Results: S's distribution to P is an intercompany distribution. Treas. Reg. § 1.1502-13(b)(1)(i)(D). Therefore, under Treas. Reg. § 1.1502-13(f)(2)(ii), the $100 of dividend income is not taken into account by P but is excluded to the extent P reduces its basis in S under Treas. Reg. § 1.1502-32. Because the transaction is an intercompany distribution, with P treated as the buying member (B), S is required to take into account the difference between P's corresponding items and P's recomputed corresponding items pursuant to the matching rule. If P and S were divisions of a single corporation, the corporation would take a $40 gain into account in Year 3 when it sold the land. Thus, P's recomputed corresponding gain is $40. P's corresponding item in Year 3 is a $10 gain. S must take into account the difference of $30 in Year 3. Under Treas. Reg. § 1.1502-32, P's basis in S increases by $30 when S takes the deferred gain into account in Year 3.

EXAMPLE 29 -- § 301 Distributions (Loss)

Facts: S owns land with a $130 basis and a $100 value. On January 1 of Year 1, P's basis in S's stock is $100. During Year 1, S declares and makes a dividend distribution of the land to P. Under § 301(d), P's basis in the land is $100. P reduces its basis in S to zero under Treas. Reg. § 1.1502-32. On July 1 of Year 3, P sells the land to X, a nonmember, for $110.

Results: Under Treas. Reg. § 1.1502-13(f)(2)(ii) and (iii), the $100 of dividend income is not taken into account by P, and the principles of § 311(b) apply to S's loss from the intercompany distribution. S is required to take a $30 loss into account in Year 3, reflecting the difference between P's corresponding gain of $10 and its recomputed corresponding loss of $20. Under Treas. Reg. § 1.1502-32, P's basis in S's stock is reduced by the amount of the distribution to zero in Year 1 and from zero to an ELA of $30 in Year 3. This is consistent with single-entity treatment, because a hypothetical single entity would be entitled to a $30 loss on the sale to an unrelated third party. (However, any distribution to nonmembers is governed by § 311(a); i.e., S's loss is not recognized to the extent there are minority shareholders of S.) If P had distributed the land to its shareholders instead of selling it, P would have taken its $10 gain into account under § 311(a) and S would be required to recognize the $30 loss under the matching rule. However, $20 of S's loss would be recharacterized under the matching rule as a noncapital, nondeductible expense.

EXAMPLE 30 -- Entitlement Rule and § 301 Distributions

Facts: S owns land with a $70 basis and a $100 value. On January 1 of Year 1, P's basis in S's stock is $100. On January 1 of Year 1, S declares a dividend distribution of the land to P, but does not actually distribute the land. Before the distribution is made, S issues additional stock to the public on July 1 of Year 1 and becomes a nonmember.

Results: Under Treas. Reg. § 1.1502-13(f)(2)(i) and (iv), the determination of whether the distribution is an intercompany distribution is made under the entitlement rule of Treas. Reg. § 1.1502-13(f)(2)(iv). Because P is treated as receiving the distribution when P becomes entitled to the distribution, the distribution is deemed to occur on January 1 of Year 1. The distribution is thus excluded from P's gross income. S's $30 gain is intercompany gain, and recognition of the gain is accelerated when S deconsolidates. See Treas. Reg. § 1.1502-13(d). P has a net reduction in its basis in S stock of $70 (negative adjustment of $100 for the distribution, positive adjustment to reflect S's gain taken into account under the acceleration rule immediately before the deconsolidation). P is not required to include the dividend in gross income on a separate-entity

basis when it is actually received and is not entitled to the dividends-received deduction.

EXAMPLE 31 -- ELAs (Intercompany Distribution)

Facts: S owns 100% of T and has a $10 basis in T's stock. The T stock has a fair market value of $100. S has substantial E&P while T has $10 of E&P from preaffiliated years. On January 1 of Year 1, S declares and distributes a dividend to P consisting of all of T's stock. Under § 311(b), S has a $90 gain. Under § 301(d), P's basis in the T stock is $100 (its fair market value). During Year 3, T borrows $90 and declares and makes a $90 dividend to P (or T incurs operating losses of $90). P's basis in T's stock is reduced under Treas. Reg. § 1.1502-32 by $90, from $100 to $10. The $90 dividend is excluded from P's gross income under Treas. Reg. § 1.1502-13(f)(2). During Year 6, T has $5 of earnings that increase P's basis in T's stock from $10 to $15. In Year 9, T issues additional stock to X and becomes a nonmember.

Results: P's $100 of dividend income from S's distribution of T stock and $10 of dividend income from T's distribution of $90 are not included in income. Treas. Reg. § 1.1502-13(f)(2)(ii). If S and P were divisions of a single corporation, P would have succeeded to S's $10 basis in T's stock, and the $90 distribution and $5 positive basis adjustment would have resulted in a $75 ELA. This $75 ELA is the recomputed corresponding item. P has no corresponding item in Year 9. Therefore, S takes $75 of its $90 gain into account in Year 9, which reflects the difference between P's corresponding gain of zero and P's recomputed corresponding gain of $75. S's remaining $15 intercompany gain is taken into account based on subsequent events, for example, when P sells its T stock. S's gain is not accelerated in its entirety, because S and B (P in this case) remain members of the group. The deconsolidation of the intercompany asset is not an acceleration event. See Treas. Reg. § 1.1502-13(f)(7), Ex. 2(a), (b), and (c).

EXAMPLE 32 – ELAs (Intercompany Distribution)

Facts: S owns 100% of T and has a $10 basis in T's stock. The T stock has a fair market value of $100. S has substantial E&P while T has $10 of E&P from preaffiliated years. On January 1 of Year 1, S declares and distributes a dividend to P consisting of all of T's stock. Under §311(b), S has a $90 gain. Under §301(d), P's basis in the T stock is $100 (its fair market value). During Year 3, T borrows $90 and declares and makes a $90 dividend to P (or T incurs operating losses of $90). P's basis in T's stock is reduced under Treas. Reg. §1.1502-32 by $90, from $100 to $10. The $90 dividend is excluded from P's gross income. During Year 6, T has $5 of earnings that increase P's basis in T's stock from $10 to $15. In

Year 9, P sells 10% of T's stock to X for $1.50, but T remains a member of the P group.

Results: P's $100 of dividend income from S's distribution of T stock and $10 of dividend income from T's distribution of $90 are not included in income. Treas. Reg. §1.1502-13(f)(2)(ii). If S and P were divisions of a single corporation, P would have succeeded to S's $10 basis in T's stock, and the $90 distribution and $5 positive basis adjustment would have resulted in a $75 ELA. In Year 9, 10% of this $75 ELA would be taken into account by a single entity (plus the $1.50 sales proceeds); i.e., the recomputed corresponding gain is $9. P has no corresponding item in Year 9, because its basis in the T stock was equal to its value. Therefore, S takes $9 of its $90 gain into account in Year 9, which reflects the difference between P's corresponding gain of zero and P's recomputed corresponding gain of $9. S's remaining intercompany gain is taken into account based on subsequent events, for example when P sells the rest of its T stock.

EXAMPLE 33 -- ELAs (Intercompany Sale)

Facts: S owns 100% of T and has a $10 basis in T's stock. The T stock has a fair market value of $100. S has substantial E&P while T has $10 of E&P from preaffiliated years. On January 1 of Year 1, S sells all of its T stock to P for $100. Under § 1001, S has a $90 gain. P's basis in the T stock is $100. During Year 3, T borrows $90 and declares and makes a $90 dividend to P (or T incurs operating losses of $90). P's basis in T's stock is reduced under Treas. Reg. § 1.1502-32 by $90, from $100 to $10. The $90 dividend is excluded from P's gross income. During Year 6, T has $5 of earnings that increase P's basis in T's stock from $10 to $15. In Year 9, T issues additional stock to X and becomes a nonmember.

Results: P's $10 of dividend income from T's distribution of $90 is not included in income. Treas. Reg. § 1.1502-13(f)(2)(ii). If S and P were divisions of a single corporation, P would have succeeded to S's $10 basis in T's stock, and the $90 distribution and $5 positive basis adjustment would have resulted in a $75 ELA. This $75 ELA is the recomputed corresponding item. P has no corresponding item in Year 9. Therefore, S takes $75 of its $90 gain into account in Year 9, which reflects the difference between P's corresponding gain of zero and P's recomputed corresponding gain of $75. In other words, the timing and attributes are the same in the case of an intercompany sale to the parent corporation as they would be if S had distributed the stock to P. However, P's basis in S is $100 higher than it would otherwise have been. See Treas. Reg. § 1.1502-13(f)(7), Ex. 2(g).

B. Boot in Intercompany Reorganizations

1. **General rules for boot received in a tax-free reorganization or division**. Boot received in a reorganization otherwise qualifying as a tax-free transaction under § 354 or § 355 is usually taxed under § 356. Generally, § 356(a) taxes the boot to the extent of any gain that may be recognized in the transaction but otherwise preserves the tax-free treatment of the transaction. Under § 356(b) if the exchange has the effect of the payment of a dividend, the boot received is taxed as such to the extent of the distributing corporation's earnings and profits.

2. **Special rule for intercompany reorganizations**. The current rules provide a special rule whereby boot received as part of an intercompany reorganization is treated as received in a separate transaction. A reorganization qualifies as an intercompany reorganization only if no party to the reorganization becomes a member or nonmember as part of the plan of reorganization. Treas. Reg. § 1.1502-13(f)(3). For example, if S merges into a nonmember in a transaction otherwise described in § 368(a)(1)(A), the special rule does not apply. The special rule, if applicable, is deemed to apply for all federal income tax purposes.

3. **Timing of deemed separate transaction**. If the boot is treated as received in a transaction to which § 354 would otherwise apply, the boot is taken into account as if the deemed separate transaction had occurred immediately after the intercompany transaction. If the boot is treated as received in a transaction to which § 355 would otherwise apply, it is taken into account as if the deemed separate transaction had occurred immediately before the intercompany transaction. Treas. Reg. § 1.1502-13(f)(3)(ii).

EXAMPLE 34 -- Intercompany Reorganization

Facts: P forms S and B by contributing $200 to the capital of each. During Years 1 through 4, S and B each earn $50. Thus, under Treas. Reg. § 1.1502-32, P adjusts its stock basis in each to $250. On January 1 of Year 5, the fair market value of S's assets and stock is $500. S merges into B in an otherwise tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of $350 and $150 in cash.

Results: Under Treas. Reg. § 1.1502-13(f)(3), the reorganization is an intercompany reorganization, and the boot received in the reorganization is treated as received in a separate transaction immediately after the intercompany reorganization. Thus, P is deemed to receive B stock worth $500 with a basis under § 358 of $250. Immediately after the intercompany merger, $150 of the stock is treated as redeemed, giving rise to a distribution to which § 301 applies under § 302(d). Because the boot

is treated as received in a separate transaction, § 356 does not apply and no basis adjustments are required under § 358(a)(1)(A) or (B). Under § 381(c)(2), B is treated as receiving S's E&P. Accordingly, $100 of the deemed redemption is a dividend under § 301. Thus, under Treas. Reg. § 1.1502-32, P's basis in the B stock received in the reorganization is reduced by $100 to reflect the deemed dividend and again by the remaining $50 reflecting a return of capital. The portion treated as dividend income is excluded from P's gross income under Treas. Reg. § 1.1502-13(f)(2)(ii). (Note that if B had distributed depreciated property instead of cash, the depreciated property would also be treated as having been received in a separate transaction. The effect on P would be the same, but B would have an intercompany loss that is deferred and taken into account under the matching and acceleration rules based on subsequent events.)

EXAMPLE 35 -- Divisive Reorganization

Facts: Pursuant to a plan, S distributes the stock of a wholly owned lower tier subsidiary, T, to P in a spin-off transaction to which § 355 applies, along with $150 in cash.

Results: The distribution of T stock is an intercompany reorganization under Treas. Reg. § 1.1502-13(f)(3). P is treated as receiving the $150 in cash immediately before the stock distribution as a distribution to which § 301 applies. P reduces its basis in S stock by the amount of the distribution under Treas. Reg. § 1.1502-32 at that time. § 356(b) does not apply. No basis adjustments are required under § 358(a)(1)(A) or (B). Because P's basis in S is adjusted immediately before the spin-off, the basis allocated to the T stock reflects this adjustment.

C. **Acquisition by Issuer of its Own Stock.** If an issuer acquires its own stock (or an option to buy or sell its own stock) in an intercompany transaction, the member's basis is eliminated, and the elimination is taken into account for purposes of applying the current rules. Note that such an eliminated amount may be a corresponding item of the member. For example, if B acquires its own stock, S's intercompany items with respect to its B stock are taken into account unless nonrecognition rules apply. Treas. Reg. § 1.1502-13(f)(4).

EXAMPLE 36 -- Stock Redemptions

Facts: Before becoming a member of the P group, S owned P stock with a basis of $30. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, P redeems the P stock held by S for $100 in a transaction to which § 302(a) applies.

Results: Under Treas. Reg. § 1.1502-13(f)(4), the receipt of its own stock results in the elimination of P's basis in the stock. Therefore, S's $70 gain

will never be taken into account under the matching rule. As a result, the acceleration rules require S to take the gain into account in Year 3. Under Treas. Reg. § 1.1502-13(d)(1)(ii), S's attributes are redetermined as if P sold the property to a nonmember affiliate. Although P's corresponding items are eliminated under § 1032, S's gain cannot be excluded from gross income. See Treas. Reg. § 1.1502-13(c)(6)(ii). Therefore, S's gain is taken into account as a capital gain, because this would be the result if P sold its stock to an affiliated nonmember. (Query the logic of this last conclusion. Issuance of stock by single entity to third party sounds capital in nature, but since it never results in gain or loss how do you know?)

EXAMPLE 37 -- Stock Distribution

Facts: Before becoming a member of the P group, S owned P stock with a basis of $30. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, S distributes the P stock it holds to P in a transaction to which § 301 applies. Under § 311(b), S has a $70 gain.

Results: Under Treas. Reg. § 1.1502-13(f)(4), P's basis in the P stock acquired from S is treated as eliminated. Therefore, S is required to take $70 of intercompany gain into account in Year 3. In other words, the results are generally the same whether P receives its own stock as a dividend or by redemption or repurchase. Obviously, however, P's basis in S will be higher if it pays for the stock it receives.

EXAMPLE 38 -- Loss Stock

Facts: Before becoming a member of the P group, S owned P stock with a basis of $130. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, P redeems the P stock held by S for $100 in a transaction to which § 302(a) applies. Under § 302(a), S has a $30 loss.

Results: As in the examples above, P's basis is eliminated. Treas. Reg. § 1.1502-13(c)(6) does not apply to limit the exclusion of intercompany losses. Thus, it does not prevent recharacterization of loss as a noncapital, nondeductible expense. Accordingly, S's loss is taken into account in Year 3 under the acceleration rule as described above, but is treated as a noncapital, nondeductible amount.

D. Relief for Certain Liquidations and Distributions.

1. Netting permitted in some circumstances

a. **In general**. The combination of the matching or acceleration rules and the limits on exclusion of gain may be unduly harsh in some circumstances. Accordingly, relief may be elected in certain circumstances to avoid recognizing S's intercompany gain.

b. **Example of the problem**. For example, if S sells all of its stock in T (a lower tier member) to B, and has blocks of both appreciated and depreciated stock, S realizes intercompany gains and losses. If T subsequently liquidates into B, in a transaction described in § 332, the elimination of B's basis in T requires S to take its gain and loss into account under the matching rule. Note that the T assets received in the liquidation are not successor assets under Treas. Reg. § 1.1502-13(j), because they do not reflect B's basis in the T stock. Because B does not take anything into account on its elimination of the basis, under the general matching rule principles, S's gain and loss should be redetermined to be excluded from gross income. However, under Treas. Reg. § 1.1502-13(c)(6), S's gain cannot be excluded. Moreover, the loss is redetermined to be a noncapital, nondeductible expense. Thus, S realizes gain on the gain stock but gets to take no loss into account on the loss stock.

c. **Netting permitted**. Netting of gain and loss is permitted in these circumstances. The current rules provide that, if S has both intercompany gain and intercompany loss with respect to stock of the same corporation having the same material terms, only the income or gain in excess of the deduction or loss is taken into account. Treas. Reg. § 1.1502-13(f)(5)(i). This rule only applies in a transaction in which B's basis in T is permanently eliminated under § 332 or in a comparable nonrecognition transaction such as:

(i) A merger of B into T under § 368(a);

(ii) A distribution by B of its T stock in a transaction described in § 355; or

(iii) A deemed liquidation of T resulting from an election under § 338(h)(10).

2. **Elective relief in some circumstances**

a. **In general**. Under the current rules, S's intercompany items from an intercompany transfer to B of stock of another member, T, may be taken into account in certain circumstances, even if T stock is never held by a nonmember after the intercompany transaction. For example, if S sells all of T's stock to B at a gain, and T liquidates into B in a § 332 transaction, S's gain would be taken into account. Treas. Reg. § 1.1502-13(c)(6) prevents S from redetermining the intercompany gain to be excluded from gross income. Apparently, the government is concerned that without this rule taxpayers would use nonrecognition transactions to shift the location of gain, which is one aspect of intercompany transactions

that is not intended to be applied on a single-entity basis. See Preamble to the current rules, 60 Fed. Reg. at 36,675-76.

b. **Elective relief provided**. The current rules provide elective relief for certain nonrecognition transactions that will prevent S's intercompany gain being taken into account. If the transaction is eligible for relief and the group makes the election, S's items may be recharacterized so that they are not taken into account or to offset those items. The election is only available if, throughout the period beginning with S's transfer of the T stock and ending with completion of the nonrecognition transaction, T remains a member. The exact nature of the relief depends on the nature of the liquidation or comparable transaction.

c. **Relief in the case of § 332 transaction**

(i) **In general**. If § 332 applies to T's liquidation into B, and B transfers T's assets to a new member (New T) the transfer will be treated as pursuant to the same plan for purposes of the intercompany transaction rules, even if it would not otherwise be treated as pursuant to the same plan by the relevant provisions of the tax law. If the transaction qualifies as a reorganization described in § 368(a), B's stock in New T will be a successor asset. Accordingly, S will not be required to take its intercompany items into account as a result of the liquidation of Old T. See Treas. Reg. § 1.1502-13(f)(5)(ii)(B).

(ii) **Time limitations**. The transfer to new T must be made within the 12-month period immediately following the timely filing (including extensions) of the tax return for the year of the liquidation. The transfer to New T must be pursuant to a written plan, a copy of which must be attached to the same return.

(iii) **Appropriate adjustments**. Appropriate adjustments must be made for any assets of Old T not transferred to New T as part of the plan. For example, if B retains an asset received in the liquidation of Old T, the asset is treated as transferred to New T as part of the plan, but distributed to B immediately after the reorganization.

(iv) **Downstream mergers**. The same principles that apply to a liquidation of T into B apply, with appropriate adjustments, to a downstream merger of B into T. For example, if after S sells T stock to B, B is merged into T in a transaction described in § 368(a), S will not recognize its intercompany

items with respect to the sale of T stock to the extent T (as successor to B) forms New T with substantially all of Old T's assets. Treas. Reg. § 1.1502-13(f)(5)(ii)(B)(3). The merger is not comparable to a § 332 liquidation, however, if any B stock is owned by a nonmember immediately before the merger or any new B stock is owned by nonmembers.

EXAMPLE 39 -- Intercompany Stock Sale Followed by § 332 Liquidation

Facts: S owns all of the stock of T with a basis of $70 and a $100 value. T's assets have a basis of $10 and a value of $100. On January 1 of Year 1, S sells all of T's stock to B for $100. On July 1 of Year 3, T distributes all of its assets to B in an unrelated complete liquidation to which § 332 applies.

Results (with no election): B's unrecognized gain or loss under § 332 is a corresponding item for purposes of applying the matching rule. Treas. Reg. § 1.1502-13(b)(3)(ii). Under the matching rule, S takes into account the difference between B's corresponding item and the recomputed unrecognized corresponding gain of zero in Year 3. The attributes of S's gain and B's corresponding item are redetermined as if they were divisions of a single corporation. Therefore, $30 of S's gain is taken into account in Year 3. Because B's corresponding item is not a deduction or loss disallowed under the Code or regulations, Treas. Reg. § 1.1502-13(c)(6) does not permit S to exclude this gain. If S's intercompany item had been a loss rather than a gain, however, (c)(6) would not apply, and S would recognize the loss but would redetermine the attributes of the loss to treat the loss as a noncapital, nondeductible amount.

Results (with elective relief): If the election is made under (f)(5)(ii), and B transfers former T's assets to New T within 12 months of the timely filing of the group's return for the year of liquidation, the transfer will be deemed to be pursuant to the same plan as the liquidation. This will generally result in the entire transaction being treated as a reorganization with New T treated as the successor of Old T. Because B's stock in New T will be a successor asset, the acceleration rule is not triggered and S continues to take its items into account based on subsequent events under the matching rule.

d. **Relief in the case of § 338(h)(10) transaction**

(i) **Special relief if election is not made**. Somewhat different rules apply to a deemed § 332 liquidation of T into B as a result of an election under § 338(h)(10) or a "comparable transaction." See Treas. Reg. § 1.1502-13(f)(5)(ii)(C). The

rules do not apply, however, if the election under (f)(5)(ii)(B) is made with respect to the § 332 liquidation.

(ii) **Deemed § 331 liquidation**. Under Treas. Reg. § 1.1502-13(f)(5)(ii)(C), B is treated as recognizing, as a corresponding item with respect to each share of its T stock, any loss or deduction it would recognize (after application of the basis adjustment rules of Treas. Reg. § 1.1502-32) as if § 331 applied to the deemed liquidation. The recharacterization of the transaction as a § 331 liquidation applies only for this purpose. In effect, this rule generally enables the group to take an offsetting loss with respect to S's intercompany gain.

(iii) **Limitation on loss recognized**. The amount of loss permitted to be recognized with respect to T stock is limited: (i) the aggregate amount of loss recognized with respect to the T stock under this rule cannot exceed S's gain with respect to the same stock (after application of the (f)(5)(i) netting rule); (ii) the aggregate amount of loss recognized under this rule from T's deemed liquidation cannot exceed the net amount of deduction or loss (if any) that would be taken into account from the deemed liquidation if § 331 applied with respect to all of T's shares.

EXAMPLE 40 -- 338(h)(10) Election

Facts: S owns T stock with a basis of zero. T has assets with a value of $100 and a basis of zero. S sells all the stock of T to B for $100 in Year 1, recognizing $100 of gain. In Year 2, B sells the T stock to X, a nonmember, for $110. X and P make an election under § 338(h)(10) causing T to recognize gain on a deemed asset sale of $110, followed by a deemed liquidation of T into B.

Results: The general rules would treat T as having liquidated into B under § 332, eliminating B's basis in the T stock and triggering S's deferred gain. In effect, the $100 gain is taxed twice, once under the intercompany transaction rules and again under the § 338 rules. Under the current rules, the P group may elect to treat the deemed liquidation of T into B as one that does not qualify under § 332. The deemed liquidation will, therefore, be governed by § 331.

B's basis in the T stock will be increased by $110 to reflect the gain on the deemed asset sale under the investment basis adjustment rules of Treas. Reg. § 1.1502-32. This increases B's basis to $210. B will then treated as receiving the $110 in the deemed liquidation of T into B. The receipt of $110 in redemption of stock with a basis of $210 gives rise to loss of

$100, which will be recognized under § 331. Thus, B has a corresponding loss of $100. The recomputed item is zero. Therefore, S must take $100 of gain into account in Year 3, but it will be offset by B's loss. Thus, the P group will be taxed once on $110 of gain on the T assets, which is consistent with the treatment of a single entity making a § 338(h)(10) election.

e. **Relief in the case of a § 355 transaction**. If S sells its T stock to B, recognizing intercompany gain, and B distributes the T stock to P in a § 355 transaction, P would normally be required under § 358 to allocate its basis in B stock between its B and T stock, eliminating T's stock basis and potentially triggering the recognition of S's items. Treas. Reg. § 1.1502-13(f)(5)(ii)(D) permits the group to treat the distribution as subject to § 301 or 311 rather than § 355. The application of this election requires B to take gain or loss from the distribution into account but permits S to defer recognition of its items to the extent permitted under the matching rule.

EXAMPLE 41 -- § 355 Transaction With Nonmembers

Facts: S owns stock of T with a $70 basis and a $100 value. On January 1 of Year 1, S sells its T stock to M, a member of the group, for $100, recognizing $30 of intercompany gain. In Year 3, M distributes the T stock to its nonmember shareholders in a transaction to which § 355 applies. At that time, the fair market value of the T stock is $150.

Results: M's $50 gain not recognized under § 355 is a corresponding item. The recomputed corresponding item would be an $80 gain not recognized. Therefore, S is required to take into account its $30 gain in Year 3. Because § 355 does not permanently and explicitly disallow a loss of M, paragraph (c)(6) of the current rules limits the exclusion of S's gain that would otherwise be required under the matching rule when S redetermines its attributes. Elective relief is not available, because M's distribution is not an intercompany distribution.

EXAMPLE 42 -- § 355 Transaction Within the Group

Facts: S owns stock of T with a $70 basis and a $100 value. On January 1 of Year 1, S sells its T stock to M, a member of the group, for $100, recognizing $30 of intercompany gain. In Year 3, M distributes the T stock to B, a member of the group, in a transaction to which § 355 applies. At that time, the fair market value of the T stock is $150. B takes a $75 basis in the T stock under § 358.

Results (without elective relief): M's $50 gain not recognized under § 355 is a corresponding item. However, because B takes, in part, a

carryover basis in the T stock, B is a successor to M. Therefore, both M and B's corresponding items could cause S to take its items into account. Generally, taking S's items into account under the matching rule based on B's corresponding items will achieve the effect most consistent with single entity theory and is, therefore, required under paragraphs (j)(3) and (j)(4) of Treas. Reg. § 1.1502-13. However, because there is only a $5 difference between B's basis in the T stock ($75) and the basis the stock would have had if S, B, and M were divisions of a single corporation ($70), only $5 of S's intercompany gain can be taken into account under the matching rule based on subsequent events affecting B's T stock. The remaining intercompany gain must be taken into account in Year 3 to reflect M's corresponding item of excluded gain, and may not be redetermined as excluded under paragraph (c)(6).

Results (with elective relief): If the distribution of the T stock to B is treated as a dividend pursuant to the election under (f)(5)(ii)(D), M has a $50 gain with respect to the distribution that is deferred rather than excluded. S and M take their gain into account based on subsequent events with respect to the T stock held by B. (No amount is taken into account in Year 3). See generally Treas. Reg. § 1.1502-13(j)(4) (special operating rules for successive intercompany transactions).

E. Transactions Involving Common Parent

1. **Treatment of member stock under the current rules**. The current rules, like the temporary and proposed rules, generally apply separate-entity principles to member stock insofar as they treat member stock as an asset separate from the member's underlying assets. Gain or loss is taken into account with respect to intercompany transactions in member stock under the matching and acceleration rules as it is for any other asset.

2. **Treasury approach to member stock transactions**. The government is studying whether an extension of single-entity treatment to member stock is feasible or appropriate. However, the government has expressed concern that the current separate-entity treatment of member stock provides taxpayers with an opportunity to manipulate the current rules to their advantage. See Preamble to the temporary rules, 60 Fed. Reg. 36,669-70.

EXAMPLE 43 -- Circular Ownership of Stock in Common Parent

Facts: In Year 1, P sells stock to S for $10 per share. Under § 1032, the transaction gives rise to no gain or loss to P. In Year 2, when P raises new capital, if the P stock has depreciated since Year 1, P will cause S to sell its P stock at a loss.

<u>Results</u>: S's loss on the P stock will not generally be subject to disallowance under Treas. Reg. § 1.1502-20, which applies to loss on the sale or deconsolidation of stock in subsidiaries. P is not a subsidiary of S. <u>See</u> Treas. Reg. § 1.1502-1(c). If P's stock had appreciated, S would realizes a gain if it sold the stock. However, P can instead choose to issue new stock, which gives rise to no gain or loss to the P group. The government views this as creating opportunities for taxpayers to game the system.

3. **Justification of the government's approach**. It is not clear that the transaction itself is inherently objectionable. Corporations can take advantage of such selective use of § 1032 to generate losses in the separate-entity context as well. (This is merely the flip-side of the "zero basis" problem. If a subsidiary receives parent stock to use as consideration in a transaction intended to qualify as a tax-free reorganization, the subsidiary will be taxed on any gain on the parent stock if the transaction fails to qualify for tax-free treatment.) The principle difference in the single-entity context is that S's losses would not generally be available to offset P's gains (absent, for example, a § 332 liquidation of S into P). However, this appears to be a concern with the <u>extent</u> of the tax benefit, rather than the fact that gaming of the system is arguably possible.

4. **Rules applied to transactions in P stock**

   a. **In general**. The current rules are applicable only to transactions in P stock. They generally disallow permanently any loss recognized with respect to P stock held by a member under rules analogous to those in Treas. Reg. § 1.1502-20. <u>See</u> Treas. Reg. § 1.1502-13(f)(6). The rules are effective for gain or loss taken into account, and transactions occurring, on or after July 12, 1995.[4]

   b. **Applicability**. The current rules of (f)(6) apply to P stock and positions in P stock, such as options to purchase or sell P stock. <u>See</u> Treas. Reg. § 1.1502-13(f)(6)(iv). For this purpose, P stock includes stock in the current common parent held by a member, and stock issued by a member that was formerly the common parent if the stock was held by another member at the time the issuer was the common parent. Treas. Reg. § 1.1502-13(f)(6). The current rules do not, however, apply to dealers in P stock or positions in P stock. Treas. Reg. § 1.1502-13(f)(6)(iii).

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[4] However, for gain or loss taken into account, or transactions occurring, during a tax year ending prior to December 31, 1995, the taxpayer may treat the transaction under Temp. Treas. Reg. 1.1502-13T(f)(6). Treas. Reg. § 1.1502-13(f)(6)(v).

c. **Elimination of loss on P stock**

(i) **Loss stock disallowance**. In any case in which loss is recognized by a member with respect to P stock, the loss is permanently disallowed and does not reduce earnings and profits. Under Treas. Reg. § 1.1502-32(b)(3)(iii)(A), the basis of that member's stock will be reduced to reflect the noncapital, nondeductible amount. See Treas. Reg. § 1.1502-13(f)(6)(i)(A).

(ii) **Basis reduction**. The current rules also provide that, to the extent the preceding rule will not apply (i.e., loss is not recognized), a member must reduce its basis in P stock to its fair market value immediately before the P stock is owned by a nonmember. See Treas. Reg. § 1.1502-13(f)(6)(i)(B). For example, if M ceases to be a member of the P group, or M contributes the P stock to a nonmember in a § 351 transaction, the basis of the P stock must be reduced to its fair market value immediately before such a deconsolidation contribution. This rule is analogous in most respects to the basis reduction rule of Treas. Reg. § 1.1502-20(b).

(iii) **Waiver of built-in loss**. The current rules further provide that if a nonmember that owns P stock with a built-in loss becomes a member of the P consolidated group in a qualifying cost basis transaction (i.e., a transaction in which basis is determined under § 1012), the P group may elect to waive the built-in loss. This is accomplished by reducing the basis of the P stock to its fair market value immediately before the nonmember becomes a member. Teas. Reg. § 1.1502-13(f)(6)(i)(C). This rule was added in the final regulations to address the concern that the basis adjustments rules of Treas. Reg. § 1.1502-32 could result in artificial gain when the joining member subsequently sells the built-in loss stock. See Preamble to current rules, 61 Fed. Reg. at 10,448.

d. **Elimination of gain on P stock**

(i) **Qualified disposition of P stock recharacterized**. If M disposes of P stock in a qualified disposition, M is treated as purchasing the P stock from P for its fair market value immediately before the qualified disposition with cash contributed by P (via any intermediate members). See Treas. Reg. § 1.1502-13(f)(6)(ii). In effect, the gain is relocated to P where it is eliminated under § 1032.

(ii) **Definition of qualified disposition**. Only certain transactions qualify as "qualified dispositions." In effect, the rules eliminate the "zero basis" problem as compensation for applying loss disallowance. However, the rules do not come close to providing symmetrical elimination of gain and loss on P stock held by members. To be a qualified disposition:

(a) The member must have acquired the P stock directly from P as a contribution to capital (including through any intermediate members in a series of transactions);

(b) Pursuant to a plan, the member must transfer the stock to a nonmember (not related to any member of the P group within the meaning of § 267(b) or 707(b));

(c) No nonmember may receive a substituted basis in the P stock within the meaning of § 7701(a)(42);

(d) The P stock may not be exchanged for other P stock; and

(e) Neither P nor M may become or cease to be a member as part of, or in contemplation of, the plan. See Treas. Reg. § 1.1502-13(f)(6)(ii).

(iii) **Effect of Treas. Reg. § 1.1032-3**. The rules governing the elimination of gain on P stock were supplanted by Treas. Reg. § 1.1032-3. As a result, Treas. Reg. § 1.1502-13(f)(6)(ii) (and the last sentence of Treas. Reg. § 1.1502-13(f)(6)(iv)(A)) no longer apply to dispositions on or after May 16, 2000.

VII. Special Rules for Member Obligations

A. Definition of an Obligation

1. **In general**. For purposes of the special rules for member obligations, an obligation is any obligation that constitutes indebtedness under the applicable principles of the federal income tax laws. Treas. Reg. § 1.1502-13(g)(2)(i)(A).

2. **Does not include executory contracts**. For this purpose, the definition of an obligation does not include an executory obligation to purchase or provide goods or services. Treas. Reg. § 1.1502-13(g)(2)(i)(A).

3. **§ 475 securities**. An obligation includes a security described in § 475(c)(2)(D) or (E), or any comparable security with respect to commodities, unless the security is a position with respect to member stock. Treas. Reg. § 1.1502-13(g)(2)(i)(B); see also Treas. Reg. § 1.1502-13(f)(4) and (f)(6) (providing rules regarding positions with respect to member stock).

4. **Definition of an intercompany obligation**. An intercompany obligation is an obligation between members, but only for the period during which both parties are members. Treas. Reg. § 1.1502-13(g)(2)(ii).

B. Deemed Satisfaction and Reissuance of Intercompany Obligations Leaving The Group

1. **Current rules in general**. To achieve single-entity treatment, the sale of an obligation outside the group is recharacterized under the current rules. First, the obligation is deemed to be satisfied for the amount of the sales price immediately prior to the sale. This gives rise to intercompany and corresponding items that are taken into account under the matching and acceleration rules. Then the obligation is treated as a new obligation issued by the debtor to the nonmember for the sales price. Treas. Reg. § 1.1502-13(g)(3)(ii)(A), (iii). In effect, the obligation is treated as newly issued to the nonmember for purposes of determining original issue discount ("OID"). These principles are similar to those found in § 108(e)(5). If the obligation leaves the group because a debtor or creditor member leaves the group, the obligation is treated as satisfied immediately before the member leaves the group for an amount equal to its fair market value. Then the debtor is deemed to issue a new obligation for the identical amount. Treas. Reg. § 1.1502-13(g)(3)(ii)(A), (iii).

2. **Prior law**. If S were an intercompany creditor (i.e., held an intercompany obligation) and sold the intercompany obligation outside the group, prior law respected the initial issuance of the obligation to S. The sale outside the group, if made at a discount, would be treated as giving rise to market discount -- not OID -- to the holder and would not generally have required the nonmember holder to accrue OID currently. This result was inconsistent with single-entity treatment, because the issuance of an obligation between divisions of a single entity would not be treated as the original issue of the obligation. See Prior Treas. Reg. § 1.1502-14(d).

3. **Application of deemed satisfaction and reissuance rule**. If a member realizes any amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of an intercompany obligation, the obligation is treated for all federal income tax purposes as satisfied and, if the obligation remains outstanding, reissued. Similar principles apply if a member realizes any amount, directly or indirectly, from a comparable transaction such as marking the

obligation to market or taking a bad debt deduction, or if an intercompany obligation becomes an obligation that is not an intercompany obligation (e.g., the debtor or creditor member leaves the group). Treas. Reg. § 1.1502-13(g)(3)(i)(A).

a. **Exceptions**. The foregoing rules do not apply in every instance. There are four basic exceptions to the deemed satisfaction and reissuance rule. Under Treas. Reg. § 1.1502-13(g)(3)(i)(B), the rule does not apply if:

(i) The obligation became an intercompany obligation by reason of an event described in § 1.108-2(e) (which generally provides exceptions to the rule that if a related person acquires an issuer's obligation, the debtor is deemed to have acquired its own obligation and realizes any COD income with respect to that obligation). Exceptions under Treas. Reg. § 1.108-2(e) include (1) the obligation has a remaining maturity of less than one year and is, in fact, retired within one year of being acquired, or (2) the obligation is acquired by an unrelated party in the ordinary course of its business as a securities dealer.

(ii) The amount realized is from reserve accounting under § 585 (reserves for losses on loans of banks) or 593 (reserves for losses of loans of thrifts). Special rules are provided in paragraph (g)(3)(iv) for such transactions.

(iii) The amount realized is from the conversion of an obligation into the stock of the debtor.

(iv) Treating the obligation as satisfied and reissued will not have a significant effect on any person's federal income tax liability for any year.

b. **Deemed Satisfaction**

(i) **General rule**. If a creditor member sells an intercompany debt for cash, the debt is treated as satisfied for the cash by the debtor member immediately before the sale. If the creditor member sells the debt for property, the debt is treated as satisfied for an amount equal to the issue price of a new note, with identical terms, issued for the property. If the rule applies because one of the parties to the intercompany obligation becomes a nonmember, the intercompany debt is treated as satisfied for an amount of cash equal to fair market value of the debt immediately before the deconsolidation. Similar principles apply to

intercompany obligations other than debt. Treas. Reg. § 1.1502-13(g)(3)(ii)(A).

(ii) **Timing and attributes**. For purposes of applying the matching and acceleration rules, Treas. Reg. § 1.1502-13(c)(6)(ii) does not apply in this context; i.e., no member will be limited in excluding gain as required by the matching or acceleration rules. Gain or loss from an intercompany obligation also is not subject to § 108(a), § 354, or § 1091. Treas. Reg. § 1.1502-13(g)(3)(ii)(B).

c. **Deemed Reissuance**. If a creditor member sells an intercompany debt for cash or property, and the debt remains outstanding, the debt is treated as reissued immediately after the transaction for the cash or the property. If the rule applies because one of the parties to the intercompany obligation becomes a nonmember, the debt is treated as reissued immediately after the transaction for an amount of cash equal to its fair market value. Similar principles apply to intercompany obligations other than debt. Treas. Reg. § 1.1502-13(g)(3)(iii).

d. **Special rule for certain bad debt reserves**. A member's deduction under § 585 or § 593 for an addition to its bad debt reserve with respect to an intercompany loan is not taken into account under these rules until the intercompany obligation ceases to be an intercompany obligation, or if earlier, the obligation is canceled or redeemed.

EXAMPLE 44 -- Intercompany Obligations

Facts: On January 1 of Year 1, B borrows $100 from S in return for B's note, which promises to repay $100 at the end of Year 20 and bears coupon interest at the market rate of 10 percent. Alternatively, B issues a zero coupon note to S at a discount.

Results: Each accrual of interest on the note is a separate transaction. See Treas. Reg. § 1.1502-13(b)(iii). Notwithstanding their separate-entity accounting treatment, S and B are required under the matching rule to take their income and deduction into account symmetrically, because the accrual of interest on the note is a corresponding item and the recomputed interest income between divisions of a single entity would be zero. The same principles apply to B's deduction of interest under § 163(e) in the case of accrued OID.

EXAMPLE 45 -- Intercompany Obligation Becomes a Non-intercompany Obligation--Sale of Obligation

Facts: On January 1 of Year 1, B borrows $100 from S in return for B's note, which promises to repay $100 at the end of Year 5 and bears coupon interest at an annual rate of 10 percent. In Year 3, S sells the note to X, a nonmember, for $70, its current fair market value.

Results: Under Treas. Reg. § 1.1502-13(g)(3), the debt is treated as satisfied by B immediately before the intercompany obligation leaves the group for an amount equal to the cash S receives ($70). B is, therefore, required to recognize $30 of discharge of indebtedness income under § 61(a)(12). S would ordinarily have an offsetting $30 capital loss under § 1271(a)(1), but it is treated as an ordinary loss under the matching rule to conform with the character of B's ordinary income. See Treas. Reg. § 1.1502-13(c)(4)(i). B is treated as issuing to X a new note (with a new holding period) with a $70 issue price and a $100 stated redemption price at maturity immediately after the note is sold. The new note deemed to be reissued, therefore, has OID, which will be taken into account by B and X under §§ 163(e) and 1272.

EXAMPLE 46 -- Intercompany Obligation Becomes a Non-intercompany Obligation--Creditor Deconsolidation

Facts: On January 1 of Year 1, B borrows $100 from S in return for B's note, which promises to repay $100 at the end of Year 20 and bears coupon interest at an annual rate of 10 percent. B fully performs in Years 1 through 3. In Year 3, S issues stock, which results in S becoming a nonmember. At the time S becomes a nonmember, the intercompany debt is worth only $70 because of a rise in prevailing market interest rates.

Results: Under Treas. Reg. § 1.1502-13(g)(3), the note is treated as satisfied by B immediately before S becomes a nonmember for an amount equal to the fair market value of the note. B is treated as issuing a new note to S immediately after S becomes a nonmember for its fair market value. B must, therefore, recognize discharge of indebtedness income in the amount of $30. The acceleration rule requires S's offsetting intercompany loss to be recharacterized as an ordinary loss. The new note deemed to be issued to S has $30 of OID. (The same results would be reached if B rather than S were deconsolidated.)

C. **Deemed Satisfaction and Reissuance of Obligations Becoming Intercompany Obligations**

1. **In general**. If an obligation that is not an intercompany obligation becomes an intercompany obligation, for example because the holder of

debt issued by a member joins the group, similar rules apply. Treas. Reg. § 1.1502-13(g)(4).

2. **Exceptions for certain obligations becoming intercompany obligations**. Under Treas. Reg. § 1.1502-13(g)(4)(i)(B), the deemed satisfaction and reissuance rule does not apply if:

   a. The obligation becomes an intercompany obligation by reason of a transaction to which Treas. Reg. § 1.108-2(e) applies.

   b. Treating the obligation as satisfied and reissued will not have a significant effect on any person's federal income tax liability. For this purpose, all obligations issued as part of the same transaction or related transactions are treated as one obligation. This exception does not apply if the aggregate effect of the exception for all obligations in a year would be significant.

3. **Debt obligations**. If the obligation is a debt, § 108(e)(4) does not apply to treat the debt as acquired by the debtor. The debt is deemed to be satisfied immediately after it becomes an intercompany debt, and a new debt is deemed issued to the holder in an amount determined under the principles of Treas. Reg. § 1.108-2(f). All attributes from the deemed satisfaction are determined on a separate-entity basis, and any intercompany gain or loss taken into account is not subject to § 354 or § 1091. Solely for purposes of Treas. Reg. § 1.1502-32(b)(4), any loss recognized as a result of the nonmember becoming a member is treated as a SRLY loss. <u>See</u> Treas. Reg. § 1.1502-13(g)(4)(ii).

4. **Obligations other than debt**. If the intercompany obligation is not a debt, the same principles apply to treat the obligation as satisfied and reissued for an amount of cash equal to its fair market value immediately after the obligation becomes an intercompany obligation. Treas. Reg. § 1.1502-13(g)(4)(iii).

<u>EXAMPLE 47 -- Obligations Become Intercompany Obligations</u>

<u>Facts</u>: B borrows $100 from X, a nonmember, in return for B's note, which has a term of five years and pays interest at an annual rate of 10 percent. As of January 1 of Year 3, the fair market value of the note is $70 as a result of a rise in the prevailing market interest rate. On January 1 of Year 3, P purchases all the stock of X. X is not insolvent at the time P purchases the X stock.

<u>Results</u>: Under Treas. Reg. § 1.1502-13(g)(4), the note is treated as satisfied under the principles of Treas. Reg. § 1.108-2(f)(2) for $70 immediately after X becomes a member. Both X's $30 capital loss and B's $30 discharge of indebtedness income are taken into account for purposes

of determining consolidated taxable income. Under Treas. Reg. § 1.1502-13(g)(4)(ii)(C), the attributes of the items resulting from the deemed satisfaction are determined on a separate-entity basis; i.e., there is a mismatch. B is treated as issuing a new note for $70 with a stated redemption price at maturity of $100. The new note, therefore, has OID of $30. The Treasury rejected suggestions from taxpayers that matching of attributes should be required in this case, arguing that taxpayers should not be permitted to elect single-entity treatment by retiring the debt immediately before X becomes a member. See Preamble to current rules, 60 Fed. Reg. at 36,677.

EXAMPLE 48 -- Bad Debt Deduction

Facts: On January 1 of Year 1, B borrows $100 from S in return for B's note, which promises to repay $100 at the end of Year 5 and bears coupon interest at an annual rate of 10 percent. B fully performs in Years 1 through 3. In Year 4, B defaults but is not insolvent. S claims a partial bad debt deduction under § 166(a)(2) of $40 on a separate-entity basis.

Results: The debt is deemed to be satisfied for $60 immediately before S claims the bad debt deduction, and is deemed to be reissued immediately thereafter for $60. The new note, therefore, has OID of $40. S's loss and B's COD income are both ordinary.

EXAMPLE 49 -- Cancellation of Intercompany Debt

Facts: On January 1 of Year 1, B borrows $100 from S in return for B's note, which promises to repay $100 at the end of Year 5 and bears coupon interest at an annual rate of 10 percent. B fully performs in Years 1 through 3. In Year 4, S sells the B note to P for $60. B is insolvent. Assume B has no remaining assets or tax attributes that could be reduced under § 108(b) at the time the debt is deemed satisfied. (Note that under Treas. Reg. § 1.108-3, a deferred intercompany loss would be treated as basis for purposes of § 108(b).)

Results: Ordinarily, S would be permitted a bad debt deduction of $40. Under § 108(b), on a separate-entity basis, B would exclude $40 of COD income, without a reduction in attributes of which it has none. If S and B had been divisions of a single corporation, however, this double benefit would not be available. Therefore, Treas. Reg. § 1.1502-13(g)(3) treats B as satisfying the debt for $60 and reissuing a new note for $60 with a stated redemption price at maturity of $100. B's COD income of $40 on the new note will offset S's $40 loss (which is a capital loss on a separate-entity basis). Under Treas. Reg. § 1.1502-13(g)(3)(ii)(B), § 108(a) does not apply to B's COD income. Because B's COD income exactly offsets S's intercompany loss in amount, Treas. Reg. § 1.1502-13(c)(4)(i) requires

S to recharacterize its bad debt loss as ordinary to achieve matching consistent with single-entity treatment.

D. **Application of AHYDO Rules**. The current rules provide that the AHYDO rules of § 163(e)(5) will not apply to an intercompany obligation issued in a return year beginning on or after July 12, 1995. However, once an obligation loses its status as an "intercompany" obligation, AHYDO rules will apply. Treas. Reg. § 1.1502-80(e). The AHYDO rules of § 163(e)(5) disqualify "excessive" yield on certain obligations from deduction as OID interest under § 163(e).

E. **Proposed Regulations**. On December 21, 1998, Prop. Treas. Reg. 1.1502-13(g) was issued. The proposed regulations clarify both the form and the timing of the recast applied to transactions subject to the regulation.[5] Despite the claim that they are intended to clarify the current regulations, the proposed regulations eliminate certain exceptions contained in the current regulations and apply in a broader range of circumstances than the current regulations.

1. **In General**. The proposed regulations, unlike the current regulations, recharacterize all transactions involving the transfer of an intercompany obligation, regardless of whether a member realizes an amount of income, gain, deduction, or loss as a result of the transfer. The proposed regulations also eliminate the exception contained in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(4) relating to situations where "[t]reating the obligation as satisfied and reissued will not have a significant effect on any person's federal income tax liability for any year." The preamble to the proposed regulations provides that the exception was eliminated due to uncertainty as to its application and scope. 63 Fed. Reg. at 70,354. The proposed regulations do not alter the treatment accorded transactions in which an intercompany obligation becomes a non-intercompany obligation.

2. **Deemed Satisfaction**. Under the recharacterization set forth in the proposed regulations, the debtor is first deemed to pay the creditor member an amount of money in retirement of the obligation. Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(A). Determining the amount of money deemed paid is dependent upon the transaction involved.

   a. The proposed regulations retain the rule that if the debt is sold for an amount of money, the amount deemed paid by the debtor member is the amount of cash actually received by the selling member on the disposition of the note.

   b. The proposed regulations retain the rule that if the creditor member exchanges the intercompany note for property, then the debtor

[5] See Preamble to Prop. Treas. Reg. § 1.1502-13(g), REG-105964-98, 63 Fed. Reg. 70,354 (Dec. 21, 1998).

member is deemed to pay the creditor member an amount equal to the issue price (determined under § 1273 or 1274) of a note issued in exchange for the property with terms identical to the existing note. In cases in which neither the property nor the obligation are publicly traded, the issue price will generally equal the note's stated redemption price at maturity if the note provides for adequate stated interest. See §§ 1273(b)(4) and 1274(a)(1).

c. The proposed regulations retain the rule that where an intercompany obligation becomes a non-intercompany obligation because of the deconsolidation of the debtor or creditor member, the debtor corporation is deemed to pay the member an amount of money equal to the fair market value of the obligation immediately before the debtor or creditor becomes a nonmember.

d. The proposed regulations also clarify the amount of the deemed satisfaction in two situations not specifically covered under the current regulations. First, if a corporation assumes the debtor's liability in exchange for property of the debtor, the debt is treated as satisfied for an amount equal to the issue price (determined under § 1273 or 1274) of a new debt, with identical terms, issued for such property on the date of the transaction. Second, if an intercompany obligation is extinguished, the debt is treated as satisfied for an amount equal to the issue price (determined under § 1273 or 1274) of a new debt issued to a third party on the date of the transaction for property that is not publicly traded. Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(A).

3. **Reissuance**. Under the proposed regulations, if the obligation actually remains outstanding following the deemed satisfaction, the creditor member is treated as transferring the deemed satisfaction proceeds to the actual transferee of the note. The transferee is then deemed to transfer this amount to the debtor in exchange for a new obligation with terms identical to the existing obligation. Prop. Treas. Reg. § 1.1502-13(g)(3)(iii).

   a. In general, the issue price of the new obligation will be determined under the rules of § 1273 or 1274 (illustrated below). If the obligation becomes a non-intercompany obligation because the debtor or creditor becomes a nonmember, then the issue price of the obligation equals its fair market value determined immediately after the debtor or creditor becomes a nonmember. Prop. Treas. Reg. § 1.1502-13(g)(3)(iii).

4. **Effective Date**. The proposed regulations are effective upon publication in final form in the federal register. However, taxpayers may presently rely upon the form and timing of the recast transaction, as clarified by the

proposed regulations. Preamble to Prop. Treas. Reg. § 1.1502-13(g)(3), 63 Fed. Reg. at 70,355.

VIII. SPECIAL OPERATING RULES

A. Successor Rules

1. **Successor property**. Under Treas. Reg. § 1.1502-13(j)(1), a reference to any asset includes reference to any other asset the basis of which is determined in whole or in part by reference to the first asset.

2. **Successor person**. Under Treas. Reg. § 1.1502-13(j)(2)(i), reference to any person includes, as the context requires, reference to a predecessor or successor.

   a. **Definition**. The predecessor is defined as the transferor of assets to a transferee (the successor) in one of the following transactions:

      (i) A transaction to which § 381(a) applies;

      (ii) A transaction in which substantially all the assets of the transferor are transferred to members in complete liquidation;

      (iii) A transaction in which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the basis of the transferor, but the transferee is a successor only with respect to that portion of the basis that reflects the transferor's basis; or

      (iv) A transaction that is an intercompany transaction but only with respect to assets being accounted for by the transferor in a prior intercompany transaction.

   b. **Effect**. The successor succeeds to the predecessor's intercompany items if it acquires the predecessor's assets. If the assets are acquired by more than one successor, the intercompany items are taken into account consistently, in a manner that reasonably carries out the purpose of the intercompany transaction rules. Treas. Reg. § 1.1502-13(j)(ii). The successor apparently does not inherit the predecessor's corresponding items. Rather, it has corresponding items of its own in addition to the corresponding items of the predecessor.

EXAMPLE 50 -- Successor Person or Property

Facts: S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to M (a member) for $100. On July 1 of Year 2, M

transfers the land to B in exchange for all of B's stock, in a transaction to which § 351 applies. Under § 358, M's basis in B's stock is $100. Under § 362(b), B's basis in the land is $100. In Year 4, M sells 20% of B's stock to X, a nonmember, for $22. B holds the land for sale in the ordinary course and sells 20% of it in Year 5 for $22.

Results: Under the successor asset rules of Treas. Reg. § 1.1502-13(j)(1), references to the land include references to M's B stock. Under the successor person rules of Treas. Reg. § 1.1502-13(j)(2)(i), references to M include references to B with respect to the land. S's intercompany gain is taken into account to reflect the difference between the corresponding item of the buying member and the buying member's recomputed corresponding items. Because of the successor rules, both M's B stock, and B's land can cause S's intercompany gain to be taken into account under the matching rule or acceleration rule. The transaction creates the potential for multiple corresponding items of M or B with respect to the land or B stock. M's corresponding items (with respect to B stock as successor asset to the land) continue to be relevant. Because there are multiple corresponding items, S must take its intercompany items into effect in the manner most consistent with the purposes of the current rules. See discussion below of the Multiple Trigger Rule. Thus, S takes $6 of its gain into account in Year 4 to reflect the difference between M's corresponding gain of $2 taken into account from the sale of B stock and M's recomputed corresponding gain taken into account of $8. Similarly, S recognizes $6 of its gain in Year 5 when B sells 20% of the land.

B. Multiple Triggers

1. If more than one corresponding item can cause an intercompany item to be taken into account under the matching rule, the intercompany item is taken into account in connection with the corresponding item most consistent with the treatment of members as divisions of a single corporation. Treas. Reg. § 1.1502-13(j)(3).

2. For example, if S sells a truck to B, its intercompany gain from the sale is not taken into account by reference to B's depreciation if the depreciation is capitalized under § 263 as part of B's cost for a building. Instead, S's gain relating to the capitalized depreciation is taken into account when the building is sold or as it is depreciated. Id.

3. If B purchases appreciated land from S and transfers the land to a lower tier member in exchange for stock, thereby duplicating the basis of the land in the basis of the stock, items with respect to both the stock and the land can cause S's intercompany gain to be taken into account. If the lower tier member becomes a nonmember as a result of the sale of its stock, the attributes of S's intercompany gain are determined with respect to the land rather than the stock. Id.

C. **Successive or Multiple Intercompany Transactions**

1. If a member's intercompany item or corresponding item affects the accounting for more than one intercompany transaction, appropriate adjustments are made to treat all of the intercompany transactions as transactions between divisions of a single corporation. Treas. Reg. § 1.1502-13(j)(4).

2. For example, if land is transferred in successive intercompany transactions, all of the participating members are treated as divisions of a single corporation for purposes of determining the timing and attributes of each of the items from the land. Similar principles apply with respect to intercompany transactions that are part of the same plan or arrangement. For example, if S sells separate properties to different members as part of the same plan or arrangement, all of the participating members are treated as divisions of a single corporation for purposes of determining the timing and attributes of the intercompany items and corresponding items from each of the properties.

EXAMPLE 51 -- Multiple Intercompany Transactions

Facts: S holds land for investment with a basis of $70. On January 1 of Year 1, S sells the land to M for $90. M is also a member of the consolidated group and holds the land for investment. On July 1 of Year 3, M sells the land to B for $100. B holds the land for sale to customers in the ordinary course. During Year 5, B sells all the land to customers for $105.

Results: Under Treas. Reg. § 1.1502-13(b)(1), S's sale of the land to M and M's sale of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. Under Treas. Reg. § 1.1502-13(j)(4), S, M, and B are treated as divisions of a single corporation for purposes of determining the timing of their items from the intercompany transactions. See also Treas. Reg. § 1.1502-13(j)(2) (B is treated as a successor to M for purposes of taking S's intercompany gain into account). Thus, S's $20 gain and M's $10 gain are both taken into account in Year 5 to reflect the difference between B's $5 gain taken into account with respect to the land and the $35 recomputed gain (the gain that B would have taken into account if the intercompany sales had been transfers between divisions of a single corporation and B succeeded to S's $70 basis). Under Treas. Reg. § 1.1502-13(j)(4), the attributes of the intercompany items and corresponding items of S, M, and B are also determined by treating S, M, and B as divisions of a single corporation. For example, the attributes of S's and M's intercompany items are determined by taking B's activities into account.

D. Acquisition of entire group

1. Special operating rules apply if a consolidated group (the terminating group) ceases to exist as a result of the acquisition by a member of another consolidated group (the surviving group) of either the stock or the assets of the terminating group's common parent (in a § 381(a) transaction) or under the application of the general principles of Treas. Reg. § 1.1502-75(d)(2) or (3).

2. In such circumstances, the surviving group is treated as the terminating group for purposes of applying the intercompany transactions rules. This rule does not apply, however, to members of the terminating group that do not become members of the surviving group. Treas. Reg. § 1.1502-13(j)(5).

E. Former Common Parent Treated As Continuation of Group

1. If the group terminates because the former common parent becomes the only member, the common parent succeeds to the treatment of the terminating group for purposes of the current rules. Treas. Reg. § 1.1502-13(j)(6).

2. This successor rule applies only if the common parent does not become a member of an affiliated group filing separate returns or a corporation described in § 1504(b) (i.e., ceases to be an "includible corporation").

EXAMPLE 52 -- Successor Group

Facts: In Year 1, B borrows $100 from S in return for B's note. In Year 3, X acquires all of P's stock and, as a result, becomes common parent of the group.

Results: The note will not be treated as satisfied and reissued under the rules of Treas. Reg. § 1.1502-13(g), despite the fact that B's note ceases to be an obligation of the P group. Under Treas. Reg. § 1.1502-13(j)(5), the X group succeeds to the treatment of the P group, and the note will be analyzed as an intercompany obligation of the X group.

EXAMPLE 53 -- Successor Subgroup

Facts: In Year 1, B borrows $100 from S in return for B's note. In Year 3, X acquires all of S's stock and all of B's stock from P. S and B join the X group.

Results: Treas. Reg. § 1.1502-13(j)(5) does not apply to the acquisition of subgroups. Thus, unless one of the exceptions of Treas. Reg. § 1.1502-

13(g)(3)(i)(B) applies, the note will be treated as satisfied and reissued, because B's note ceases to be an obligation of the P group.

EXAMPLE 54 -- Liquidations

Facts: X has preferred stock described in § 1504(a)(4) outstanding. In Year 1, S purchases all of X's common stock, and B purchases all of X's preferred stock. X's assets have zero basis and a $100 value. In Year 3, X distributes all of its assets to S and B in a complete liquidation to which § 332 applies by operation of Treas. Reg. § 1.1502-34. At the time, the assets have built in gain. Under §§ 336 and 337, X recognizes no gain or loss from its distribution to S but recognizes gain under § 337(c) on its distribution to B.

Results: Under the matching rule, X's gain from the distribution of the assets to B is intercompany gain. The intercompany gain is not taken into account as a result of the liquidation. Under the successor rules of Treas. Reg. § 1.1502-13(j)(2), S and B are both successors to X. To achieve consistency as required by Treas. Reg. § 1.1502-13(j)(2)(ii), S will be treated as succeeding to X's intercompany gain, which S must take into account under the matching and acceleration rules based on subsequent events.

IX. Anti-Avoidance Rules

Treas. Reg. § 1.1502-13(h) provides a broad anti-avoidance rule. If a transaction is engaged in or structured with a principal purpose to avoid treatment as an intercompany transaction, or to avoid the purposes of the intercompany rules, adjustments must be made to carry out the purposes of the intercompany transaction rules. The rule is illustrated in the regulations by way of a number of examples. The preamble states that business transactions undertaken for legitimate purposes generally will be unaffected. 60 Fed. Reg. at 36,677. Additional anti-avoidance rules related to effective dates are provided in Treas. Reg. § 1.1502-13(l).

EXAMPLE 55 -- SRLY (Contribution to Partnership)

Facts: B has NOLs from a separate return limitation year (SRLY) subject to limitation. S holds land with a basis of $10 and a fair market value of $100. With a principal purpose of moving income into B to absorb B's SRLY NOLs, S contributes the land to a partnership in Year 1, in return for a 10% capital and profits interest in the partnership. In Year 2, S sells its interest in the partnership to B for $100. No § 754 election is in effect. In Year 3, the partnership sells the land to an unrelated party, resulting in allocation of $90 of built-in gain to B under § 704(c). B's basis in the partnership increases to $190. At the end of Year 3, the partnership distributes $100 of cash to B in redemption of its interest in the partnership. B recognizes a $90 capital loss under § 731(a).

Results: Absent the anti-abuse rule, the transaction would increase B's SRLY limitation under Treas. Reg. § 1.1502-21(c). B's loss on the disposition of its partnership interest would not be subject to limitation under the SRLY rules. Because the contribution of property to the partnership and the sale of the partnership interest were part of a plan, a principal purpose of which was to achieve a reduction in consolidated tax liability by creating offsetting gain and loss for B while deferring S's intercompany gain, B's allocable share of the partnership's gain from its sale of the land is treated under Treas. Reg. § 1.1502-13(h)(1) as not increasing the amount of B's SRLY limitation.

X. Effective Date

A. **In general**. The current intercompany rules apply to transactions occurring in years beginning on or after July 12, 1995. Treas. Reg. § 1.1502-13(l). If both the old rules and the current rules apply to a transaction, or neither applies, with the result that items are duplicated, omitted, or eliminated, the old rules must be applied. For example, S's and B's items with respect to an intercompany sale of land occurring prior to the effective date are taken into account under the old rules, even though B sells the land to a nonmember after the effective date of the current rules.

B. **Anti-avoidance rule**. If a transaction is engaged in or structured after April 8, 1994 with a "principal purpose" to avoid the intercompany rules and to duplicate, omit, or eliminate an item in determining taxable income, or to treat an item inconsistently, Treas. Reg. § 1.1502-13(l)(2) requires "appropriate adjustments" to prevent this avoidance or abuse.

EXAMPLE 56 -- Distribution Of Loss Property

Facts: P is the common parent of an affiliated group of corporations, within the meaning of § 1504, that join in filing a consolidated return. S is the wholly owned first-tier subsidiary of P and a member of the P group. S holds an asset that has depreciated in value. The asset has a basis in S's hands of $130 and a value of $100. On August 1, 1995, S distributes the depreciated property to P as a dividend.

Result: Under the old rules, no loss is recognized by S, but P takes a basis in the property equal to S's basis in the property. Thus, when P subsequently sells the property, the loss will be recognized by P. In effect, S's loss in this case will be relocated to P. Under the new regulations, S's loss ordinarily would be recognized but deferred. See Treas. Reg. § 1.1502-13(f)(2)(iii). In contrast to the old regulations, when the loss is ultimately taken into account, it will be S's loss; i.e., the location of the loss will be unchanged. The distribution of the property in 1995 ordinarily will be governed by the old regulations, because it occurs in a tax year

beginning prior to July 12, 1995. Therefore, P will take a carryover basis in the property. However, to the extent the relocation of S's loss to P under the old regulations results in tax advantages, there is concern that the anti-avoidance rule will apply to impose adjustments. Application of the anti-avoidance rule depends on whether the distribution was structured with a "principal purpose" to avoid the rules of the current regulations.

C. **Election for Stock Elimination Transactions**. In the case of "stock elimination transactions," which generally are stock transfers between S and B where the stock is deemed to have been subsequently canceled, redeemed, distributed, or transferred in a manner that would cause S's items to be taken into account under the old rules, the group may elect to apply the current rules to the transaction. Treas. Reg. § 1.1502-13(l)(3).