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**THE CONSOLIDATED RETURN INVESTMENT
BASIS ADJUSTMENT RULES -
STUDY PROBLEMS**

By

Theresa A. Abell
Internal Revenue Service
Washington, D.C.

Jerred G. Blanchard, Jr.
Ernst & Young LLP
Houston, TX

Joseph M. Pari
Dewey & LeBoeuf LLP
Washington, D.C.

Patricia W. Pellervo
PricewaterhouseCoopers LLP
San Francisco, CA

Mark J. Silverman
Step toe & Johnson LLP
Washington, D.C.

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Introduction

- The purpose of the investment adjustment system is “to treat P and S as a single entity so that consolidated income reflects the group’s income.” Reg. § 1.1502-32(a)(1).
- Ambiguities and oversights are governed by a rule of reason.
- Adjustments may not be made “in a manner that has the effect of duplicating an adjustment.” Reg. § 1.1502-32(a)(2).
- The current regulations, unlike the prior regulations, de-link stock basis adjustments and earnings and profits (“E&P”).
- The current stock basis adjustment system is analogous to the systems for adjusting the basis of partnership interests and of S corporation stock.
- For most subsidiaries, the net investment adjustment when the subsidiary is disposed of should be the difference between the subsidiary’s net inside tax basis at the time it was acquired and its net inside tax basis at the time of the disposition (assuming no change in its capital structure).
- Basis in subsidiary stock is increased under Reg. § 1.1502-32(b) by positive adjustments and decreased by negative adjustments, as described below. The adjustments required are comprised of two component parts (treating income and gain items as increases and treating loss and deduction items and distributions as decreases):
 - (i) Net Residual Adjustment consisting of: taxable income or tax loss, tax-exempt income, and noncapital, nondeductible expenses, and
 - (ii) Distributions.
- After computing the potential stock basis adjustment amount (i.e., distributions and the net residual adjustment), Reg. § 1.1502-32(c) requires an allocation of that amount among:
 - (i) Different classes of stock, and
 - (ii) Equally within classes of stock to each share, unless shares have differing excess loss accounts (“ELAs”). Reg. §§ 1.1502-19(d), -32(c)(2)(i).

- Adjustments to S’s stock are taken into account in determining adjustments to higher tier stock in the order of the tiers, from lowest to highest. Reg. § 1.1502-32(a)(3)(iii).
- Adjustments are to be made at the close of the consolidated return year or as of any other time it is necessary to determine the tax liability of any person. Reg. § 1.1502-32(b)(1)(i).
- On September 17, 2008, the Service published new final regulations in Reg. § 1.1502-36¹ that adjust members’ bases in the stock of a subsidiary (S) and S’s attributes when a member (M) “transfers”² a loss share of S stock.³ The regulations were titled the “Unified Rule for Loss on Subsidiary Stock,” and are generally referred to as the “Unified Loss Rules.” The Unified Loss Rules (at Reg. § 1.1502-36(b) in particular) are based in part on the notion that the presumptions underlying the investment adjustment rules frequently are inaccurate and, unless altered, can distort the group’s consolidated taxable income or tax liability.
- The Unified Loss Rules contain three substantive rules: (i) the basis redetermination rule of Reg. § 1.1502-36(b); (ii) the basis reduction rule of Reg. § 1.1502-36(c); and (iii) the attribute reduction rule of Reg. § 1.1502-36(d). If, after taking into account the effects of all other applicable rules of law (such as basis reductions under sections 108 and 1017 and Reg. § 1.1502-28), a share of S stock is “transferred” by a member of the P group, and at the time of the transfer the S share is a “loss share,”⁴ the Unified Loss Rules of Reg. § 1.1502-36 apply to determine the following:
 - (i) Whether the basis of the share must be redetermined by allocating all or part of the loss to other S shares (the basis redetermination rule of Reg. § 1.1502-36(b)). Under this rule, only basis attributable to investment adjustments can be reallocated among the shares.

¹ T.D. 9424, 2008-44 I.R.B. 1012. The Service had published Prop. Reg. § 1.1502-36 on January 23, 2007. *See* REG-157711-02, 2007-1 C.B. 537. *See also* Announcement 2007-74, 2007-2 C.B. 483 (making technical corrections to the proposed regulations).

² Reg. § 1.1502-36(f)(10) defines the term “transfer” for purposes of the Unified Loss Rules.

³ Reg. § 1.1502-36(a)(1).

⁴ Reg. § 1.1502-36(f)(7) defines “loss share” as a share of S stock the adjusted basis of which exceeds its value and “gain share” as a share of S stock the value of which exceeds its adjusted basis. Reg. § 1.1502-36(f)(11) defines “value” as the amount realized on a disposition of the share, or if there is no amount realized, the share’s fair market value.

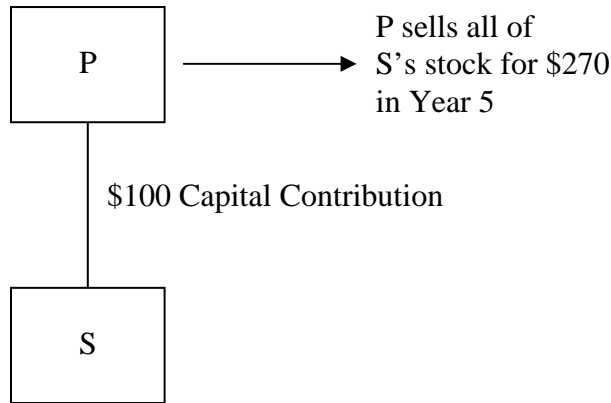
- (ii) If the share remains a loss share after the basis of the share is adjusted under the basis redetermination rule, whether all or part of the loss must be eliminated by a further basis reduction that does not result in a reallocation of basis (the basis reduction rule of Reg. § 1.1502-36(c)). Under this rule, basis in a share can be reduced (but not below the share's fair market value) by the lesser of the share's "disconformity" amount (i.e., the amount by which the basis of the share exceeds the proportionate interest in S's inside net attributes) and the share's net positive investment adjustment (determined without regard to the negative adjustment for distributions).
- (iii) If the share remains a loss share after the basis of the share is adjusted under the basis reduction rule, whether any of S's attributes must be reduced in order to prevent loss duplication (the attribute reduction rule of Reg. § 1.1502-36(d)).

Significant Aspects of Investment Adjustment Rules

- The investment adjustment rules apply generally to determinations and transactions in taxable years beginning on or after January 1, 1995.
- Once the rules apply, stock basis and E&P must be redetermined as if the rules had always been in effect.
- There are special transition rules for expiring losses, distributions of affiliated, nonconsolidated E&P, group structure changes, and elimination of E&P when subsidiaries leave the group.
- The allocation rules, including the elimination of the 30-day rules under the prior law, generally apply to corporations that become or cease to be members on or after January 1, 1995.
- The regulations require groups to maintain annual books and records necessary for accurate stock basis adjustments.
- The regulations contain a cumulative redetermination rule, which requires redetermination of investment adjustments for years prior to enactment of the regulations, and which requires reallocation of adjustments (e.g., between preferred and common stock) at the time stock is disposed of to reflect the economics of the investment at the time of disposition.
- The regulations require a negative adjustment to reflect an expiring loss incurred in a SRLY, but permit taxpayers to avoid the negative adjustment by waiving their right to use the expiring loss.
- The regulations do not extend circular basis adjustment relief to sales of brother-sister corporations.
- The regulations eliminate the basis reallocation election (which, under the prior rules, permitted groups to eliminate an ELA by reallocating basis in preferred stock to common stock).
- The regulations, contain an entitlement rule so that, in the consolidated return context, section 301(c) distributions are deemed to occur for all Federal income tax purposes no later than the date the shareholder becomes entitled to the distribution.
- The regulations require negative adjustments for all distributions, including distributions of E&P accumulated in affiliated, nonconsolidated years.
- The regulations permit the allocation of tax liability for E&P purposes to be conformed to its allocation for stock basis purposes.

- The regulations permit a ratable allocation election, except that certain extraordinary income items cannot be ratably allocated.
- In connection with eliminating the 30-day rule, the regulations permit the ratable allocation of an acquired subsidiary's items (other than extraordinary items) for the month of sale.
- The regulations allow a transaction occurring on the day a subsidiary is acquired to be treated as occurring on the day following the acquisition, provided the transaction is properly allocable to the portion of the day following the closing.

Example 1: Taxable Income v. E&P



	<u>Years 1-5</u>	
<u>Items</u>	<u>Income</u>	<u>E&P</u>
Gross income	\$210	\$210
Depreciation	\$100	\$ 50
Allowable Charitable Contribution	<u>\$ 10*</u>	<u>\$ 15</u>
Taxable Income	<u>\$100</u>	
E&P		<u>\$145</u>
*Excess Charitable Contribution	\$ 5	N/A

- (i) **Facts.** At the beginning of Year 1, P forms S with a \$100 capital contribution. P and S file consolidated returns. During Years 1 to 5, S has an aggregate of \$210 of gross income, \$100 of tax depreciation, and \$15 of charitable contributions (of which \$5 is an excess charitable contribution). Thus, S has \$100 of taxable income for Years 1 to 5. Because S has only \$50 of depreciation for E&P purposes, and the entire \$15 charitable contribution is deducted from E&P, S has \$145 of E&P for Years 1 to 5. P sells S's stock at the end of Year 5 for \$270.

(ii) **Results**

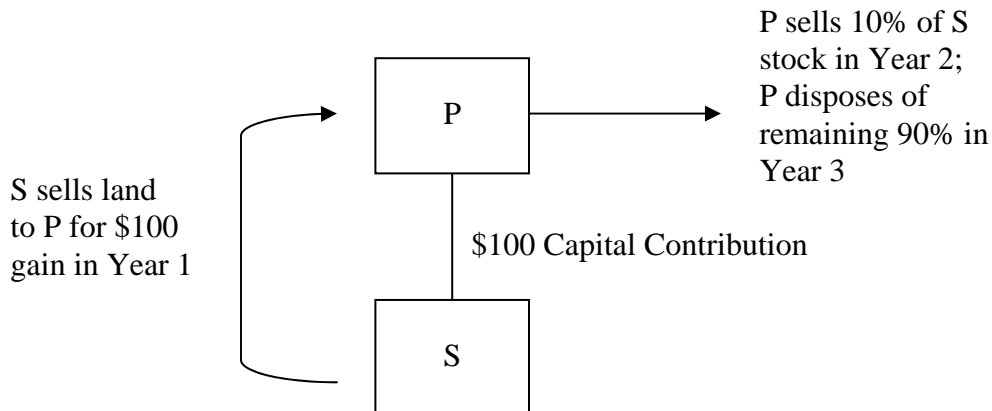
- **Current Regulations.** The basis of S’s stock is adjusted by S’s taxable income or loss. Reg. § 1.1502-32(b)(2)(i). S’s taxable income or loss is consolidated taxable income (“CTI”). CTI is determined by taking into account only those items of S’s income, gain, deduction, and loss that are taken into account in determining CTI, treating S’s deductions and losses as taken into account to the extent they are absorbed by S or any other member. Reg. § 1.1502-32(b)(3)(i). Because suspended losses have not been absorbed, the suspended losses do not reduce basis in the current year. Instead, the basis reduction occurs in a later year when the tax benefit arises (or the potential for the tax benefit is eliminated). P’s basis for purposes of determining gain or loss on the sale of the S stock would be:

Capital contribution	\$100
S’s items included in CTI.....	<u>100</u>
Total Basis	\$200
Gain (\$270-\$200)	\$ 70

- **Prior Regulations.** Under prior law, stock basis adjustments were determined at the end of a taxable year (or earlier in the case of a disposition before the end of a taxable year). The adjustments were determined by reference to net changes in S’s E&P and with reductions for certain distributions. Under this E&P system, P’s basis for purposes of determining gain or loss on the sale of the S stock would be:

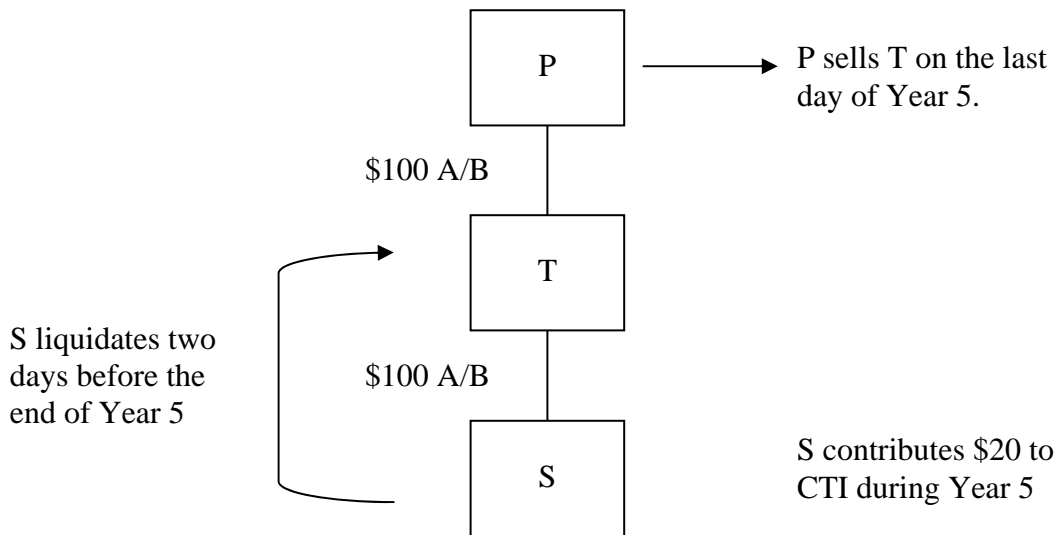
Capital contribution.....	\$100
Net positive adjustment -32(b)(1)(i).....	145
Section 1503(e)(1)(A).....	<u>(50)</u>
Total Basis.....	\$195
Gain (\$270-\$195).....	\$ 75

Example 2: Treatment of Deferred Gain



- (i) **Facts.** P forms S with a \$100 capital contribution. P and S file consolidated returns. S's only source of income is \$100 of gain (tax and E&P) from the sale of land to P in Year 1. S's gain is deferred under Reg. § 1.1502-13 (and its E&P gain is deferred under Reg. § 1.1502-33(c)(2)). At the end of Year 2, P sells 10 percent of S's stock. At the end of Year 3, P sells its remaining 90-percent interest in S's stock.
- (ii) **Results.**
- **Deferred Gain Not Part of CTI or E&P in Years 1 or 2.** The deferred gain does not increase P's basis in the S stock in Years 1 or 2 under either the prior rules or the current rules. Accordingly, no portion of the \$100 deferred gain will be taken into account for purposes of determining P's gain on the sale of the 10-percent block of S stock. Reg. § 1.1502-13(d) (disposition of the stock does not result in S's ceasing to be a member of the P consolidated group and, therefore, does not constitute an acceleration event for purposes of either taxable income or E&P).
 - **Allocable Portion of Accelerated Deferred Gain Only Increases Basis in Retained Shares.** The \$100 deferred gain is taken into account immediately before S ceases to be a member of the P group at the end of Year 3. Reg. § 1.1502-13(d). However, because the basis adjustment resulting from the related taxable income is allocated equally to each share of S stock, including the 10-percent block owned by the nonmembers, the bases of the retained shares increase only by their \$90 allocable portion of the restored gain. Reg. § 1.1502-32(c)(2). The remaining \$10 of accelerated gain does not produce a basis increase, because it is allocated to stock held by a nonmember. Thus, in effect, \$10 of the deferred gain is taxed twice. The current regulations reach the same result as the prior regulations.

Example 3: Timing of Adjustments

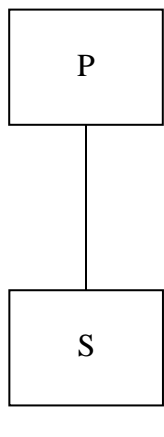


(i) **Facts.** P forms T with a \$100 capital contribution and T, in turn, forms S with a \$100 capital contribution. P, S, and T file consolidated returns. For various nontax business reasons, S is liquidated into T two days before the end of Year 5. On the last day of Year 5, P sells the stock of T. Assume that the only potential adjustment with respect to the S stock is S's \$20 contribution to CTI (and its net positive E&P amount) for Year 5.

(ii) **Results.**

- **Current Regulations.** The current regulations credit T's basis in the S stock and, in turn, P's basis in the T stock for S's \$20 contribution to CTI immediately prior to the liquidation of S during Year 5. See Reg. § 1.1502-32(b)(1)(i) (adjustments made at year end or any other time if necessary to determine tax liability of any person). Thus, the gain with respect to the T stock is not overstated when P sells it.
- **Prior Regulations.** Under the prior rules, a liquidation to which section 332 applies was not a "disposition" under a mechanical reading of Former Reg. § 1.1502-19(b). Thus, an adjustment arguably would not be made to T's basis in the S stock (or to P's basis in the T stock) at that time, and the amount of gain with respect to the T stock would, under the prior rules, be overstated by \$20. See Former Reg. § 1.1502-32(a).

Example 4: Time Loss Carryforward Taken Into Account

	Year 1 No income or loss	Year 2 \$20 capital gain
	\$40 ordinary income \$20 capital loss	No income or loss

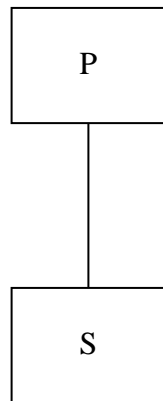
(i) **Facts.** P owns all of the stock of S. P and S file consolidated returns. During Year 1, S has \$40 of ordinary income and \$20 of capital loss; P breaks even. S's capital loss is not carried back to prior years. During Year 2, P has \$20 of capital gain, which is the only item of income or loss of the P group for Year 2.

(ii) **Results.**

- **Current Regulations.** P's basis in S is increased by S's taxable income. For these purposes, S's taxable income is CTI, which is determined by taking into account only S's items of income, gain, deduction, and loss, treating S's deductions and losses as taken into account to the extent they are absorbed by S or any other member. Reg. § 1.1502-32(b)(3)(i). Thus, in Year 1, P's basis in S is increased by the \$40 taxable income, and in Year 2, it is reduced by the \$20 absorbed loss.
- **Prior Regulations.** Under the prior rules, P's basis in S was increased by S's current E&P. Therefore, if the \$40 of taxable income and \$20 of capital loss translated into net current E&P of \$20, P's basis in S would be increased by \$20 in Year 1. Former Reg. § 1.1502-32(b)(1)(i). However, because the capital loss is not carried back, P's basis is increased by an additional \$20 to reflect the unabsorbed loss. Former Reg. § 1.1502-32(b)(1)(ii). Thus, at the end of Year 1, P's basis in S is increased by \$40. In Year 2, S has no current E&P but, due to P's \$20 capital gain, S's \$20 capital loss from Year 1 is finally absorbed. This causes a \$20 net negative adjustment to P's basis in S for Year 2. Former Reg. § 1.1502-32(b)(2)(ii). Thus, over the two-year period, P's basis is increased by a net amount of \$20.

- **All Losses Accounted For Under Current Rules.** Note that under the prior rules, a special provision was necessary in order to “add back” unabsorbed losses. Because E&P is reduced by losses whether or not they are absorbed, this provision prevented an unabsorbed loss from causing a negative basis adjustment. Former Reg. § 1.1502-32(b)(1)(ii), (2)(ii). However, this treatment applied to operating and capital losses only. Thus, it might be argued that, for example, a suspended passive activity loss would cause a net negative basis adjustment even though it might be many years before it is absorbed and the group reaps the benefit of the loss. But see Wyman-Gordon Co. & Rome Industries, Inc. v. Comm’r, 89 T.C. 207, 223 (1987) (purposes of consolidated return regulations may support treating discharge of indebtedness income that is excluded from taxable income as not increasing E&P under Former Reg. § 1.1502-32(b)(1)(i)). The current rules eliminate any ambiguity by uniformly applying a clear rule that losses do not reduce basis until absorbed.

Example 5: Computation of Net Adjustment



S's Year 1 Tax Items and Attributes

\$80	of tax-exempt interest income
\$60	of expenses for which a deduction is permanently disallowed
\$100	of dividend income
\$70	of dividends-received deduction
\$63	of capital loss carryforward incurred in a SRLY (which expires at the end of Year 1)
\$15	of COD income (with a related \$15 reduction in the SRLY loss carryforward)

- (i) **Facts.** P owns all of the stock of S. P and S file consolidated returns. For the taxable year beginning January 1, 1995, S has \$80 of interest income permanently excluded from gross income under section 103; \$60 of expenses for which a deduction is permanently disallowed under section 265; \$100 of dividend income; and a related \$70 dividends-received deduction. In addition, S has a \$63 capital loss carryforward from a prior year of the P group, which will expire at the end of the year. Finally, S purchases some of its own debt at a discount, which generates \$15 of cancellation of indebtedness income. S was insolvent by at least that amount when the debt was repurchased, so section 108(b) applies to reduce S's capital loss carryforward by \$15.
- (ii) **Results.** P's basis in S reflects S's taxable income, tax-exempt income, and nondeductible, noncapital expenses. Reg. § 1.1502-32(b)(2).
 - **Tax-exempt Income.** Tax-exempt income is income that is permanently excluded from gross income. Reg. § 1.1502-32(b)(3)(ii)(A). Thus, the \$80 of interest income permanently excluded from gross income under section 103 is treated as tax-exempt income. The portion of a dividend permanently offset by the dividends-received deduction is also treated as tax-exempt income. Reg. § 1.1502-32(b)(3)(ii)(B). Thus, the \$70 of dividend income offset by the dividends-received deduction will be reflected in basis. Cancellation of indebtedness income that is excluded under section 108 is treated as tax-exempt income to the extent the excluded amount is applied to reduce tax attributes under sections 108(b) and 1017. That attribute reduction is also taken into account as a noncapital, nondeductible expense. Reg. § 1.1502-32(b)(3)(ii)(C). Any excluded COD income that does not meet this definition is ignored for stock basis adjustment purposes. Thus, the \$15 of excluded COD income is treated as tax-exempt income, as long as the \$15 reduction in the capital loss carryforward is treated as a noncapital, nondeductible expense.

- **Noncapital, Nondeductible Expenses.** Negative stock basis adjustments are required for noncapital, nondeductible expenses. Included in the definition of these expenses are permanent decreases in the basis of S's assets (or an equivalent attribute such as a loss carryover). Reg. § 1.1502-32(b)(3)(iii)(A), (iv)(B). Thus, the \$15 reduction in S's capital loss carryforward under section 108(b) is a \$15 noncapital, nondeductible expense. The expiration of the remainder of the carryforward is also treated as a noncapital, nondeductible expense. In addition, a noncapital, nondeductible expense includes expenses that are permanently disallowed as deductions. Reg. § 1.1502-32(b)(3)(iii)(A). Thus, the \$60 expense permanently disallowed under section 265 is treated as a noncapital, nondeductible expense.
- **Summary of Adjustments.** P's basis in S thus increases by \$72, computed as follows:

	\$30 of taxable income (\$100 dividend less \$70 dividends-received deduction)
+	\$70 of tax-exempt income (the portion of the dividend permanently offset by the deduction)
+	\$80 of tax-exempt income (the section 103 interest income)
+	\$15 of tax-exempt income (the COD income excluded under section 108)
-	\$15 of nondeductible expenses (the attribute reduction under section 108)
-	\$60 of nondeductible expenses (the section 265 expenses)
-	\$48 of nondeductible expenses (the expiring capital loss carryforward)
<hr/>	
=	\$72 of net positive basis adjustments

- **Prior Rules.** Under the prior rules, P's basis in S reflected S's current E&P. Under the prior rules, P's basis in S would increase by \$120, computed as follows:

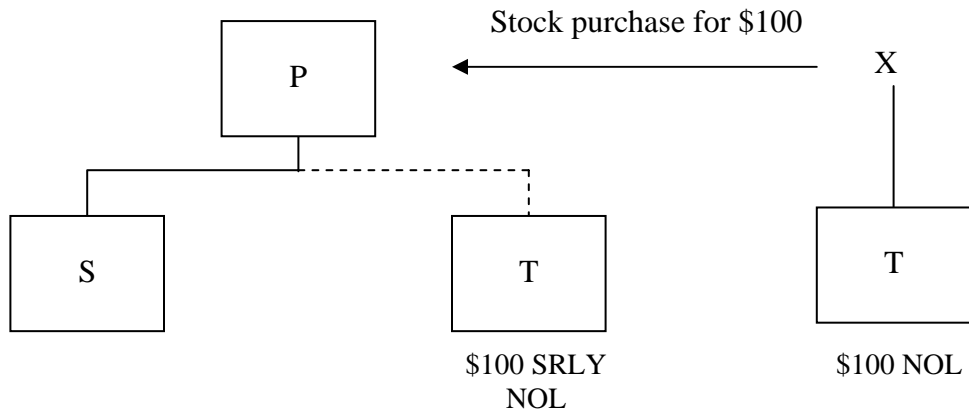
	\$100 of dividend income
+	\$80 of section 103 interest income
+	\$15 of COD income excluded under section 108
-	\$60 in section 265 expenses
-	\$15 of the capital loss carryforward that is absorbed
<hr/>	
=	\$120 net positive basis adjustments

The \$48 difference in result is due to the fact that under the prior rules, expiring loss carryovers did not reduce basis, while under the current rules, such expiring losses

clearly are taken into account. Reg. § 1.1502-32(b)(3)(iii)(A). This treatment provides conformity of inside and outside basis and is consistent with the treatment of partners and S corporation shareholders when losses flow through to them from the entity (thus reducing the bases in their interests) and expire unused.

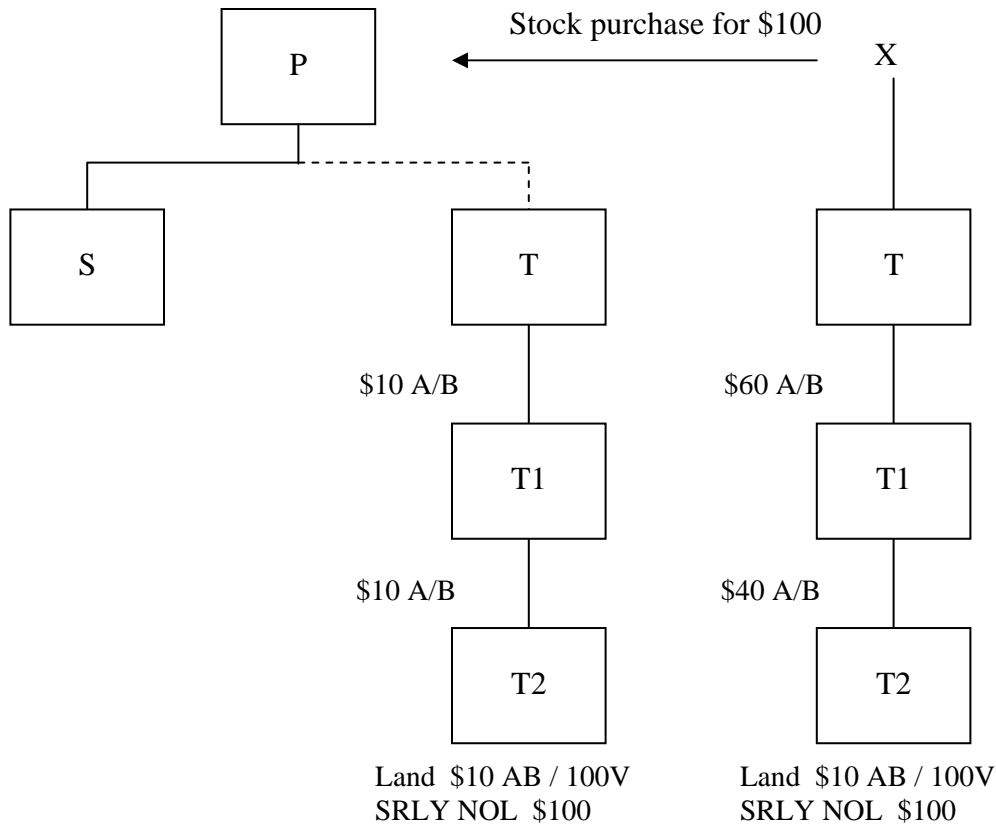
Under a special transition rule, however, the expiring loss carryover rule is not applied to SRLY losses of subsidiaries acquired in taxable years of the acquiring group beginning before January 1, 1995.

Example 6(a): Expiring NOL Carryovers



- (i) **Facts.** At the beginning of Year 1, P buys all of the stock of T for \$100. T has an asset with a value of \$100 and a basis of \$0, and a \$100 NOL carryover that expires at the end of Year 2.
- (ii) **Results.**
- **Basis Reduction.** Under Reg. § 1.1502-32(b)(3)(iii)(A), the expiration of T’s NOL at the end of Year 2 is a noncapital, nondeductible expense that reduces P’s \$100 cost basis in the T stock from \$100 to \$0 under Reg. § 1.1502-32(b)(2). The basis reduction takes place at the end of Year 2, after all other adjustments, to reflect the timing of the expiration under section 172.
 - **Prior Law.** Under prior Reg. § 1.1502-32(b)(2), P’s basis in the T stock was only reduced for losses “absorbed.” Although the phrase “absorbed” was not defined, it was generally thought not to include an expiration. See generally CSI Hydrostatic Testers, Inc. v. Comm’r, 103 T.C. 398 (1994). Consequently, the expiration would not have reduced P’s basis in T’s stock.

Example 6(b): Waiver of NOL Carryovers



(i) **Facts.** T owns all of the stock of T1 with a basis of \$60, and T1 owns all of the stock of T2 with a basis of \$40. T and T1 have no other assets, and T2 owns land with a \$10 basis and \$100 value. T2 also has a \$100 NOL carryover that will expire at the end of Year 5. At the beginning of Year 1, P buys all of the stock of T for \$100, and T, T1, and T2 become members of the P consolidated group. To avoid a basis reduction when T2's NOL carryover expires at the end of Year 5, the P group elects under Reg. § 1.1502-32(b)(4) to treat the carryover as expiring immediately before T2 becomes a member of the P group.

(ii) **Results.**

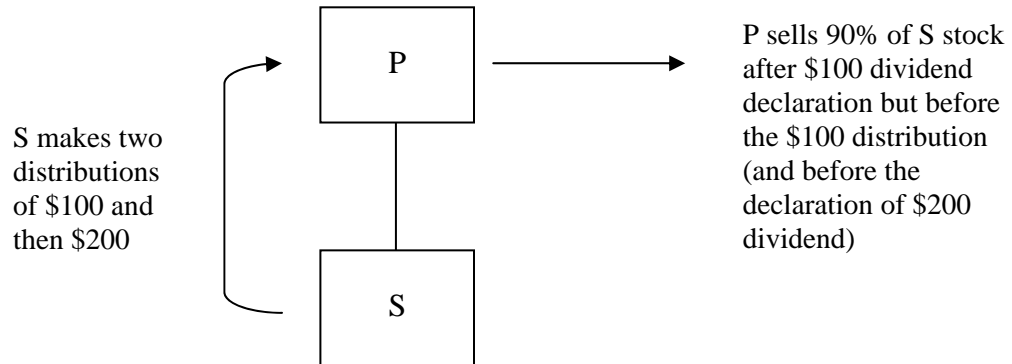
- **Basis Reduction.** Under Reg. § 1.1502-32(b)(3)(iii)(A) and (b)(4)(ii), the deemed expiration of T2's carryover causes a \$100 reduction in T1's basis in the T2 stock, thus creating a \$60 ELA. This reduction tiers up and also reduces T's basis in the T1 stock by \$100, thus creating a \$40 ELA. Under Reg. § 1.1502-32(b)(4)(ii), because P acquired the T stock in a qualifying cost basis transaction, P is not required to reduce its basis in the T stock.

- **Net Asset Basis Floor.** Under Reg. § 1.1502-32(b)(4)(iii), the stock basis reduction is restored to conform each subsidiary's stock basis to the net basis of its assets. Thus, T1's basis in the T2 stock is restored to \$10 (eliminating the \$60 ELA). This restoration does not tier up to T's basis in the T1 stock. Instead, the process is repeated, and T's basis in the T1 stock is restored to \$10 (eliminating the \$40 ELA). This floor only applies if the NOL expires by waiver or deemed waiver.
- **Consolidated Section 382/SRLY Overlap.** It appears that the waiver rule of Reg. § 1.1502-32(b)(4) continues to apply under the SRLY regulations, as amended in 2003, in situations where a section 382 limitation overlaps with the limitation under Reg. § 1.1502-21(c) (the "SRLY limitation"). In general, Reg. § 1.1502-21(g) provides that the SRLY limitation will not apply in situations in which there is an overlap with the application of section 382. It appears that the overlap rule simply turns off the SRLY limitation, rather than recharacterizing the carryover loss as something other than a SRLY loss. Thus, the election under Reg. § 1.1502-32(b)(4) appears to remain viable.

Coordination with the Prior Loss Disallowance Rules and the Unified Loss Rules. Loss carryovers that are waived pursuant to Reg. § 1.1502-32(b)(4) are not "duplicated losses" for purposes of the loss disallowance rules of Former Reg. § 1.1502-20 and Former Reg. § 1.1502-35, and are not treated as "loss carryovers" for purposes of the attribute reduction rule in Reg. § 1.1502-36(d) of the Unified Loss Rules, because they are not carried to the subsidiary's first taxable year following the disposition.⁵

⁵ See P.L.R. 9814028 (Dec. 24, 1997); Reg. § 1.1502-36(f)(6) (excluding losses waived under Reg. § 1.1502-32(b)(4) from the definition of loss carryover for purposes of Reg. § 1.1502-36(d)). Note that waived loss carryovers are taken into account for purposes of applying the basis reduction rule in Reg. § 1.1502-36(c) of the Unified Loss Rules. As noted above, on September 17, 2008, the Service issued the Unified Loss Rules. The new regulations replace the various consolidated return loss disallowance regulations of Reg. §§ 1.337(d)-2 and 1.1502-20. In addition, the new regulations limit the consolidated return anti-loss duplication regulations of Reg. § 1.1502-35 to pre-September 17, 2008 dispositions of S stock and post-September 16, 2008 dispositions of assets other than S stock where the basis of the asset is determined, in whole or in part, directly or indirectly, by reference to the basis of S stock. The Unified Loss Rules apply to transfers of shares of subsidiary stock occurring on or after September 17, 2008 unless the transfer was made pursuant to a binding agreement that was in effect prior to September 17, 2008 and all times thereafter. Reg. § 1.1502-36(h). For prior transfers of subsidiary stock shares, the loss disallowance rules of Reg. §§ 1.337(d)-2, 1.337(d)-2T, and 1.1502-20, as well as the basis redetermination rules of Reg. § 1.1502-35, may be applicable.

Example 7: Earnings Stripping



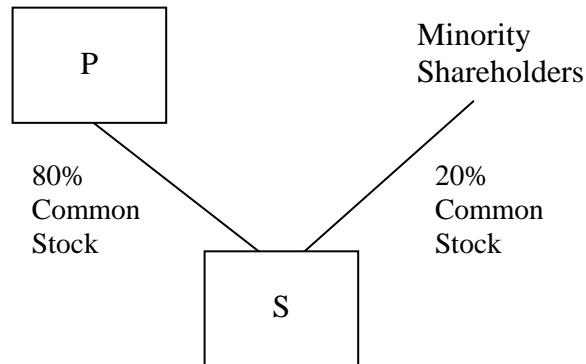
(i) **Facts.** P owns all of the 100 outstanding shares of S stock, which has a total value of \$1,000 and a basis of \$900. P and S file consolidated returns. S declares a dividend of \$100 to P. Shortly after the declaration but before the distribution, P sells 90 percent of the S stock to X for \$810. On the first day of the first separate return year of P or S, the net basis increase (as defined in Former Temp. Reg. § 1.1502-32T(a)) with respect to each share is \$3. Following the sale, S distributes the \$100 (i.e., \$1 with respect to each outstanding share). One year later, S makes a second distribution of \$200 (i.e., \$2 with respect to each outstanding share).

(ii) **Results.**

- **Stock Basis.** For stock basis adjustment purposes, all distributions are treated as having been made on the date the shareholder becomes “entitled” to the distribution. Reg. §§ 1.1502-13(f)(2)(iv); -32(b)(3)(v). Accordingly, the first \$100 distribution is treated as occurring on the date of the declaration of the dividend.
- **Earnings & Profits.** For E&P purposes, the \$100 distribution is also treated as occurring on the date the shareholder becomes entitled to it. See Reg. §§ 1.1502-13(f)(2)(iv); -33(b)(1). S’s remaining E&P, to the extent it has been taken into account by other members of the P group, is eliminated upon deconsolidation from the P group. Reg. § 1.1502-33(e). Because S’s E&P is eliminated only to the extent it was taken into account by another member, S will retain E&P if it has minority shareholders.
- **Prior Rules.** The prior regulations treated the first distribution of \$100 as if it were made immediately before the stock disposition, so that P would recognize \$90 of gain when it sold 90 percent of the S stock. Former Reg. § 1.1502-32(k). On the first day of the first separate return year, a basis reduction account in the amount of \$3 per share would be created with respect to the S stock that P retains. The amount of the second distribution would then result in a basis reduction of \$2 per share with respect to the S stock retained by P,

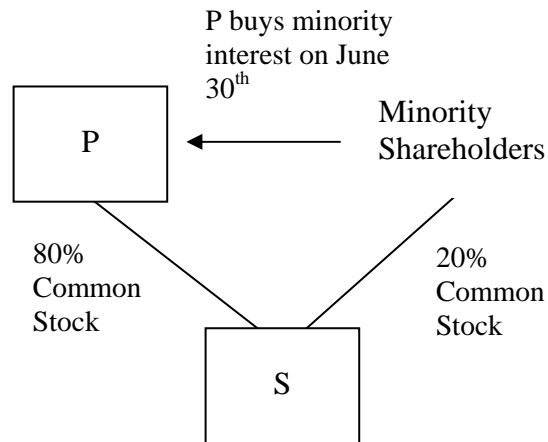
even though S was no longer a member of the P group. Assuming a 70-percent dividends-received deduction (or \$1.40 per share), this reduction was 60¢ per share too much. See Former Temp. Reg. § 1.1502-32T(a).

Example 8(a): Ownership of Less Than All of S's Stock



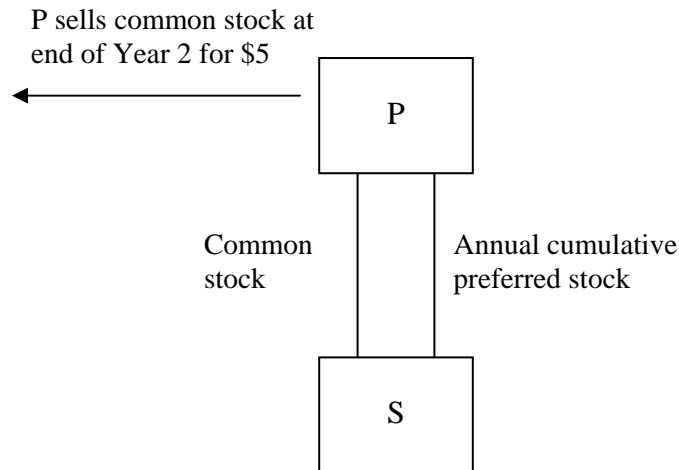
- (i) **Facts.** As of the beginning of Year 1, P owns 80 percent of S's only class of stock, which has an \$800 value and basis. A minority shareholder owns the remaining 20 percent. P and S file consolidated returns. During Year 1, S has \$100 of taxable loss.
- (ii) **Results.** Notwithstanding that the entire amount of the \$100 loss is reported on the consolidated tax return of the P group, the \$100 negative adjustment is allocated equally to each share, so that the S stock owned by P is reduced by only \$80. Reg. § 1.1502-32(c)(2). The portion of the basis adjustment allocated to stock owned by a nonmember does not affect the stock basis of the nonmember. Reg. § 1.1502-32(c)(1). This result is the same as under prior law.

Example 8(b): Varying Interest



- (i) **Facts.** The facts are the same as in Example 8(a), except that P buys the remaining 20 percent of S's stock on June 30 of Year 1. Of S's \$100 of taxable loss, \$40 is incurred in the period from January 1 to June 30, and \$60 in the period from July 1 to December 31. None of S's items of income or loss constitute extraordinary items.
- (ii) **Results.** Because P's interest in S varies during the year, Reg. § 1.1502-32(b)(1)(ii) requires S's varying interests to be determined by applying the principles of Reg. § 1.1502-76(b). The P consolidated group may use either a closing-of-the-books method or a ratable allocation method. No election is required to use ratable allocation as would be the case under Reg. § 1.1502-76(b) if S had become or ceased to be a member during the taxable year. Accordingly, P could ratably allocate S's taxable loss so that the required basis reduction for the period after P acquires all of the S stock is \$50 rather than \$60.

Example 9: Multiple Classes of Stock/Cumulative Redetermination



- (i) **Facts.** P owns all of S's common stock and preferred stock. P and S file consolidated returns. P's initial basis in the S preferred stock is \$1,000, and its initial basis in the S common stock is \$100. The preferred stock bears a \$100 cumulative annual dividend. During Year 1 (its first year of existence), S earns \$200 of taxable income, and there is a \$200 net positive basis adjustment. During Year 2, S has a \$300 tax loss, all of which is absorbed in the P group's Year 2 consolidated return. Accordingly, there is a \$300 net negative basis adjustment. On December 31 of Year 2, P sells all of S's common stock for \$5 (a price that reflects the "option value" of the S common stock). The liquidation value of the assets is \$1,000.
- (ii) **Results.**
- **Year 1/Allocation of Basis Adjustment Among Classes.** Because the preferred stock bears a \$100 annual dividend, the first \$100 of basis adjustment is allocated to the S preferred stock, and the remaining \$100 is allocated to the S common stock. Reg. § 1.1502-32(c)(1), (c)(3) (requiring allocations of positive adjustments first to preferred stock to the extent required to reflect total dividends arising during the period S is a member of the consolidated group).
 - **Year 2/Restriction On Allocating Negative Adjustments.** Because negative adjustments for tax losses can be allocated only to common stock, none of the \$300 negative adjustment in Year 2 is allocated to S's preferred stock. Reg. § 1.1502-32(c)(1). Thus, the entire \$300 negative adjustment for the tax loss absorbed in Year 2 is allocated to the S common stock, reducing the basis of that stock from \$200 (\$100 initial basis plus \$100 positive adjustment allocated in Year 1) to an ELA of \$100.

- **Year 2/Further Adjustment For Cumulative Redetermination With Respect to Year 1.** Under Reg. § 1.1502-32(c)(4), P’s basis in each share of common and preferred stock must, with certain exceptions, be redetermined whenever necessary to determine the tax liability of any person. Accordingly, a redetermination is required when the S common stock is sold in order to determine P’s tax liability on the sale. Because the preferred stock has earned \$200 of dividends at the end of Year 2, and S does not have any earnings in Year 2, it would appear that the \$100 positive adjustment allocated to the S common stock at the end of Year 1 must be reallocated to the S preferred stock at the end of Year 2. (This reallocation would be required even if the \$200 dividend accrued on the preferred stock had been distributed in Year 1.) The reallocation results in a further reduction of the basis of the S common stock to an ELA of \$200, thus seeming to result in P’s recognizing \$205 of gain on the disposition of the S common stock.⁶
- **Application of the Unified Loss Rules to Eliminate \$200 of S Preferred Stock Basis.** If one assumes the S preferred stock is worth only \$1,000 (S’s liquidation value) following the sale of the S common stock (such that the positive adjustments allocated and reallocated to the S preferred stock of \$200 has caused that stock to have a positive basis that exceeds its fair market value by \$200), it appears that each share of S preferred stock is a “loss share” within the meaning of Reg. § 1.1502-36(f)(7) (i.e., the adjusted basis of the share exceeds its fair market value on the date of the “transfer”). In addition, if the sale of the S common stock outside the P group causes S to leave the P group (as assumed in this example), then a “transfer” of the S preferred shares will also occur under Reg. § 1.1502-36(f)(10)(i) (defining “transfer” to include S shares retained by P on the date P and S are no longer members of the same consolidated group). If, after taking into account any applicable basis redeterminations required by Reg. § 1.1502-36(b) (see discussion below), a transferred S share remains a loss share, then P’s basis in the transferred share is further reduced (but not below its value) by the lesser of (i) the share’s “net positive adjustment” and (ii) the share’s “disconformity amount.”⁷
- The share’s “net positive adjustment” is defined as the greater of zero and the sum of all investment adjustments reflected in the basis of the share at the time of the transfer, as provided in Reg. § 1.1502-36(b)(1)(iii), but expanded to include all adjustments specially allocated under Reg. § 1.1502-32(c)(1)(ii) (not just the special allocation under Reg. § 1.1502-32(c)(1)(ii)(B), as in the case of the basis

⁶ Note that the rule in Reg. § 1.1502-32(c)(2)(i), which requires allocations first to common shares with an ELA, applies only after a positive adjustment has first been allocated between S’s common stock and preferred stock. Thus, this rule does not help reduce an ELA in cases in which all of the net positive adjustments must be allocated, or reallocated, to preferred stock.

⁷ Reg. § 1.1502-36(c)(2).

redetermination rule).⁸ Thus, here the definition of “net positive adjustment” includes all investment adjustments to the transferred loss share except the negative adjustment for distributions.

- The share’s “disconformity amount” is determined as of the time of the transfer and is defined as the excess, if any, of (a) P’s basis in the S share over (b) the share’s “allocable portion” of S’s “net inside attribute amount.”⁹ S’s “net inside attribute amount” generally is the sum of (i) S’s inside basis, money, net operating and capital loss carryovers, and deferred deductions, minus (ii) the amount of its liabilities.¹⁰

Here it appears that S’s “net inside attribute amount” vis-à-vis the S preferred stock is \$1,000 (hence the “disconformity amount” is \$200, which is the amount by which the \$1,200 basis in the S preferred stock exceeds S’s “net inside attribute amount”), and that the “net positive adjustment” vis-à-vis the S preferred stock is also \$200. Accordingly, to add insult to injury, it appears that the \$200 of positive investment adjustments allocated and reallocated to the S preferred stock is eliminated by Reg. § 1.1502-36(c) unless, as further discussed below, an election is made to apply the basis redetermination rules of Reg. § 1.1502-36(b).

- **Application of Basis Redetermination Rule of Reg. § 1.1502-36(b).** In addition to (and operating before) the basis reduction rule of Reg. § 1.1502-36(c), the basis redetermination rule of Reg. § 1.1502-36(b) must be consulted to determine whether all or part of the positive investment adjustments allocated to the S preferred stock (or negative adjustments allocated to the S common stock) must be reallocated to the S common stock (or to the S preferred stock). Because the deconsolidation of S results in a “transfer” of all the S stock, both common and preferred, in a single transaction to one or more nonmembers, the basis redetermination rules of Reg. § 1.1502-36(b)

⁸ Reg. § 1.1502-36(c)(3). Thus, any investment adjustments for noncapital, nondeductible expenses resulting from attribute reattribution that are specially allocated under Reg. § 1.1502-32(c)(1)(ii)(A) are taken into account under the basis reduction rule but not the basis redetermination rule.

⁹ Reg. § 1.1502-36(c)(4). A share’s “allocable portion” is defined in Reg. § 1.1502-36(f)(1) to have the same meaning as set forth in Reg. § 1.1502-32(b)(4)(iii)(B) (i.e., a vertical slice of S’s attributes). Each share within the same class will have an identical allocable portion, and if there are two or more classes of outstanding stock, S’s net inside attribute amount must be attributed to the various classes by taking into account the terms of each class and any other factors relating to the overall economic arrangement. For example, if S has 100 shares outstanding comprising a class of tracking stock, respected as S stock for federal income tax purposes, that participate in 99% of all gains, losses and cash flow relating to Asset A and in 1% of all other S gains, losses and cash flow, each tracking share would be allocated 0.99% of all attributes produced by Asset A and 0.01% of all other S attributes. Needless to say, the more complex S’s capital structure, the more difficult it becomes to determine a share’s “allocable portion” of S’s net inside attribute amount.

¹⁰ Reg. § 1.1502-36(c)(5).

may apply only if P affirmatively elects to have them apply.¹¹ If P affirmatively elects to apply the basis redetermination rules, the following relevant provisions will apply in determining whether a reallocation of investment adjustments is permitted or required:

- First, if the transferred loss share is a share of common stock of S, any positive investment adjustments previously allocated under Reg. § 1.1502-32(c) to the transferred S common share are removed from the share (until its basis equals its value) and reallocated under other provisions of the regulation.¹² The reallocation of positive investment adjustments from loss shares to other shares is available only with respect to a “transfer” of loss common stock, not a transfer of loss preferred stock.¹³
- Second, if the transferred share (whether common or preferred stock) remains a loss share after any applicable basis reduction under the positive investment adjustment reallocation rule, any negative investment adjustments previously allocated under Reg. § 1.1502-32(c) to S common shares that are not transferred loss shares are reallocated first to any transferred loss share of S that constitutes preferred stock, until its basis equals its value, and then to any transferred loss share of S that constitutes common stock, until its basis equals its value.¹⁴ If there are not sufficient negative adjustments to bring the bases of all transferred loss shares

¹¹ Reg. § 1.1502-36(b)(1)(ii). Even if all the S shares are transferred or otherwise disposed of (e.g., via a worthless stock deduction), Reg. §§ 1.1502-36(b)(1)(ii)(B) and (e)(5) provide the P group with an election to apply the basis redetermination rule.

¹² Reg. § 1.1502-36(b)(2)(i)(A).

¹³ Reg. § 1.1502-36(b)(2) can never apply to remove positive investment adjustments from the basis of a transferred share of preferred stock, even if the preferred share is a loss share. The apparent reason for this is the notion that, under Reg. § 1.1502-32(c)(1), (3) and (4), preferred stock picks up positive investment adjustments only to the extent section 301 distributions accrue on the preferred stock, hence those positive investment adjustments have economic reality. However, as noted in the following text, negative investment adjustments initially allocated to common stock are permitted to be reallocated to a share of preferred stock that is a transferred loss share.

¹⁴ Reg. § 1.1502-36(b)(2)(i)(B). Reg. § 1.1502-36(f)(8) defines “preferred stock” and “common stock” by incorporating the definitions of those terms found in Reg. § 1.1502-32(d)(2) and (3). Reg. § 1.1502-32(d)(3) defines “common stock” as any class of stock that is not “preferred stock” within the meaning of Reg. § 1.1502-32(d)(2). Reg. § 1.1502-32(d)(2) generally defines “preferred stock” as “stock that is limited and preferred as to dividends and has a liquidation preference.” However, if members of the group own less than 80% of each class of common stock, the second sentence of Reg. § 1.1502-32(d)(2) reclassifies “preferred stock” as “common stock.” The reason for the reclassification is to permit negative adjustments for absorbed losses and noncapital, nondeductible expenses to be allocated under Reg. § 1.1502-32(c)(1) to preferred shares held by members of the group where affiliation under section 1504(a)(2) results from their ownership of voting preferred stock and less than 80% of the participating common stock. Because preferred shares reclassified under Reg. § 1.1502-32(d)(2) as common shares may be allocated negative investment adjustments for absorbed losses and noncapital, nondeductible expenses that are reallocable under Reg. § 1.1502-36(b)(2), the Unified Loss Rules have an interest in being consistent with the investment adjustment rules in the classification of preferred shares and common shares.

constituting preferred stock down to their fair market value, the negative adjustments must be reallocated in a fashion that, to the greatest extent possible, reduces the disparity between the basis and value of each such share. Any negative adjustments remaining after the allocation to preferred shares are reallocated to all outstanding shares that constitute common stock under the same basis disparity reduction method.

Because positive adjustments may be reallocated only from common shares, none of the positive investment adjustments allocated and reallocated under Reg. § 1.1502-32(c) to the S preferred shares may be reallocated to the S common shares. However, negative investment adjustments can be reallocated from the “transferred” common shares because they are not transferred “loss” shares since their adjusted basis (an ELA of \$200) does not exceed their fair market value (\$5). Therefore, assuming the fair market value of the S preferred stock on the date of the “transfer” of the S common and preferred is \$1,000 (\$200 less than the \$1,200 basis of the S preferred stock), it would appear that \$200 of the \$300 negative adjustment originally allocated to the S common stock is required to be reallocated under Reg. § 1.1502-36(b)(2) to the S preferred stock, thus reducing the basis of the S preferred stock by \$200 to the stock’s value of \$1,000 and increasing the basis of the S common stock by \$200 from an ELA of \$200 to \$0. In summary, if P has sufficient knowledge of the basis redetermination rules of Reg. § 1.1502-36(b) to affirmatively elect to apply those rules to the deconsolidation of S caused by the sale of the S common stock outside the group, it would appear that the ELA would be eliminated, with P retaining the S preferred stock at a basis of \$1,000.¹⁵

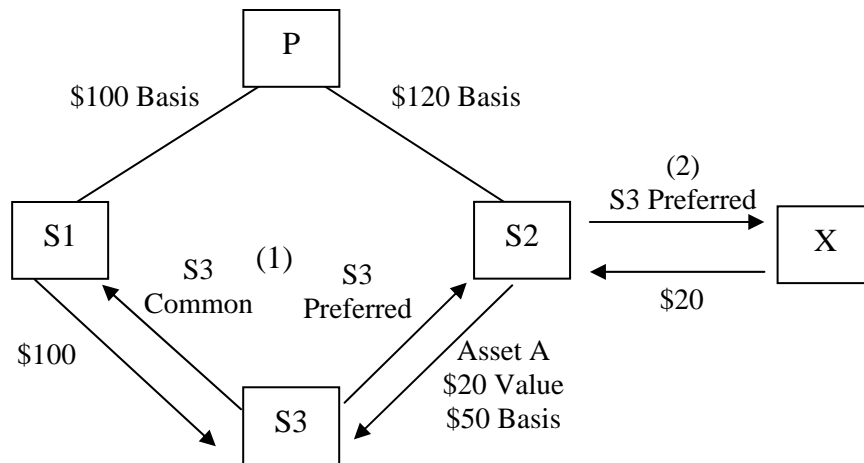
- **Economic/Tax Consequences of Redetermination.** Assuming P does not affirmatively elect to avail itself of the basis redetermination rules of Reg. § 1.1502-36(b) to reallocate \$200 of the \$300 negative adjustment from the S common stock to the S preferred stock, P would be required to recognize \$205 of gain on the sale of the S common stock at the end of Year 2. There is some disagreement as to whether this produces “phantom gain,” or whether it is consistent with the economics and prior tax history. The P group has used \$200 of S’s losses in excess of its \$100 contribution with respect to the common stock (but \$0 in excess of its total \$1,100 investment contribution in S common and preferred stock). This \$200 of income in excess of the \$5 gain with respect to the option value of stock represents turn-around, or recapture, income with respect to the S common stock investment. Here, the regulation binds P

¹⁵ The anti-avoidance rule of Reg. § 1.1502-36(g)(1) clouds a conclusion that such an election would be effective. However, this affirmative use of the election authorized by Reg. § 1.1502-36(b)(1)(ii)(B) and (e)(5) to reverse \$200 of the \$300 negative investment adjustment allocation to the S common stock should not be reversed by the anti-abuse rule in Reg. § 1.1502-36(g)(1). The preamble to T.D. 9424 indicates that the election is intended to provide taxpayers with the flexibility to use the basis redetermination rule to reverse noneconomic adjustments resulting from the investment adjustment system. T.D. 9424, 2008-44 I.R.B. 1012. In this example, it is relatively clear that the S preferred stock has borne a significant portion of the economic decline in the value of S caused by its large year 2 loss. Thus, it seems the election to reallocate \$200 of the \$300 negative adjustment to the S common stock to reflect the absorbed loss of S is permitted under the Unified Loss Rules.

to its form of having two separate types of economic investments in S – common and preferred – and analyzes them separately. Although S may not have a liquidation value of \$1,200 (the \$1,000 preference value plus \$200 dividend arrearages) at the time the S common stock is sold, the P group retains the first claim on S's assets up to the \$1,200 amount, and the S common presumably has potential value or a third party would not have paid to acquire S's common stock. Nonetheless, the combination of the allocation rule of Reg. § 1.1502-32(c) and the loss disallowance rule of Reg. § 1.1502-36(c) may effectively erase the entire \$200 positive basis adjustment in Year 1 from the system, thereby effectively taxing twice the \$200 of taxable income in Year 1. Thus, in this example it is imperative that P affirmatively elect to apply the basis redetermination rule of Reg. § 1.1502-36(b) to shift \$200 of the \$300 negative investment adjustment from the S common stock to the S preferred stock, thus eliminating the ELA in the S common stock.

- **No Other Election To Reduce Basis Available.** Reg. § 1.1502-19 does not contain a provision, similar to Former Reg. § 1.1502-19(a)(6), that would permit P to apply the ELA in the S common stock to reduce the adjusted basis of the S preferred stock. Under the facts of this example, the election would not have been available in any event, because it would be precluded by Former Reg. § 1.1502-19(a)(6)(ii), which prevents netting that would frustrate the purposes of the loss disallowance rules. Thus, absent affirmative election to apply the basis redetermination rule of Reg. § 1.1502-36(b) to shift \$200 of the \$300 negative investment adjustment from the S common stock to the S preferred stock, thus eliminating the ELA in the S common stock, there is no other relief available.

Example 10: Basis Redetermination – No Deconsolidation



- (i) **Facts.** P owns all of the stock of S1, with a value of \$130 and a basis of \$100, and S2, with a value of \$90 and a basis of \$120. In Year 1, S1 and S2 form S3. S1 contributes \$100 cash to S3 in exchange for all of the S3 common stock. S2 contributes Asset A, with a value of \$20 and a basis of \$50 in exchange for all of the preferred stock of S3. In Year 3, S2 sells the S3 preferred stock to X for \$20, and S3 remains a member of the P group.
- (ii) **Results.** In general, if a member transfers a share of stock of a subsidiary member that has a basis in excess of its value (i.e., a loss share), the basis of each share of the subsidiary stock held by each member of the group is redetermined immediately before such transfer as follows (Reg. § 1.1502-36(b)(2)):

First, if the transferred loss share is a share of common stock of S3, any positive investment adjustments previously allocated under Reg. § 1.1502-32(c) to the transferred S3 common share are removed from the share (until its basis equals its value) and reallocated under other provisions of the regulation. The reallocation of positive investment adjustments from loss shares to other shares is available only with respect to a “transfer” of common stock, not a transfer of preferred stock.

Second, if the transferred share (whether common or preferred stock) remains a loss share after any applicable basis reduction under the positive investment adjustment reallocation rule, any negative investment adjustments previously allocated under Reg. § 1.1502-32(c) to S3 common shares that are not transferred are reallocated first to any transferred loss share of S3 that constitutes preferred stock, until its basis equals its value, and then to any transferred loss share of S3 that constitutes common stock, until its basis equals its value.

Here, because the transferred loss shares are shares of S3 preferred stock and S3 is not deconsolidated, there is no “transfer” within the meaning of Reg. § 1.1502-36(f)(10)(i) of the S3 common shares. More importantly, any positive investment adjustments to the S3 preferred shares may not be reallocated under Reg. § 1.1502-36(b)(2) to the retained S3 common shares, and there are no negative adjustments to the S3 common shares that may be reallocated under Reg. § 1.1502-36(b)(2) to the “transferred” S3 preferred shares. Thus, Reg. § 1.1502-36(b)(2) will not apply to redetermine the basis of either the “transferred” S3 preferred stock or the “non-transferred” S3 common stock.

Turning to Reg. § 1.1502-36(c)(2), as discussed above in the context of Example 9, that provision will eliminate the high basis in the “transferred” S3 preferred stock to the extent of the lesser of (i) the net positive adjustment to the S3 preferred stock basis (which is \$0 here) and (ii) the S3 preferred stock’s disconformity amount (which is also \$0 here because the aggregate outside basis of the S3 common and preferred stock of \$150 equals the \$150 inside asset basis of S3). Therefore, Reg. § 1.1502-36(c)(2) will not apply to reduce the \$50 basis of the S3 preferred stock down to the \$20 fair market value of that stock.

Turning to Reg. § 1.1502-36(d), in order to further single entity principles by preventing a subsidiary, S (or lower-tier subsidiaries of S) from using losses or deductions to the extent the group or its members (including former members) have used (or preserved for future use) a corresponding loss in S shares, Reg. § 1.1502-36(d) reduces the attributes of S (or a lower-tier subsidiary of S) to the extent they duplicate a net loss on shares of S stock transferred by members in one transaction.¹⁶ The attribute reduction rule applies only if the transferred S share remains a loss share after making all adjustments to its basis under all applicable rules, including the rules in Reg. § 1.1502-36(b), (c) and (d)(5)(iii) (negative S stock basis adjustment to reflect attribute reduction amounts of lower-tier subsidiaries of S).¹⁷ In addition, unless the common parent affirmatively elects to reduce attributes under Reg. § 1.1502-36(e)(5), attribute reduction does not occur if the aggregate attribution reduction amount in the transaction is less than 5% of the value of the S shares transferred by members in the transaction.¹⁸

Reg. § 1.1502-36(d)(3)(i) defines “attribute reduction amount” to be the lesser of:

- The “net stock loss” (defined in Reg. § 1.1502-36(d)(3)(ii) as the aggregate value over aggregate basis of all S shares, both gain and loss shares, transferred in the transaction), and

¹⁶ Reg. § 1.1502-36(d)(1).

¹⁷ Reg. § 1.1502-36(d)(2)(i).

¹⁸ Reg. § 1.1502-36(d)(2)(ii).

- S's "aggregate inside loss."

S's "aggregate inside loss" is the excess of (1) S's net inside attribute amount (generally as defined in Reg. § 1.1502-36(c)(5)),¹⁹ over (2) the value of all outstanding shares of S stock.²⁰

Here, the "net stock loss" is \$30 (the \$50 adjusted basis of the "transferred" S3 preferred stock over the \$20 fair market value of that stock), and the "aggregate inside loss" of S3 likewise is \$30 (S3's net inside attribute amount of \$150 minus the \$120 value of all the outstanding S3 common and preferred stock by \$30). Therefore, under Reg. § 1.1502-36(d)(2), S3 is required to reduce its inside attributes by \$30, all of which is allocated under Reg. § 1.1502-36(d)(4) to the \$50 adjusted basis of Asset A.²¹

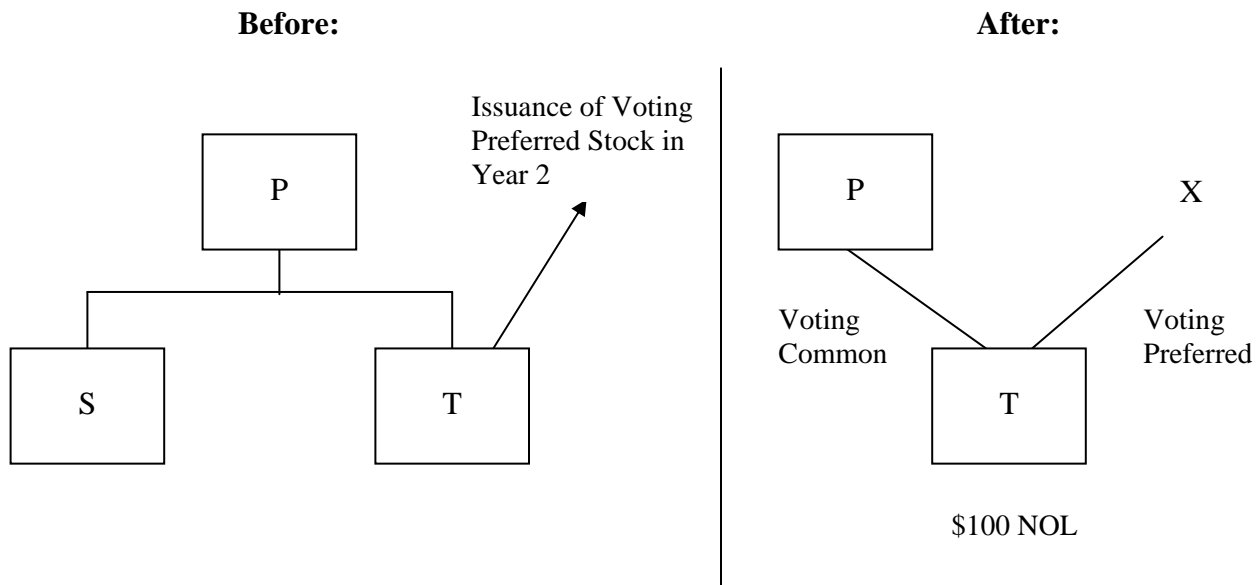
Finally, it should be noted that Reg. § 1.1502-80(h)(1) generally turns off the application of section 362(e)(2) to the contribution of Asset A to S3. However, there is an anti-abuse rule in Reg. § 1.1502-80(h)(1) that is designed to backstop the elimination of section 362(e)(2) from consolidated section 351 exchanges by making adjustments whenever a transaction is engaged in with a view to prevent the consolidated return regulations from properly addressing loss duplication. Because Reg. § 1.1502-36(d) applies in this example to prevent loss duplication, the anti-abuse rule in Reg. § 1.1502-80(h)(1) should not apply.

¹⁹ Reg. § 1.1502-36(d)(3)(iii)(B) defines S's net inside attribute amount for purposes of the attribute reduction rule.

²⁰ Reg. § 1.1502-36(d)(3)(iii)(A).

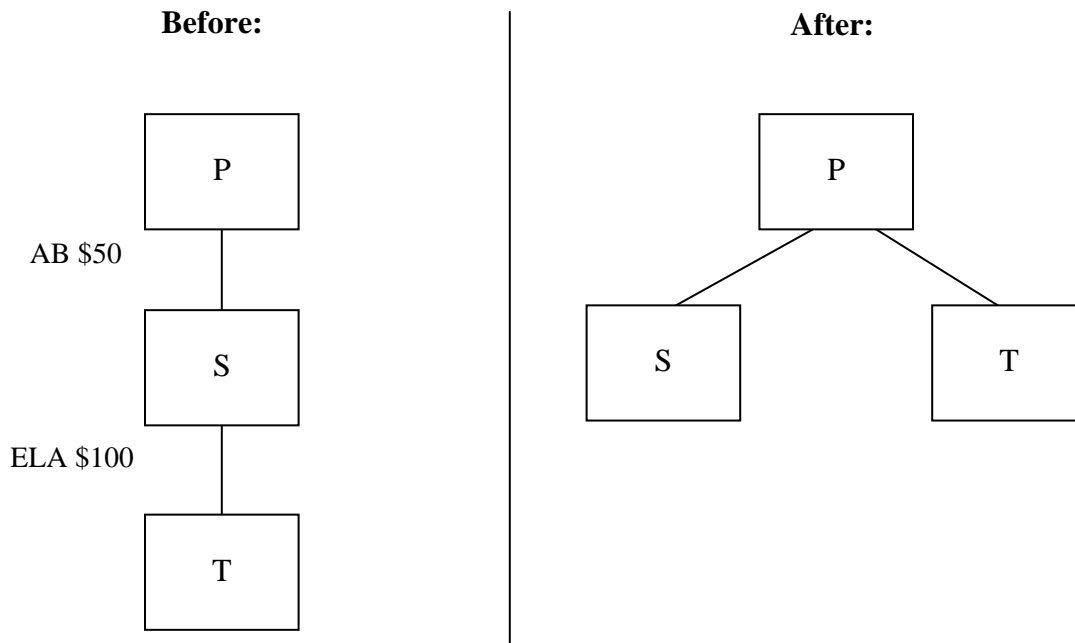
²¹ Note that the P Group may elect under Reg. § 1.1502-36(d)(6) to reduce S2's basis in the transferred S3 stock rather than requiring S3 to reduce its basis in Asset A. Reg. § 1.1502-36(d)(6) permits an election to reduce the potential for loss duplication by either (i) reducing all or any portion of members' bases in the transferred loss shares or (ii) reattributing all or any portion of the subsidiary's capital loss carryovers, net operating loss carryovers, and deferred deductions. Because S3's sole attribute is its basis in Asset A, the P Group cannot elect to reattribute and thus can only elect to reduce S2's basis in the transferred S3 stock to the extent of the \$30 attribute reduction amount. The effect of an election would be to reduce or eliminate S2's recognized loss in Year 3 and to preserve that loss in S3's basis in Asset A.

Example 11: Anti-Avoidance Rule



- (i) **Facts.** P forms T with a \$100 capital contribution, and T joins in the P group's consolidated return. For Year 1, T has \$40 of earnings, and P's basis in the T stock increases from \$100 to \$140 under Reg. § 1.1502-32. P anticipates that T will have a \$40 NOL for Year 2 that will be carried back to Year 1 and offset T's \$40 of income, reducing P's basis in the T stock to \$100. With a principal purpose to avoid the reduction, T disaffiliates at the beginning of Year 2 by issuing voting preferred stock to a nonmember.
- (ii) **Results.**
- **Appropriate Adjustments.** Under Reg. § 1.1502-32(e), deconsolidating T does not avoid the negative investment adjustment because of P's prohibited purpose. See Reg. § 1.1502-32(e)(2) ex. 4. Thus, the P group cannot straddle the consolidated and separate return rules. See T.A.M. 8827001 (same).
 - **Carryback to a Prior Separate Return Year.** If, instead, T had been acquired by P and the NOL was to be carried back to a prior separate return year of T, no investment adjustment is required. Although P causes T to become a nonmember with a principal purpose to avoid the negative adjustment, there is no inappropriate straddling of consolidated and separate return years. P bears a substantial portion of the loss because of its continued ownership of T common stock, and both T's income and loss are taken into account under the separate return rules. See Reg. § 1.1502-32(e)(2) exs. 4(c) & 5.

Example 12: Triggering ELA Before Effective Date



(i) **Facts.** In 1990, P owned all of the stock of S, and S owned all of the stock of T. P had a \$50 basis in the S stock, and S had a \$100 ELA in the T stock. The T stock represented half of the value of the S stock. S distributed all of the T stock in a spin-off that qualified under section 355.

(ii) **Results.**

- **Current regulations.** The ELA generally is not taken into account. Under Reg. § 1.1502-19, which generally treats an ELA simply as negative basis for purposes of applying Code rules, the nonrecognition and basis rules of sections 355 and 358 would apply to the ELA. S's gain in the T stock is not recognized, the ELA is eliminated, and P's basis in the S stock is allocated equally between S and T. See Reg. § 1.1502-19(g) ex. 3(a) & (b). (To the extent that the ELA is attributable to the absorption of T's losses, the negative investment adjustment under Reg. § 1.1502-32 has also tiered up to the S stock and is already reflected in its basis.)

Under Reg. § 1.1502-19(h), the current regulations are effective for determinations of basis and ELAs in taxable years beginning after 1994. If the current regulations apply, basis and ELAs must be determined as if they were in effect for all years. Reg. § 1.1502-19(h)(2)(i) provides that:

If P was treated as disposing of stock of S in a tax year beginning before January 1, 1995 . . . under the rules of this section then in effect, the amount of P's income, gain, deduction, or loss, and the

stock basis reflected in that amount, are not redetermined under paragraph (h)(1) of this section.

The effective date rules also provide that a disposition does not include an intercompany transaction to which the prior intercompany transaction rules apply. Instead, the transaction is deemed to occur as it is taken into account. Reg. § 1.1502-19(h)(2)(ii). Thus, if gain from an ELA is deferred under the prior regulations until after 1994, there may be no disposition to which the prior regulations will apply, because the disposition is treated as occurring under the current regulations. (Under the current regulations, the disposition no longer triggers the ELA.) Yet, there was a prior period intercompany transaction, and the general effective date of Reg. § 1.1502-13(l)(1) makes it clear that the prior intercompany transaction rules continue to apply to prior period intercompany transactions. Moreover, the general effective date of Reg. § 1.1502-19(h)(1) only refers to determinations of basis and ELAs after 1994 and not the re-evaluation of prior period triggers.

Does the term “treated” in Reg. § 1.1502-19(h)(2)(i) refer to treatment by the taxpayer, or to proper treatment under the prior regulations? Cf. section 382(g)(4)(D) (a zero section 382 limitation applies if stock is “treated” by certain shareholders as worthless). The former interpretation could be correct if administrative considerations were paramount. If taxpayer treatment were determinative under the effective date rule, the prior regulations would apply if the group took the ELA into account and reported the income on its 1990 return, but the current regulations would apply if the group treated the ELA as eliminated.

- **Prior regulations.** The result under the prior rules was unclear. Under Former Reg. § 1.1502-19(b)(1), the distribution would be a disposition that triggers the ELA, and the exceptions for tax-free transactions under Former Reg. § 1.1502-19(d) and (e) would not apply. Under Former Reg. §§ 1.1502-14(c) and 1.1502-14T(a), gain recognized on an intercompany distribution described in section 301(c) was deferred and taken into account in the manner specified in Former Reg. § 1.1502-13. Although gain from these taxable intercompany distributions was generally deferred, section 355 overrides the treatment under sections 301 and 311. Because there was no provision specifically applicable to section 355 transactions, it is therefore unclear whether the general deferral for distributions applied to section 355 distributions.

A group that was faced with applying the prior regulations to an ELA in a spin-off could have chosen from at least four positions:

1. The ELA is triggered, and the resulting gain is taken into account by S immediately.
2. The ELA is triggered, but the resulting gain is deferred by S under Former Reg. § 1.1502-14(c) and Former Temp. Reg. § 1.1502-14T(a).

3. The ELA is not triggered, and by analogy to carryover basis transactions, it becomes an ELA in the T stock in the hands of P.
4. The ELA is not triggered, because the failure to provide an exception for ELAs in spin-offs was inadvertent. Following the principles of sections 355 and 358(c), S's ELA in the T stock is eliminated and P's basis in the S stock is allocated between S and T based on their relative values (as under the current regulations).

(iii) **Legislative Developments.** The Taxpayer Relief Act of 1997 amended section 355 which, among other things, might result in a modification of the treatment of ELAs in connection with section 355 transactions. In relevant part, section 355(f) provides generally that, except as otherwise provided in regulations, section 355 will not apply to a distribution from one member of an affiliated group to another member of such group (an "Intragroup Distribution") if such distribution is part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent-or-greater interest (measured by vote or value) in the stock of the distributing corporation or any controlled corporation.

In addition, with respect to Intragroup Distributions, the legislation granted regulatory authority to the Secretary of the Treasury under section 358 to provide adjustments to the basis of any stock in a corporation that is a member of that group, "to appropriately reflect the proper treatment of such distribution." Section 358(g). The legislative history states that the Conferees believe that concerns exist regarding basis adjustments in the context of Intragroup Distributions, regardless of whether such distributions occur in connection with an acquisition. The legislative history explains that the concerns include (i) the elimination of an ELA of a lower tier member (as depicted above) and (ii) basis shifting that results from the fair market value basis allocation rules of section 358. H.R. Conf. Rep. No. 105-220, at 535 (1997).

Thus, it is unclear whether future regulatory guidance will provide that ELAs are triggered by reason of an Intragroup Distribution. Query whether the answer will depend on the mechanism by which the ELA was created. For example, should the answer differ depending on whether the ELA is generated by debt-financed losses over time versus an ELA that is generated by causing the controlled corporation to borrow funds that it distributes to the distributing corporation (which the distributing corporation may distribute to its shareholder(s)) in connection with an acquisition of the distributing or controlled corporation.

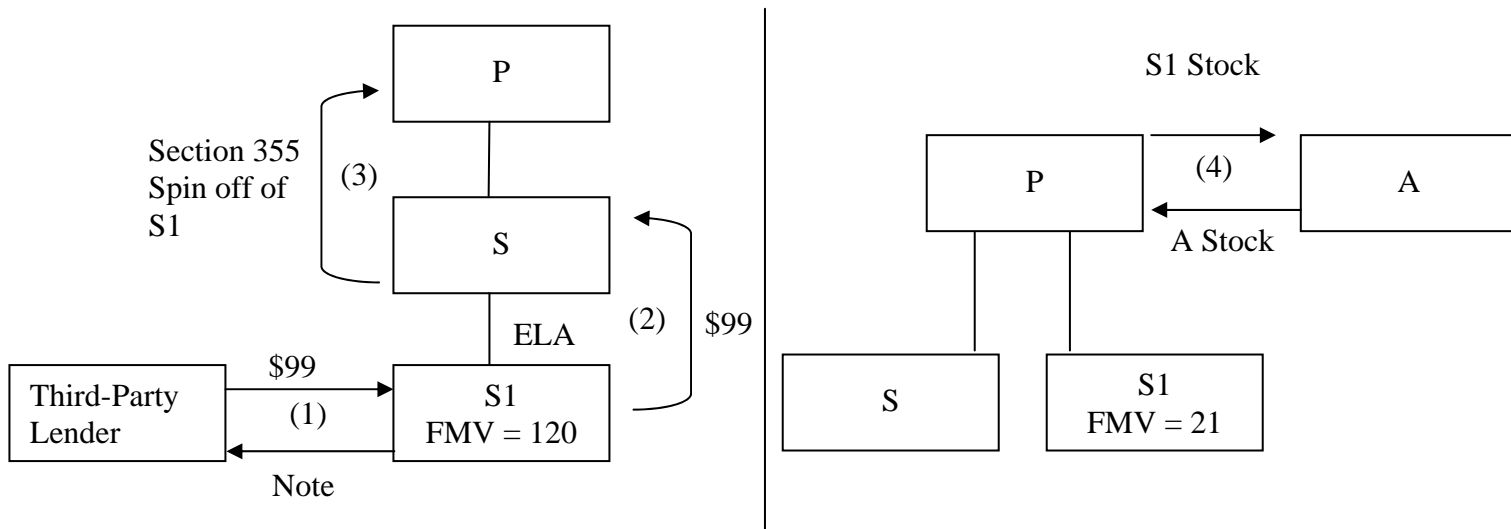
As stated above, the basis shifting concerns that troubled the drafters are not limited to situations involving ELAs. If a distributing corporation were to contribute cash to a controlled corporation prior to a spin-off, no negative investment adjustment would be required with respect to the stock of the distributing corporation under Reg. § 1.1502-32. See Reg. § 1.1502-32(c)(2)(iii)(B), (2)(v). Thus, if P owned all of the stock of S, which owned all of the stock of T, S's contribution of cash to T prior to spinning off T to P should not cause P to reduce its basis in S under Reg. § 1.1502-32 (regardless of whether

S borrowed the cash to reduce its value prior to P's spinning S out of the group). Rather, P would allocate its predistribution basis in S between the T and S stock under section 358. Thus, no ELA would be created even if the cash contributed by S to T were to exceed P's basis in the S stock.

The amendments to sections 355 and 358 grant broad regulatory authority to the Treasury Department to address concerns regarding basis. That legislative history suggests several approaches that might be taken including (i) requiring a carryover basis (or basis that conforms to inside asset basis) for the controlled corporation, and (ii) reducing the basis in the distributing corporation to reflect the change in value and basis of the distributing corporation's assets (perhaps to an amount that is less than the aggregate basis of the stock of the distributing corporation before the distribution). H.R. Conf. Rep. No. 105-220, at 536.

It is unclear whether the Treasury will adopt one or more of the Conferees' suggestions regarding basis and/or change the treatment of ELAs in the context of Intragroup Distributions. The legislative history states, however, that in the context of Intragroup Distributions that are not part of plan to have a prohibited 50-percent-or-greater ownership change, any such regulations are expected to be prospective, except in cases to prevent abuse. H.R. Conf. Rep. No. 105-220, at 537.

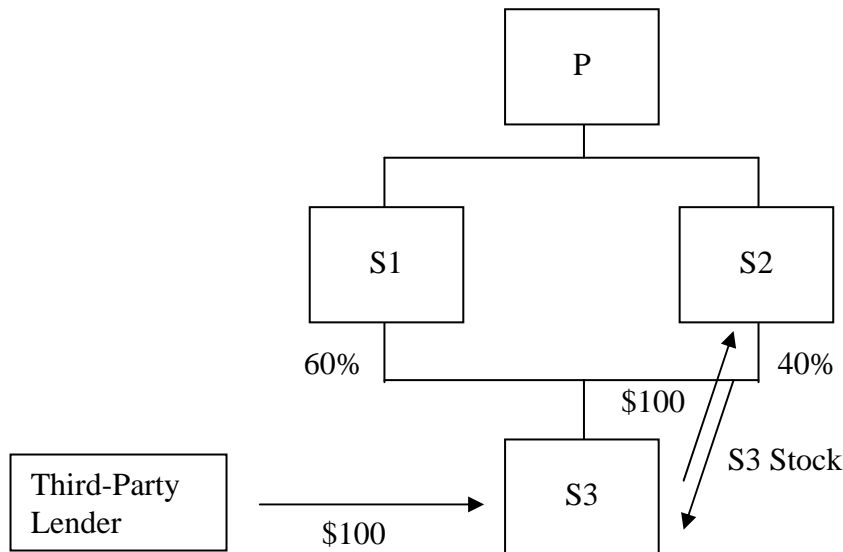
Example 13: ELA Elimination Transaction



- (i) **Facts.** S1 borrows money from third-party lender and distributes the proceeds to Subsidiary, which creates an ELA with respect to S1 stock. S then distributes stock of S1 tax free to P. A acquires the stock of S1 from P in exchange for more than 50 percent of A stock.
- (ii) **Results.** As discussed in Example 12, under Reg. § 1.1502-19, no gain is recognized to Parent Group under section 355.²² P’s basis in S is allocated between S and S1, and S1’s ELA is eliminated. Reg. § 1.1502-19(g) ex. 3. But see F.S.A. 200022006 (Dec. 9, 1999) (concluding that the intervening section 355 distribution did not prevent the triggering of the ELA, because the principal purpose of the distribution was to avoid recognition of the ELA).

²² Note that section 355(e) would trigger tax on any built-in gain that Subsidiary had in its Subsidiary 1 stock if Parent had ended up owning less than 50 percent of Acquiror.

Example 14: Redemptions Taxable Under Section 301(c)



(i) **Facts.** P owns all the stock of S1 (value of \$150 and basis of \$0) and all the stock of S2 (value of \$200 and basis of \$100). S1 owns 60% of the stock of S3 (value of \$150 and basis of \$0), and S2 owns the remaining 40% of the stock of S3 (value of \$100 and basis of \$0). S3 borrows \$100 from a third party lender and distributes that cash to S2 in redemption of S2's 40% interest in the S3 stock

(ii) **Results.**

- Assuming the redemption of the 40% interest in the S3 stock held by S2 does not qualify for sale or exchange treatment under any of the tests in section 302(b) by reason of the fact that S2 constructively owns 100% of the S3 stock after the redemption under section 318(a)(2)(C) (the rule attributing S1's S3 stock to P) and (a)(3)(C) (the rule attributing to S2 all the S3 stock constructively owned by P), the redemption distribution is required to be treated under sections 302(d) and 1059(e)(1) as an "extraordinary" distribution taxable under sections 301(c) and 1059(a).²³ Section 1059(a) and Reg. § 1.1502-32(b)(2)(iv) require the \$100 distribution to S2 to reduce the basis of S2's S3 stock by \$100 (creating a \$100 ELA), and Reg. § 1.1502-13(f)(2) treats the \$100 distribution as tax-exempt income to S2. However, S2 does not own any S3 stock after the redemption that can reflect the \$100 ELA created by operation of Reg. § 1.1502-32(b)(2)(iv). So, what happens to the ELA?

²³ If the redemption of the S3 stock held by S2 is part of a "firm and fixed plan" to dispose of the S2 stock (e.g., the redemption is being done to eliminate an asset, the S3 stock, that is not wanted by a prospective purchaser of the S2 stock), then the attribution of S1's S3 stock to S2 under sections 318(a)(2)(C) and (a)(3)(C) would be terminated, and the redemption would qualify for sale or exchange treatment under section 302(b)(3). See Merrill Lynch & Co. v. Commissioner, 120 T.C. 3 (2003).

- Reg. § 1.302-2(c) provides that proper adjustment to the basis of remaining stock must be made whenever a redemption is treated as a distribution of a dividend.²⁴ In Reg. § 1.302-2(c), Ex. (2), husband owns 50% of the stock of X and wife owns the other 50% of the stock of X. In the example, X distributes \$150,000 to X in complete redemption of husband's 50% interest in the X stock and the redemption is taxed as a dividend to husband because husband constructively owns the remaining 50% of the X stock held by wife. The example concludes that husband's \$50,000 basis in the redeemed X shares shifted to wife's basis in the remaining X shares, increasing her basis from \$50,000 to \$100,000.²⁵
- Reg. § 1.1502-19(a)(2)(ii) provides that ELAs are treated as negative basis. See also Reg. § 1.1502-19(b)(2)(i) (applying the nonrecognition provisions of the Code, such as section 332, to transactions eliminating ELAs).
- Therefore, one might conclude in this case that S2's \$100 ELA in the redeemed S3 stock hops over and reduces (dollar for dollar) the adjusted basis of the S3 shares held by S1 under the theory that it is S1's S3 stock that caused the redemption to be taxable under section 301(c). In fact, this is precisely the conclusion reached by the Service in PLR 9815050 (Jan. 9, 1998).²⁶

²⁴ If, due to the absence of earnings and profits in the redeeming corporation, none of the distribution is treated as a dividend under section 301(c)(1), arguably Reg. § 1.302-2(c) does not apply. However, this is because, outside of consolidation, a non-dividend distribution first reduces the distributee shareholder's basis under section 301(c)(2), with the balance then yielding sale or exchange treatment under section 301(c)(3). In consolidation, section 301(c)(3) is turned off, and the entire amount of a distribution (even the portion treated as a dividend under section 301(c)(1)) causes a dollar-for-dollar reduction in basis under Reg. § 1.1502-32(b)(2)(iv), with any excess distribution over basis creating an ELA. Thus, in consolidation, the basis hopping rule of Reg. § 1.302-2(c) should not be limited to distributions out of earnings and profits that are characterized as dividends under section 301(c)(1). To illustrate, suppose in the text Example 52, S2's basis in the redeemed S3 stock had been \$150, and S3 has no earnings and profits. After the \$100 redemption distribution, S2's remaining \$50 basis in the redeemed S3 shares should be reflected as a \$50 increase in the adjusted basis of S1's S3 shares under Reg. § 1.302-2(c) even though no portion of the \$100 distribution to S2 is a dividend under section 301(c)(1). Otherwise S2's \$50 of excess basis in the redeemed S3 shares is lost forever.

²⁵ If husband had retained even one share of X stock following the redemption, Reg. § 1.302-2(c), Ex. (3), indicates that the basis of the redeemed shares would be reflected in that one share even though it likely would create a built-in loss. Similarly, under the facts of the text Example 52, if S2 had retained a share of S3 stock following the redemption, presumably the entire \$100 ELA would be reflected in that one share.

²⁶ In Notice 2001-45, 2001-2 C.B. 129, the Service concludes that a basis shifting transaction, arising by reason of a tax-exempt person's constructive ownership under section 318(a)(4) (the option attribution rule) of stock owned by a U.S. taxpayer and a subsequent complete redemption of the tax-exempt person's stock, is a "listed" transaction that will be attacked under various general tax principles. Presumably such "basis shifting" transactions are limited to cases in which options or other strained arrangements are created for the purpose of generating artificial income to a tax-insensitive party for the purpose of reducing the income of a taxpayer by shifting basis from shares redeemed from the tax-insensitive party to the shares held by the taxpayer and does not apply to cases, such as Example 52, in which an isolated redemption is taxable as a distribution as a result of pre-existing stock ownership. See also Reg. § 1.7701(l)-3(b)(2)(ii) (providing that "Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of section 302(d) unless there is a principal purpose of achieving the same economic

- The next question is the investment adjustments to the basis of the stock of S1 and S2. Under Reg. § 1.1502-32(b)(2)(ii) and (iv), the adjusted basis of the S2 stock is increased by \$100 to reflect S2's tax-exempt income (the \$100 distribution excluded from S2's income by Reg. § 1.1502-13(f)(2)) and decreased by \$100 to tier up the negative adjustment to S2's S3 stock to reflect the distribution. In addition, the elimination of the negative basis of \$100 in S2's S3 stock is a noncapital, nondeductible expense under Reg. § 1.1502-32(b)(2)(iii) that must be subtracted from the basis of P's S2 stock. Because the subtraction of a negative number (the \$100 ELA) yields a positive number, the net result is that P increases the adjusted basis of its S2 stock by \$100 (from \$100 to \$200). This makes sense from a policy perspective because the \$100 net increase in the S2 stock basis reflects the \$100 increase in the inside basis of S2's assets (S2 substituted its \$0 basis S3 stock for \$100 of cash).
- Turning to P's S1 stock basis, Reg. § 1.1502-32(b)(2)(ii) requires an adjustment to reflect any tax-exempt income of S1 (which includes a permanent increase in S1's inside asset basis that is not accompanied by an equal amount of taxable income), and Reg. § 1.1502-32(b)(2)(iii) requires an adjustment to reflect any S1 noncapital, nondeductible expense. Because S1's inside asset basis is reduced by \$100 (its S3 stock basis is reduced from \$0 to an ELA of \$100), these rules require a \$100 negative adjustment to the basis of P's S1 stock (taking that basis down from \$0 to a \$100 ELA). Thus, as far as P's S1 and S2 stock basis is concerned, it appears that P's S2 stock basis is increased by \$100 to \$200 and its S1 stock basis is decreased by \$100 to a \$100 ELA. Accord PLR 200810015 (Dec. 4, 2007); PLR 9815050 (Jan. 9, 1998).
- In Announcement 2006-30, 2006-19 I.R.B. 879, the Service announced the withdrawal of proposed regulations addressing section 301 redemptions (Prop. Reg. § 1.302-5, REG-150313-01, 2002-1 C.B. 777, 67 F.R. 64331 (Oct. 18, 2002)) but warns that it is studying how basis should be adjusted following such redemptions, both within and outside of consolidation. Also, Reg. § 1.1502-19(e) sets forth an anti-avoidance rule authorizing adjustments when a principal purpose of any action is to avoid the purposes of the ELA rules or to apply the ELA rules to avoid the effect of any other consolidated return rule. Thus, while the ELA hopping results summarized above seem appropriate under current law, there is some risk the Service might argue under current law that allowing the ELA to hop is inconsistent with the policies underlying Reg. § 1.1502-19 and, hence, an adjustment (e.g., triggering S2's \$100 ELA as current capital gain) is required if a principal purpose of the redemption is to cause the ELA to hop.

and tax effect as a fast-pay arrangement," thereby indicating that an isolated redemption of stock that is taxed as a dividend but has the effect of a return of the redeemed shareholder's investment will not be recast under the fast-pay regulations).

- Following up on its admonition in Announcement 2006-30, on January 21, 2009, the Service published proposed regulations (primarily under sections 301, 302, 304, 354, 356, 358, 861, and 1016) to provide guidance regarding basis allocation under section 358 and the recovery of stock basis in distributions under section 301 and transactions that are equivalent to section 301 distributions, such as redemptions that do not qualify for sale or exchange treatment under section 302(b) or boot taxable as a dividend equivalent under section 356(a)(2). REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009). This effort seems to be far more thoughtful than the earlier effort published in October of 2002. *See American Bar Association Section of Taxation, Comments Concerning Proposed Regulations Providing Guidance Regarding the Treatment of Unutilized Basis of Stock Redeemed in Certain Transactions*, 2003 TNT 178-47 (Sept. 9, 2003). Nevertheless, the proposed regulations contain a few rather surprising and many quite interesting policy calls in terms of how stock basis is recovered in return of capital distributions (whether in the context of section 301 or dividend equivalent transactions governed by section 302, section 304 or section 356) and how basis is allocated among shares of stock in section 351 exchanges and capital contributions.
- Prop. Reg. § 1.301-2(a) provides, “That portion of a distribution which is not a dividend shall be applied pro rata, on a share-by-share basis, to reduce the adjusted basis of each share of stock held by the shareholder within the class of stock upon which the distribution is made.” This provision will apply to distributions after the date the regulations are finalized.
- The “popping basis” rule of Reg. § 1.302-2(c) (which shifted the basis of redeemed shares in a dividend equivalent redemption into unredeemed shares of the taxpayer, or into constructively owned shares where all the taxpayer’s shares were redeemed) would be revoked. In its place would be Prop. Reg. § 1.302-5(a)(1), which provides, “In any case in which an amount received in redemption of stock ... is treated as a distribution to which section 301 applies, that portion of the distribution that is not a dividend shall be applied to reduce the adjusted basis of each share held by the redeemed shareholder ... in the redeemed class” Prop. Reg. § 1.302-5(a)(2) goes on to state, “[Except in the case in which all the shares actually owned by the shareholder in a redeemed class are redeemed], immediately following the reduction of basis as provided in section 301(c)(2) and paragraph (a)(1) of this section, all shares of the redeemed class, including the redeemed shares, held by the redeemed shareholder will be treated as surrendered in a reorganization described in section 368(a)(1)(E) in exchange for the number of shares of the redeemed class directly held by the redeemed shareholder after the redemption. The basis of the shares deemed received in the reorganization ... will be determined under the rules of section 358 and § 1.358-2.” “Redeemed class” is defined in Reg. § 1.302-5(b)(2) as all shares actually owned by the redeemed shareholder that are in the same class as the redeemed shares. For this purpose, the proposed regulation defines “class” by reference to economic

rights to distributions rather than “the labels attached to the shares or rights with respect to corporate governance” (i.e., voting rights).

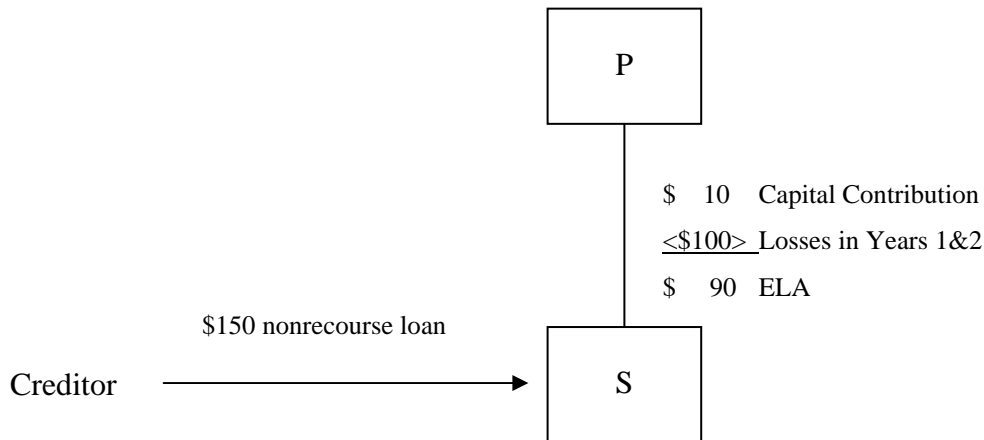
- Prop. Reg. § 1.302-5(a)(3) provides that if there is a redemption of all the shares of the redeemed class that are actually owned by the shareholder, any basis in the redeemed shares remaining after the basis reduction required by section 301(c)(2) (as applied by Prop. Reg. § 1.302-5(a)(1)) must be treated as a loss from the disposition of the redeemed stock on the redemption date, and the attributes (e.g., character and source) of the loss are determined as of the redemption date as if the shares had been disposed of in a sale or exchange transaction. This loss is deferred until there is an “inclusion date.”²⁷
- Regarding the impact of these rules in consolidation, the preamble to the proposed regulations merely states that the government continues to study the issues raised by the deferred loss rule of Prop. Reg. § 1.302-5(a)(3). Currently, Reg. § 1.1502-32(b)(2)(iv) requires a basis reduction for the total amount of a distribution, not just the amount in excess of E&P. As noted above, Reg. § 1.1502-19(a)(2) allows the basis of a share to be negative, creating an ELA, and Reg. § 1.1502-32(c)(1) requires the negative adjustment for distributions to be allocated exclusively to each share to which the distribution relates. Nothing in the preamble to the proposed regulations indicates whether or how these rules will be altered. However, if Reg. § 1.302-2(c) is revoked, at a bare minimum it would seem that the ELA would not “pop” over into the S3 shares owned by S1. Since S2 actually owns no S3 shares following the redemption, does this mean the ELA is recognized by S1? If so, would it be currently taxed or deferred (e.g., until there is an “inclusion date” that would have permitted S2 to take into account a capital loss if, instead of an ELA, the redemption distribution had been less than the basis of the redeemed shares)?
- Note also that Prop. Reg. § 1.302-5 and section 301(c)(2) require a basis reduction only to the extent the dividend-equivalent redemption exceeds the earnings and profits of the redeeming corporation, whereas Reg. § 1.1502-32(b)(2)(iv) requires a basis reduction for the entire amount of the distribution, not just the return of capital portion. Does it make sense to trigger capital gain to S2 by the full amount of the excess distribution over the basis of its S3 shares, or should the gain be limited to the excess of the distribution over the sum of S3’s earnings and profits plus the basis of the S3 shares held by S2? If so, should section 1059 principles be introduced as well? There seem to be a

²⁷ Prop. Reg. § 1.302-5(b)(4)(i) generally defines “inclusion date” as the earlier of (A) the date on which one of the exchange tests in section 302(b)(1), (2) or (3) is satisfied by the redeemed shareholder, or (B) the date on which all classes of stock of the redeeming corporation become worthless within the meaning of section 165(g). If the redeeming corporation’s assets are acquired by another corporation in a section 381(a) transaction, the “inclusion date” tests are applied by treating all relevant facts existing at the close of the section 381 acquisition date as existing immediately after the redemption.

lot of difficult issues to be addressed in the government's attempt to apply the proposed regulations in consolidation.²⁸

²⁸ The package also contains other provisions that may be either or both controversial and difficult to administer. For example, Prop. Reg. § 1.358-2(g) would apply a separate set of basis allocation, tracing and deemed issuance/recapitalization rules to section 351 exchanges. Under the general rule of Prop. Reg. § 1.358-2(g)(1) (which applies to all section 351 exchanges, including those in which liabilities are assumed), if a transferor receives more than one share of stock, then, except as otherwise required by Prop. Reg. § 1.358-2(g)(2) (applicable to the basis of transferred stock), the aggregate basis determined under Prop. Reg. § 1.358-1(b) is allocated among all transferee corporation shares received in proportion to their relative fair market values. Under Prop. Reg. § 1.358-2(g)(2), if (i) in a section 351 exchange stock (or both stock and other property) is transferred to a corporation, and (ii) no liabilities of the transferor are assumed, then the basis tracing rules of Prop. Reg. § 1.358-2(b)(1) through (3) apply to allocate the basis of the transferred stock among the transferee corporation shares received. Those basis tracing rules also apply to a transferor's receipt of money or other property in exchange for the transferred stock. Prop. Reg. § 1.358-2(g)(3) likely will be controversial. It applies a deemed issuance/recapitalization rule for purposes of both Prop. Reg. § 1.358-2(g)(1) (which applies to all section 351 exchanges except stock transfers to which Prop. Reg. § 1.358-2(g)(2) applies) and Prop. Reg. § 1.358-2(g)(2). Under this rule, if a shareholder transfers property to a corporation in an exchange to which section 351 applies but receives nothing in the exchange (or receives transferee stock and/or boot with an aggregate fair market value less than the fair market value of the transferred property), then (i) the transferor is treated as receiving, in addition to any transferee stock and/or boot actually received, additional shares of transferee stock equal in value to the excess value of the property transferred over the value of the property received; and (ii) the transferor is then treated as surrendering all of its transferee corporation shares (including shares actually owned before the exchange and those deemed received in the exchange) in a section 368(a)(1)(E) recapitalization in exchange for the number of transferee shares actually owned by the transferor. The basis of the "new" shares is then determined under Prop. Reg. § 1.358-2(b)(3). If the shareholder owns multiple classes of stock in the transferee corporation, the additional shares deemed received in the exchange are of those classes whose associated economic rights are consistent with what occurs as a result of the exchange. For example, if Y owns all the common and preferred stock of X (X's only outstanding classes of stock) and transfers cash to X without receiving anything from X in the exchange, Y is deemed to receive additional shares of X common if the contribution increases only the fair market value of the X common due to the limited rights of the X preferred. Prop. Reg. § 1.1016-2(e) extends the issuance/recapitalization principles to capital contributions to which section 118 applies.

Example 15(a): Worthlessness



Year 3 – The stock of S becomes worthless
Year 4 – S satisfies nonrecourse debt with \$60 of assets

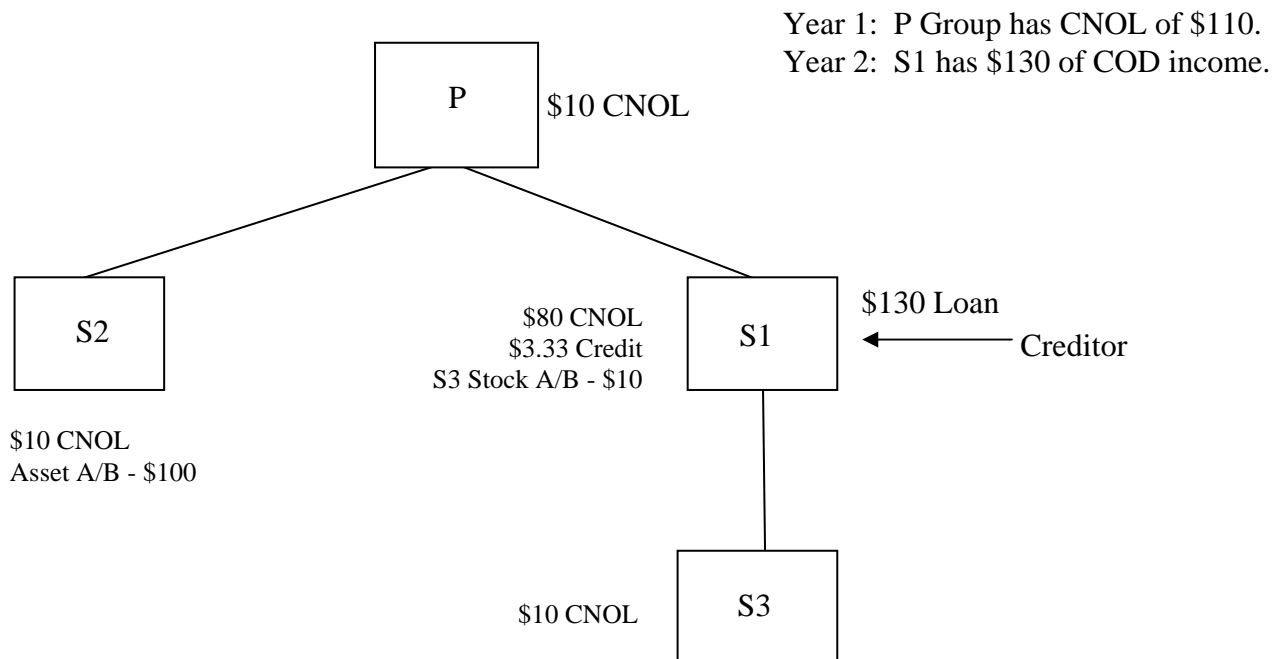
(i) **Facts.** P forms S with a \$10 capital contribution, and S borrows \$150 on a nonrecourse basis. During Years 1 and 2, S incurs \$100 of losses, all of which are absorbed by other members of the P group. As a result, the basis of the S stock is reduced by \$100, creating a \$90 ELA. During Year 3, although S continues to own significant assets, S’s stock becomes worthless within the meaning of section 165(g). During Year 4, S transfers its assets, which have a remaining basis of \$60 and a fair market value that is less than the outstanding debt, to its nonrecourse creditor in satisfaction of its \$150 liability and recognizes \$90 of gain.

(ii) **Results.**

- **Current Regulations.** Under Reg. § 1.1502-19(c)(1)(iii), worthless subsidiary stock generally is not treated as a disposition that triggers recognition of an ELA until the date that “[s]ubstantially all of S’s assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes.” Thus, even though the S stock becomes worthless in Year 3, the P group is not required to recognize the \$90 ELA in Year 3. Recognition is postponed until after S transfers all of its assets to its creditor in Year 4. As a consequence, the \$90 gain S recognizes on the transfer produces a positive basis adjustment that eliminates the ELA. Although the P group recognizes \$90 of gain on the transfer of the S assets, it does not, as under prior law, recognize an additional \$90 of income with respect to the ELA.

- **Prior Law.** Under prior law, the P group was treated as having disposed of the S stock at the end of the year in which the stock became worthless within the meaning of section 165(g). Former Reg. § 1.1502-19(b)(2)(iii). As a result, the group was required to recognize the \$90 ELA at the end of Year 3. Further, the \$90 was treated as ordinary income to the extent that S was insolvent. Former Reg. § 1.1502-19(a)(2)(ii). The gain that S recognized when it transferred its assets to its creditors increased P's basis in the S stock to the extent it gave rise to E&P. However, Former Reg. § 1.1502-20(a) prevented the P group from deducting the loss attributable to that basis.
- **Cancellation of Indebtedness Income.** Under prior law, an ELA was also triggered at the end of any year in which a subsidiary had cancellation of indebtedness income if the income was excluded from the subsidiary's income because it was insolvent. Former Reg. § 1.1502-19(b)(2)(iii). Under Reg. § 1.1502-19(c)(1)(iii), an ELA is also triggered by discharge of indebtedness income if (i) the amount excluded from income as a result of the discharge exceeds the amount of attributes (of the debtor member or any other member of the group) that are reduced under section 108(b), section 1017, or Reg. § 1.1502-28, or (ii) another member is a creditor of S and takes into account a bad debt deduction, but S does not take into account a corresponding income item. In case of an amount excluded from income as a result of the discharge of indebtedness that exceeds the amount of attributes (of the debtor member or any other member of the group) that are reduced under section 108(b), section 1017, or Reg. § 1.1502-28, an ELA is triggered only to the extent of such excess. See Reg. § 1.1502-19(b)(1)(ii), (h)(2)(ii).
- **Transfers for Consideration.** The final regulations provide that an asset of S will not be considered disposed of or abandoned if the disposition is in complete liquidation of S or is in exchange for consideration. Reg. § 1.1502-19(c)(1)(iii). However, for this purpose, relief from indebtedness is not treated as consideration. See Reg. § 1.1502-19(c)(1)(iii)(A) (parenthetical in last sentence).

Example 15(b): Insolvency



(i) **Facts.** In Year 1, Creditor lends \$130 to S1, and the P group incurs a \$110 consolidated net operating loss (“CNOL”) that is carried over to Year 2 and attributed \$80 to S1 and \$10 each to P, S2, and S3 under the principles of Reg. § 1.1502-21. In Year 2, as a result of S1 becoming insolvent, Creditor discharges S1 from its obligation to repay the loan, which causes S1 to realize \$130 of cancellation of indebtedness income (“COD income”). S1 excludes the COD income from its gross income under section 108(a)(1)(B) since S1 remains insolvent after the discharge. At the end of Year 2, in addition to the CNOL, S1 has a \$10 basis in the stock of S3 and a \$3.33 general business credit carryover. S2 has a \$100 basis in depreciable property. No member makes an election under section 108(b)(5).

(ii) **Results under Insolvency Rules: 1.1502-19, 1.1502-21, 1.1502-28, and 1.1502-32.**²⁹

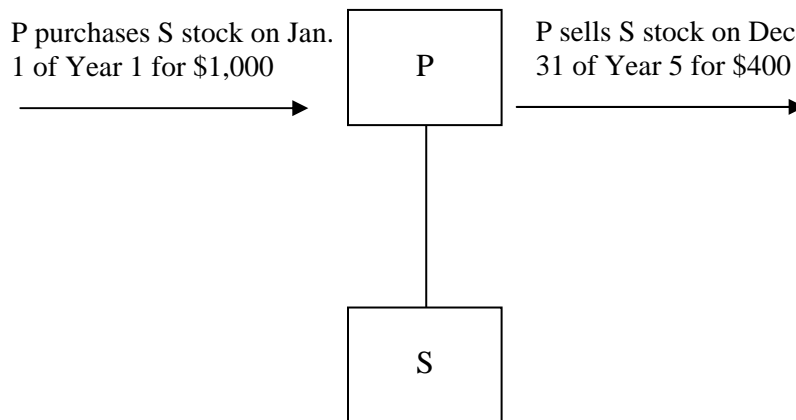
- **First Step - Separate Entity Determination.** Apply the section 108(a)(1)(B) insolvency exception to the debtor member taking into account only the debtor member’s assets and liabilities. This results in the exclusion of all of S1’s \$130 COD income from gross income. Reg. § 1.1502-28(a)(1).

²⁹ These regulations, which were originally temporary regulations, were finalized on March 22, 2005 by T.D. 9192. 70 Fed. Reg. 14395 (March 22, 2005).

- **Second Step – Reduce Attributes of Debtor Member.** Reduce the tax attributes of the debtor member, including consolidated tax attributes attributable to the debtor member, by the amount of the debtor member's excluded COD income. With respect to S1, this reduces the following attributes in the following order: (i) \$80 CNOL, (ii) \$3.33 general business credit carryover, and (iii) \$10 adjusted basis in S3 stock. Note that an ELA attributable to S3 stock cannot be created under these rules. Overall in this step, \$100 of the \$130 excluded COD income is applied to reduce tax attributes and, therefore, is taken into account for purposes of adjusting P's basis in S1 stock. However, note that the reduction in the \$3.33 general business credit carryover causes \$10 of the excluded COD income to be treated as tax-exempt income, but the reduction of the credit carryover itself does not constitute a noncapital, nondeductible expense. Thus, P's basis in S1 is increased by \$100 and reduced by \$90. Reg. §§ 1.1502-28(a)(2); 1.1502-32(b)(3)(ii)(C)(1), (3)(iii)(A).
- **Third Step – Reduce Attributes of Debtor Member Subsidiaries.** To the extent the debtor member reduced its basis in the stock of a subsidiary in the second step, such subsidiary is treated as realizing excluded COD income but only for purposes of the tax attribute reduction rules. Since S1's basis in S3 stock was reduced by \$10, S3 is treated as realizing excluded COD income of \$10 but only for purposes of the tax attribute reduction rules. The deemed excluded COD income of \$10 reduces the \$10 CNOL attributable to S3. The realization of the deemed excluded COD income and the absorption of the \$10 CNOL are not taken into account for purposes of adjusting S1's basis in S3 stock or P's basis in S1 stock. Overall in this step, \$0 of the actual \$130 excluded COD income is applied to reduce tax attributes. Reg. §§ 1.1502-28(a)(3); 1.1502-32(b)(3)(ii)(C)(1), (3)(iii)(A).
- **Fourth Step – Reduce Attributes of Members Other Than Debtor Member.** To the extent of any remaining excluded COD income, apply such remaining amount to reduce the consolidated tax attributes attributable to members other than the debtor member. The remaining \$30 of excluded COD income is applied to reduce the consolidated tax attributes (to the extent they remain) attributable to P, S2, or S3. The \$10 CNOL attributable to P and the \$10 CNOL attributable to S2 are reduced to \$0. Although \$10 of excluded COD income remains, it does not reduce S2's basis in its depreciable property, since Reg. § 1.1502-28 does not permit the reduction of asset basis of members other than the debtor member (and subsidiary members of the debtor member under the third step). Thus, the remaining \$10 of excluded COD income does not reduce tax attributes of any member of the group. Overall in this step, \$20 of the \$130 excluded COD income is applied to reduce tax attributes and, therefore, is treated as tax-exempt income of S1 for purposes of adjusting P's adjusted basis in S1 stock. The reduction of the \$10 CNOL attributable to S2 is treated as a noncapital, nondeductible expense of S2 for purposes of determining P's basis in S2 stock. Thus, P's basis in S1 is increased by \$20 and P's basis in S2 is reduced by \$10. Reg. §§ 1.1502-28(a)(4); 1.1502-32(b)(3)(ii)(C)(1), (3)(iii)(A).

- **Excess Loss Accounts.** If P had a \$40 ELA attributable to its S1 stock after the above steps, the \$10 of excluded COD income that did not reduce tax attributes would trigger that ELA into income. However, only \$10 of the \$40 ELA would be taken into income. Under prior rules, the entire \$40 ELA would have been taken into income, regardless of the fact that only \$10 of excluded COD income triggered the ELA inclusion. Reg. § 1.1502-19(b)(1)(ii).

Example 16: The Unified Loss Rules and Prior Loss Disallowance Rules



- (i) **Facts.** On January 1 of Year 1, P purchased all of the stock of S for \$1,000 at a time when the basis of S’s assets was \$0. No section 338 election was made. P sold all of the S stock to X, an unrelated party, for \$400 on December 31 of Year 5. Assume that as of the date on which the S stock is sold, S’s basis in its assets was \$200 and it had no loss carryovers or deferred deductions. Assume further that during the period of S’s membership in the P group, the following investment adjustments were made pursuant to Reg. § 1.1502-32(b) (for purposes of this example, allocation of consolidated tax liability is ignored):

Year 1:	\$300	(positive taxable income)
Year 2:	\$200	(\$300 positive taxable income less \$100 distribution)
Year 3:	\$100	(positive taxable income)
Year 4:	(100)	(loss absorbed by income of other group members)
Year 5:	<u>(300)</u>	(loss absorbed by income of other group members)
	\$200	(net Reg. § 1.1502-32(b)(2) adjustments)

Thus, P’s basis in its S stock at the time of the disposition was \$1,200, so it recognizes a loss of \$800 on the disposition absent a reduction in its S stock basis.

- (ii) **Results under the Unified Loss Rules: \$500 stock loss allowed.** Under Reg. § 1.1502-36(c), the basis in each of the transferred S shares is reduced (but not below its value) by the lesser of (i) the share’s “net positive adjustment” and (ii) the share’s “disconformity amount.”³⁰ A share’s “net positive adjustment” is defined as the greater of zero and the sum of all investment adjustments reflected in the basis of the share at the time of the transfer, as provided in Reg. § 1.1502-36(b)(1)(iii), but expanded to include all

³⁰ Reg. § 1.1502-36(c)(2). Note that, although the basis redetermination rule of Reg. § 1.1502-36(b) must be considered before the basis reduction rule of Reg. § 1.1502-36(c), the basis redetermination rule does not apply to this example because all shares of S stock are transferred in a single transaction to one or more nonmembers.

adjustments specially allocated under Reg. § 1.1502-32(c)(1)(ii) (not just the special allocation under Reg. § 1.1502-32(c)(1)(ii)(B), as in the case of the basis redetermination rule).³¹ Thus, here the definition of “net positive adjustment” includes all investment adjustments to the transferred loss share except the negative adjustment for distributions. A share’s “disconformity amount” is determined as of the time of the transfer and is defined as the excess, if any, of (a) P’s basis in the S share over (b) the share’s “allocable portion” of S’s “net inside attribute amount.”³² S’s “net inside attribute amount” generally is the sum of (i) S’s inside basis, money, net operating and capital loss carryovers, and deferred deductions, minus (ii) the amount of its liabilities.³³

Thus, if Reg. § 1.1502-36(c) of the Unified Loss Rules applies to the sale of the S stock, (i) the aggregate “net positive adjustment” to the stock would be \$300 (\$700 of positive investment adjustments, determined without regard to the \$100 negative adjustment for the Year 2 distribution, minus the \$400 of negative adjustments for S’s absorbed losses), and (ii) the aggregate “disconformity amount” would be \$1,000 (the excess of the \$1,200 basis in the S stock over S’s \$200 “net inside attribute amount”). Hence, the \$1,200 basis of the S shares must be reduced by \$300 (the lesser of \$300 or \$1,000, but not below the \$400 fair market value of the S stock at the time of the sale), leaving P with a \$900 basis in the S stock and resulting in a \$500 loss to P on the sale of the stock for \$400.³⁴

- (iii) **Results under the prior loss disallowance rules.** For transfers of subsidiary stock prior to the effective date of the Unified Loss Rules, the loss disallowance rules of Former Reg. §§ 1.337(d)-2, 1.337(d)-2T, and 1.1502-20 (with or without the duplicated loss factor), as well as the basis redetermination rules of Former Reg. § 1.1502-35, may be applicable. The Service issued Former Temp. Reg. § 1.337(d)-2T, which disallowed

³¹ Reg. § 1.1502-36(c)(3). Thus, any investment adjustments for noncapital, nondeductible expenses resulting from attribute reattribution that are specially allocated under Reg. § 1.1502-32(c)(1)(ii)(A) are taken into account under the basis reduction rule but not the basis redetermination rule.

³² Reg. § 1.1502-36(c)(4). A share’s “allocable portion” is defined in Reg. § 1.1502-36(f)(1) to have the same meaning as set forth in Reg. § 1.1502-32(b)(4)(iii)(B) (i.e., a vertical slice of S’s attributes). Each share within the same class will have an identical allocable portion, and if there are two or more classes of outstanding stock, S’s net inside attribute amount must be attributed to the various classes by taking into account the terms of each class and any other factors relating to the overall economic arrangement. For example, if S has 100 shares outstanding comprising a class of tracking stock, respected as S stock for federal income tax purposes, that participate in 99% of all gains, losses and cash flow relating to Asset A and in 1% of all other S gains, losses and cash flow, each tracking share would be allocated 0.99% of all attributes produced by Asset A and 0.01% of all other S attributes. Needless to say, the more complex S’s capital structure, the more difficult it becomes to determine a share’s “allocable portion” of S’s net inside attribute amount.

³³ Reg. § 1.1502-36(c)(5). With respect to a share of stock of a lower-tier member owned by S that is transferred in the transaction, S’s basis in that share is its actual basis, adjusted to reflect any gain or loss recognized by S on the transfer of that share. A special rule is set forth in Reg. § 1.1502-36(c)(6) where one of S’s assets is stock of a lower-tier member that is not transferred in the same transaction.

³⁴ The attribution reduction rule of Reg. § 1.1502-36(d) does not apply to this example because S’s \$200 “net inside attribute amount” does not exceed the \$400 fair market value of its outstanding stock (i.e., there is no loss duplication).

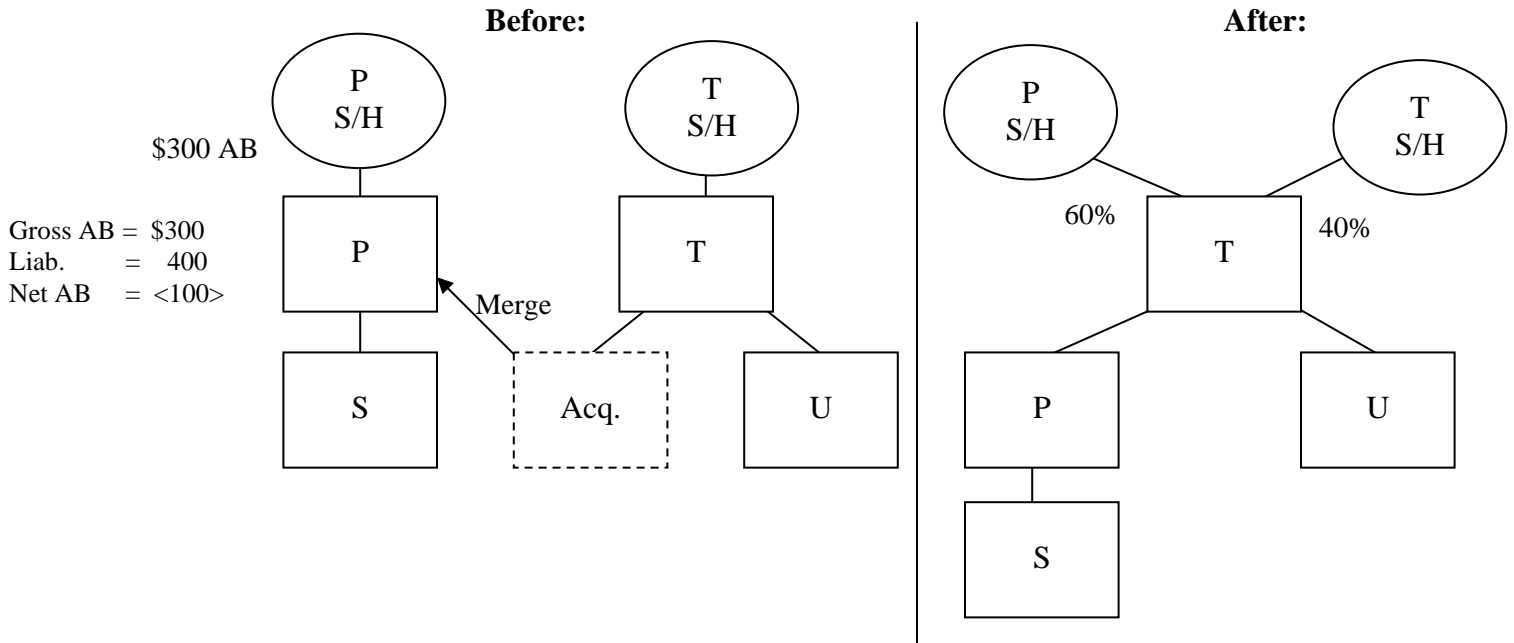
losses to the extent they were attributable to built-in gain from the disposition of an asset (similar to the extraordinary gain disposition factor of Former Reg. § 1.1502-20(c)(1)(i) and (c)(2)(i)). Prior to the effective date of Former Temp. Reg. § 1.337(d)-2T (i.e., March 7, 2002), Former Temp. Reg. § 1.1502-20T(i) permits an election. Taxpayers could elect to apply (i) Former Reg. § 1.1502-20 in its entirety, (ii) Former Reg. § 1.1502-20 without the loss duplication factor, or (iii) Former Temp. Reg. § 1.337(d)-2T. Former Temp. Reg. § 1.337(d)-2T was finalized without substantial modification on March 3, 2005. 70 Fed. Reg. 10,319 (Mar. 3, 2005). The final regulations were removed on September 17, 2008. T.D. 9424, 73 Fed. Reg. 53,933, 53,944 (Sept.17, 2008).

- **Former Reg. § 1.1502-20: \$100 stock loss allowed.** Pursuant to Former Reg. § 1.1502-20(a) and (c), P's loss on the sale of stock of its consolidated subsidiary, S, is disallowed to the extent of: (a) extraordinary gain dispositions as defined in Reg. § 1.1502-20(c)(1)(i) and (c)(2)(i); (b) positive investment adjustments described in Reg. § 1.1502-20(c)(1)(ii), (c)(2)(ii) and (c)(2)(v); and (c) S's duplicated loss calculated in accordance with Reg. § 1.1502-20(c)(1)(iii) and (c)(2)(vi).

In the facts presented, there were no extraordinary gain dispositions or duplicated losses. However, positive investment adjustments with respect to the S stock disposed of equaled \$700 (i.e., \$300 + 300 + 100). Note that in calculating positive investment adjustments, the distribution made by S in Year 2 must be disregarded (thus, the positive investment adjustment attributable to Year 2 is based upon S's income of \$300 unreduced by the \$100 distribution). In addition, the negative investment adjustments attributable to S's losses sustained in Years 4 and 5 cannot be netted against the positive adjustments from Years 1 through 3 for this purpose. Thus, \$700 of P's \$800 loss is disallowed by Former Reg. § 1.1502-20(a).

- **Former Reg. § 1.1502-20 without duplicated loss factor: \$100 loss allowed.** The results would have been identical if P applied Former Reg. § 1.1502-20 without the duplicated loss factor, because there were no duplicated losses. There were also no extraordinary gain dispositions, but \$700 of the loss is attributable to positive investment adjustments (i.e., \$300 + 300 + 100). Thus, a \$100 loss would have been allowed.
- **Results under Former Reg. § 1.337(d)-2. Entire stock loss allowed.** Under Former Reg. § 1.337(d)-2 the entire \$800 stock loss will be allowed, because none of the loss is attributable to built-in gain on the disposition of an asset. Former Reg. § 1.337(d)-2 applies to transactions occurring before September 17, 2008. T.D. 9424, 73 Fed. Reg. 53,933, 53,947 (Sept.17, 2008).

Example 17(a): Nontaxable Group Structure Change



(i) **Facts.** T forms Acquisition Co., which merges with and into P in a statutory merger. P’s shareholders receive solely T voting stock representing 60% of the total value of T stock. The acquisition of P qualifies as a tax-free reorganization under sections 368(a)(1)(A) and (a)(2)(E) as well as under section 368(a)(1)(B). The adjusted basis of P’s assets is \$300, and P has liabilities of \$400.

(ii) **Results.**

- **Reverse Acquisition/Group Structure Changes.** Because P’s shareholders own greater than 50% of the outstanding T stock after the merger, the transaction constitutes a reverse acquisition under Reg. § 1.1502-75(d)(3) and a group structure change as defined in Reg. § 1.1502-33(f). Thus, the former P affiliated group continues to exist, with T taking P’s place as the common parent of the group.
- **Stock Basis in P.** Pursuant to Reg. § 1.1502-31, T’s basis in P is equal to its allocable share of P’s “net asset basis.” Thus, T has a \$100 ELA with respect to the P stock. Note that if these consolidated return regulations were inapplicable (e.g., because the P group did not file consolidated returns prior to the merger and the continuing group did not elect to file a consolidated return

after the merger, or because the merger occurred prior to the effective dates of Reg. §§ 1.1502-30 and -31), T could determine its basis in P stock by reference to FP's basis in P (\$300) or by reference to P's net asset basis – but not lower than \$0 – pursuant to Reg. § 1.358-6.

Example 17(b): Taxable Group Structure Change

(iii) **Facts.** The facts are the same as in Example 17(a), except that in addition to receiving T voting stock representing 60% of the total value of T stock, P's shareholders also receive \$400 cash. The fair market value of the T stock received by P's shareholders is \$600. Therefore, the transaction does not qualify as a tax-free reorganization under section 368(a). Accordingly, P's shareholders must recognize gain or loss on the exchange; absent the application of Reg. § 1.1502-31, T's basis in the P stock would be \$1,000, pursuant to section 1012.

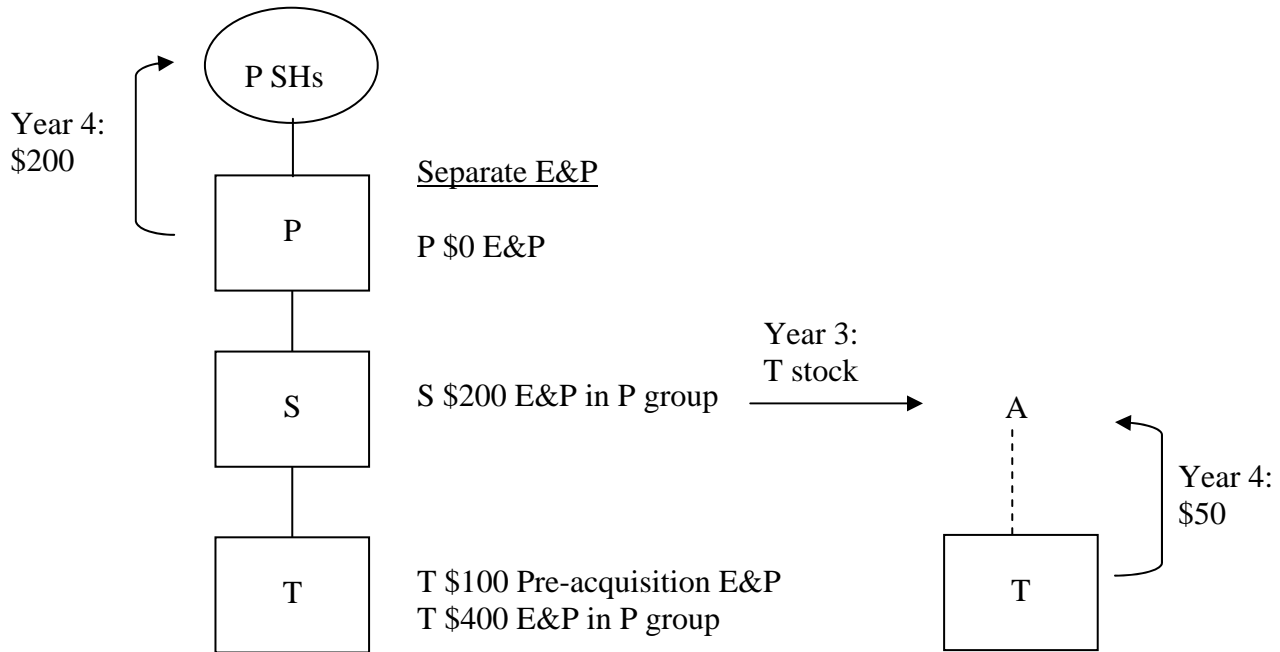
(iv) **Results.**

- **Current Regulations.** Under the newly amended Reg. § 1.1502-31, transactions in which gain is recognized in whole are excluded from the net asset basis rule. Therefore, T's basis in its P stock would be its cost (\$1,000).

The amended regulation applies to group structure changes that occur after April 26, 2004. However, a group may apply this section to group structure changes that occurred on or before April 26, 2004, and in consolidated return years beginning on or after January 1, 1995.

- **Prior Regulations.** The results would be the same as in Example 17(a). Thus, T would have a \$100 ELA in its P stock, determined by reference to P's net basis in its assets.

Example 18(a): Earnings and Profits



Facts. S purchases all of the stock of T on December 31, Year 1. As of the acquisition date, T has \$100 accumulated E&P. While a member of the group, T generates E&P of \$400. S generates \$200 E&P. P is a holding company that generates no E&P in its own right. On December 31, Year 3, S sells T to an unrelated purchaser, Individual A, recognizing neither gain nor loss on the sale. In Year 4, T distributes \$50 to A and P distributes \$200 to its shareholders (assume Year 4 E&P for all corporations is \$0).

Results.

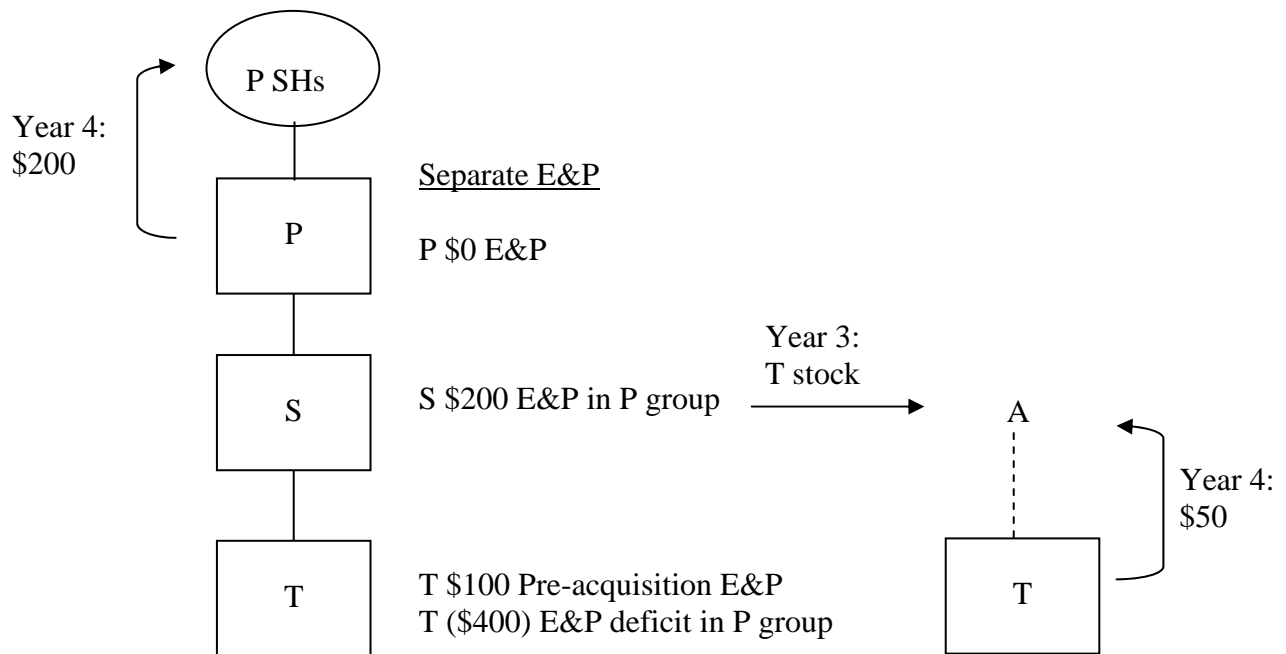
P's E&P:

The acquisition of T has no effect on the E&P of P, S, or T (i.e., no automatic tier-up). However, the E&P generated by S and T while members of the P group tiers up to P. Therefore, for purposes of characterizing the Year 4 distribution to P's shareholders, P has accumulated E&P of \$600. Accordingly, the distribution is a dividend to P's shareholders.

T's E&P:

T's E&P that has tiered up and is reflected in P's E&P is eliminated from T's separate E&P when it leaves the P group. However, T's pre-consolidation E&P is not eliminated. Therefore, T's \$50 distribution to A in Year 4 is characterized as a dividend, because T has positive E&P accumulated prior to joining the P group.

Example 18(b): Earnings and Profits



Facts. S purchases all of the stock of T on December 31, Year 1. As of the acquisition date, T has \$100 accumulated E&P. While a member of the group, T generates an E&P deficit of \$400. S generates \$200 E&P. P is a holding company that generates no E&P in its own right. On December 31, Year 3, S sells T to an unrelated purchaser, Individual A, recognizing neither gain nor loss on the sale. In Year 4, T distributes \$50 to A and P distributes \$200 to its shareholders (assume Year 4 E&P for all corporations is \$0).

Results.

P's E&P:

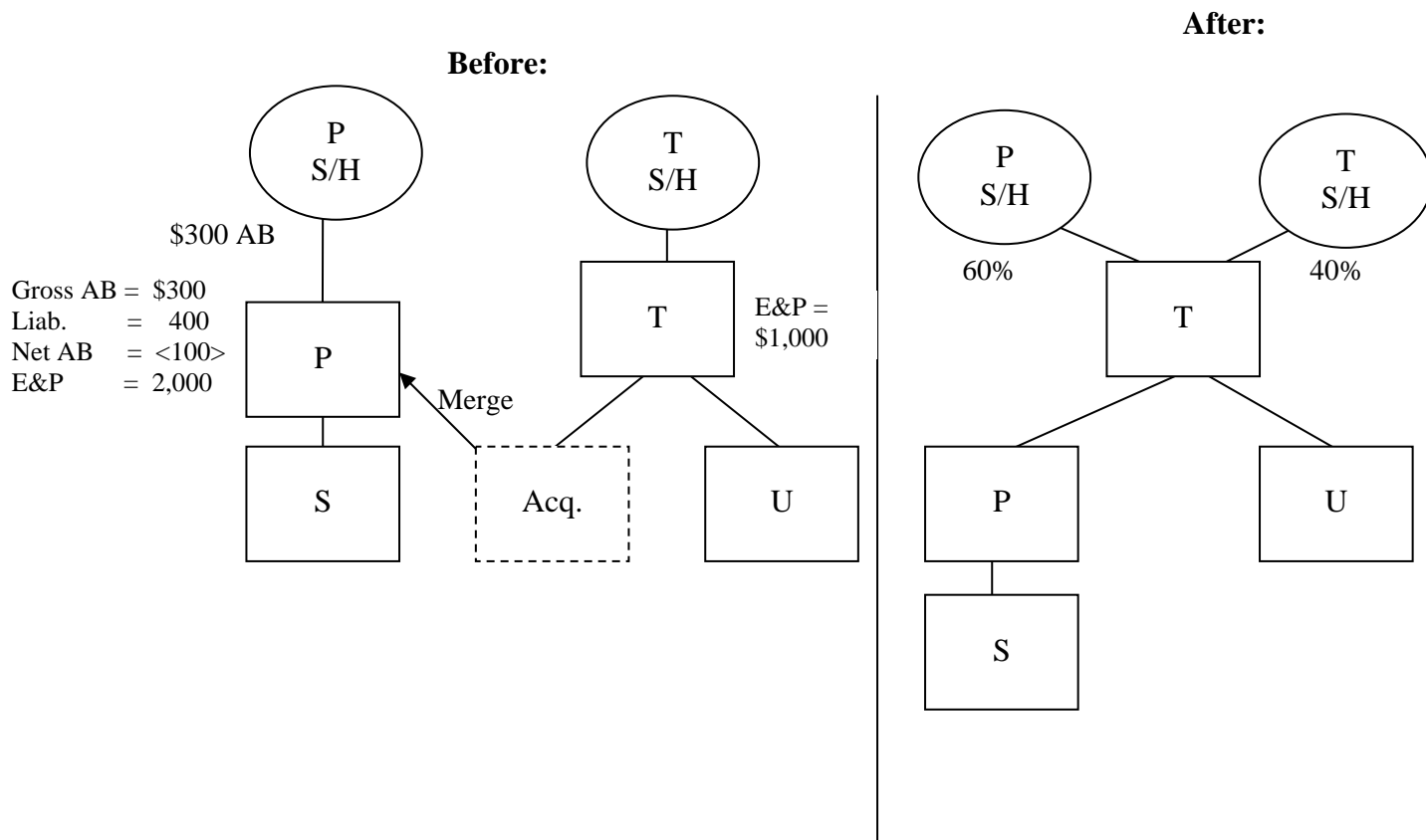
The acquisition of T has no effect on the E&P of P, S, or T (i.e., no automatic tier-up). However, the E&P generated by S and T while members of the P group tiers up to P. Therefore, for purposes of characterizing the Year 4 distribution to P's shareholders, P has an accumulated E&P deficit of \$200. Accordingly, the distribution is not a dividend to P's shareholders.

T's E&P:

T's earnings and profits are eliminated to the extent they were taken into account by any member under 1.1502-33.

Query: Is T's separate accumulated E&P (i.e., \$300 deficit) eliminated so that its E&P after disposition is \$0, or does it retain its pre-acquisition E&P of \$100?

Example 18(c): E&P Following Group Structure Change



Facts. The facts are the same as in Example 17(a). In addition, assume that immediately prior to the transaction, T’s E&P (including amounts tiered up from its subsidiary, U) is \$1,000, and that P’s E&P (including amounts tiered up from its subsidiary, S) is \$2,000.

Results.

T’s E&P:

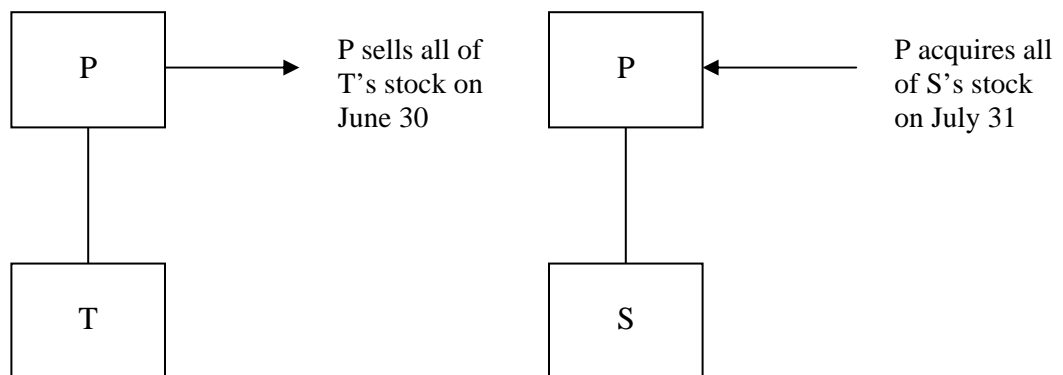
T has succeeded P as the common parent of the P group under the principles of the reverse acquisition rule. Therefore, under the group structure change rule in Reg. § 1.1502-33(f), T’s E&P is adjusted to reflect P’s E&P. Thus, immediately after the transaction, T’s accumulated E&P will be \$3,000.

P’s E&P:

P’s E&P remains \$2,000.

Note: The proposed amendments to the group structure change rules, discussed in Example 17(b), would not alter the E&P results.

Example 19: Termination of the Consolidated Group

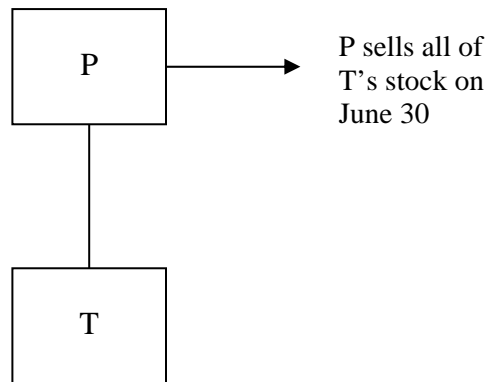


(i) **Facts.** P and T are the only members of the P group. On June 30 of Year 2, P sells all of T's stock. On July 31 of Year 2, P acquires all of S's stock. P uses a calendar year accounting period.

(ii) **Results.**

- **Current Regulations.** P files only one return for Year 2, a consolidated return. See Reg. § 1.1502-76(b)(4) ex. 1(c). P's consolidated return for Year 2 includes all of P's income, T's income for the period January 1 through June 30, and S's income for the period August 1 through December 31. T must file a separate return that includes its income from July 1 through December 31. S must file a separate return that includes its income for the period January 1 through July 31 of Year 2.
- **Prior Law.** Under the prior rules, P had to file two consolidated returns for Year 2, because the P group terminates once P no longer has any subsidiaries. Former Reg. §§ 1.1502-75(d); -76(b)(3) ex. 3. The consolidated return for P and T must include P's income for the portion of the taxable year through July 31. This return must also include T's income for the period January 1 through June 30. T must file a separate return for the remaining portion of the taxable year. The consolidated return for P and S must include P's income for the portion of the taxable year beginning August 1. This return must also include S's income for the period August 1 through December 31. S must file a separate return for the period January 1 through July 31 of Year 2.

Example 20: Allocation of Income



(i) **Facts.** P and T are the only members of the P group. On June 30 of Year 1, P sells all of T's stock. T engages in the production and sale of merchandise throughout Year 1 and is required to use inventories. In addition, on June 1 of Year 1, T incurs an expense for which the economic performance requirements are not satisfied until six months later on December 1.

(ii) **Results.**

- **Current Regulations.** If ratable allocation is elected, then T must perform an inventory valuation as of the close of Year 1 only. T's income from the inventory is then ratably allocated between its consolidated and separate returns. See Reg. § 1.1502-76(b)(4) ex. 3(b). Absent such an election, T must determine its income by closing its books. T must, therefore, perform an inventory valuation as of the acquisition date and report its income based on that valuation on the P group's consolidated return. In addition, T must perform another valuation as of the end of Year 1 and report that income on its separate return.

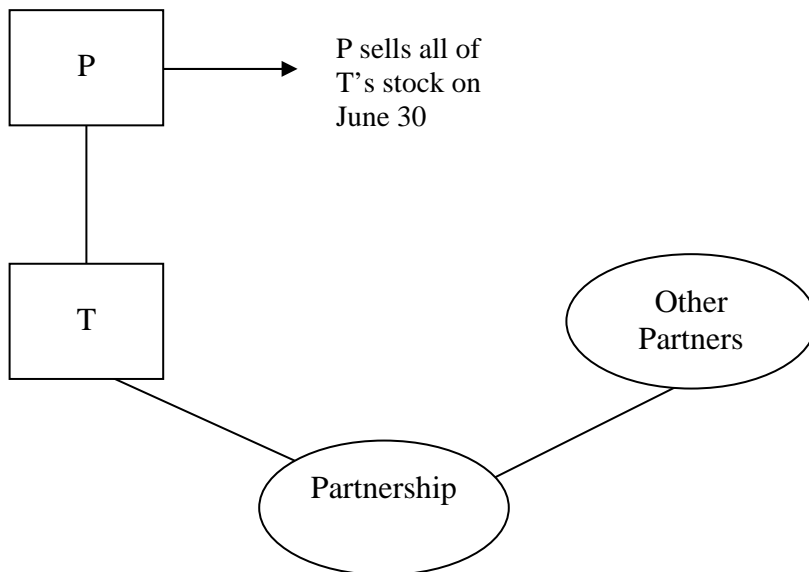
As for T's expense that is incurred on June 1, but for which economic performance does not occur until December 1, the closing-of-the-books method would probably require that the expense be included in the separate return.

- Ratable Allocation v. Closing of The Books. If T's taxable year encompasses all of Year 1, then (so long as the expense is deductible in the same year it is incurred) the deduction would be ratably allocated over the entire year if ratable allocation is elected. Reg. § 1.1502-76(b)(2)(ii)(B). However, if the expense relates to an extraordinary item, it must be allocated to the day it affects income. Assuming that the expense does not fall within one of the listed categories, the catchall item at Reg. § 1.1502-76(b)(2)(ii)(C)(14) might apply. Under that provision, an extraordinary item includes any item that the

Commissioner determines would result in substantial distortion of income if ratably allocated.

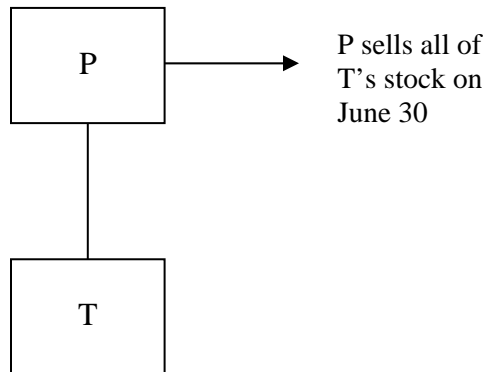
- Allocations Within The Original Year. The regulations also make clear that if a different provision of the Code ended T's taxable year, the result would be different. For instance, if T merged into X, and P received X stock, then under section 381(b)(1), T's original year would end on June 30. Thus, T's "original year" would not encompass all 365 days of Year 1. Under Reg. § 1.1502-76(b)(2)(ii)(B), the ratable allocation method allocates items over the days within T's original year. Because T's original year includes only the period during which it is a member of the P group, the result using the ratable allocation method would be the same as an allocation based on closing of the books. Reg. § 1.1502-76(b)(4) ex. 3(c).
- Eligibility for Ratable Allocation. Ratable allocation is available only if T is not required to change its taxable year (e.g., from calendar to July 1 fiscal) or its method of accounting as a result of the disposition. Reg. § 1.1502-76(b)(2)(ii)(A). If the ratable allocation election is not available or is not made, ratable allocation may nonetheless be used for the month in which the acquisition occurs under Reg. § 1.1502-76(b)(2)(iii).
- **Prior Regulations.** Under the prior regulations, if T's records would permit it to determine the portion of its inventory income attributable to the portion of the year for which it was a member of the P group, T would be required to include that portion in the group's consolidated return and the remainder in its separate return. Former Reg. § 1.1502-76(b)(4).

Example 21: Allocation of Income from Pass-Through Entities



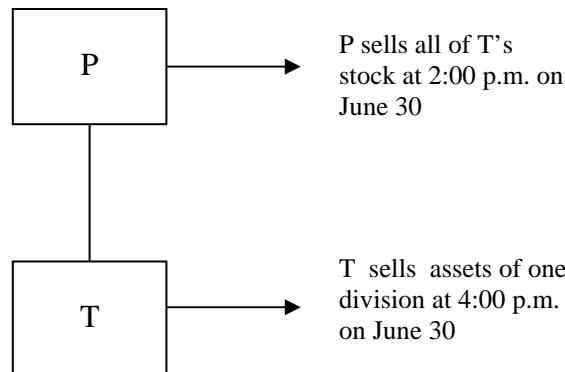
- (i) **Facts.** P and T are the only members of the P group. T is a holding company and its sole asset is a partnership interest. On June 30 of Year 1, P sells all of T's stock. The partnership in which T has an interest engages in the production and sale of merchandise throughout Year 1 and is required to use inventories.
- (ii) **Results.**
- **Current Regulations.** To determine which of T's partnership items are included in T's consolidated and separate returns, T is treated as selling its interest in the partnership immediately before the sale of T's stock. Reg. § 1.1502-76(b)(2)(v)(A). The allocation of T's share of partnership items is made under Reg. § 1.706-1(c)(2)(ii). However, if T has a 50%-or-greater interest in the partnership, then a consistent allocation method would have to be used. Reg. § 1.1502-76(b)(2)(v)(B). Thus, if ratable allocation were elected, T's distributive share of the partnership's non-extraordinary items would also be allocated ratably under Reg. § 1.706-1(c)(2)(ii). Similarly, if ratable allocation were not elected, T's distributive share of partnership items must be determined under Reg. § 1.706-1(c)(2)(ii) by an interim closing of the partnership's books.
 - **Prior Regulations.** The prior regulations provided no guidance on the allocation of items of pass-through entities in which a departing or joining member has an interest.

Example 22: Treatment of NOLs under Ratable Allocation Method



- (i) **Facts.** P and T are the only members of the P Group. On June 30 of year 1, P sells all of T's stock. T incurs a net operating loss for the year ended December 31 that it intends to carry back to the consolidated group.
- (ii) **Results.**
- **Current Regulations.** If ratable allocation is elected, T will be permitted to ratably allocate its loss regardless of whether it can be traced to a particular period, assuming no part of the loss is attributable to extraordinary items. However, to the extent it is relevant, the portion of the year that T is a member of the P group and the portion of the year after T is sold will be considered separate years. Thus, the portion of the loss allocated to the period after T leaves the P group must be carried back to a prior year to be used on the P group consolidated return (subject to SRLY). Reg. § 1.1502-76(b)(2)(ii)(B)(2). In addition, any item carried to or from any portion of Year 1 is an extraordinary item and the NOL is, therefore, not taken into account again in determining the ratable allocation of items. Reg. § 1.1502-76(b)(2)(ii)(C)(5).
 - **Prior Regulations.** Under the prior regulations, no specific guidance was provided. In general, to the extent the loss could be traced to the period in which T was a member of the P group, it would be allocated to that period. To the extent the loss was attributable to the period in which T was not a member, the loss would be allocated to that period and would have to be carried back to the prior year to be used on the P group consolidated return. See Former Reg. § 1.1502-76(b)(4)(i). In the latter case, the various limitations on carrying losses from separate return years to consolidated years would apply. If the loss could not be traced, it would be allocated to the consolidated and separate return years on a ratable basis. Former Reg. § 1.1502-76(b)(4)(ii). In that case, the portion allocated to the period in which T was a member of the P group could be used on the group's consolidated return, but the remainder would have to be carried back (subject to SRLY).

Example 23: Allocation of Items from Day of Sale



(i) **Facts.** P sells all of T's stock at 2:00 p.m. on June 30 to X for no gain or loss. X wants the assets of one of T's divisions but is not interested in the assets of the other. Because X needs cash to finance the acquisition of T, it (unbeknownst to P) plans to cause T to sell the assets of the unwanted division to an unrelated buyer for a \$500 gain. At the last minute, X's corporate counsel – without advising tax counsel – reschedules the closing from July 1 to June 30 at 4:00 p.m.

(ii) **Results.**

- **Current Regulations.** Reg. § 1.1502-76(b)(1)(ii) provides that S is generally treated as leaving a group at the end of the day, but if “on the day of S's change in status as a member, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change,” S and the acquiring group must treat the transaction as occurring at the beginning of the following day. The regulations also provide that consistent treatment of the transaction by all of the parties will be respected if it is reasonable and consistently applied. Reg. § 1.1502-76(b)(1)(ii)(B).
- **Prior Regulations.** The old rules did not directly address when a consolidated return year began or ended for a new or departing member. The Service took the position, based on examples (2) and (3) of Former Reg. § 1.1502-76(b), that all gain earned by T on the day of sale is included in the selling group's return. Thus, under the facts of this example, P would have an unanticipated \$500 gain from the sale of the T stock. It would not be able to eliminate the gain with an offsetting loss due to the application of the loss disallowance rule of Reg. § 1.1502-20. Meanwhile, X would have obtained \$500 cash tax free (and perhaps a law suit by P).

The same result would be obtained by applying a convention that was adopted by practitioners. Under this so-called “lunch rule,” if the acquisition occurred before noon, then the acquisition date was the first day of the departing

member's separate return year; if it closed after noon, then the next day was the start of the departing member's separate return year. Because P sold the T stock after noon, T would still be included in the P group's return for the entire day of the acquisition.