

INVESTMENT ADJUSTMENTS & RELATED ISSUES

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TOPICS

- Adjustments to subsidiary stock basis
- Excess loss accounts
- Loss disallowance & loss duplication rules
- Earnings & profits
- Group structure change rules
- Allocation of consolidated tax liability
- Allocation of income & deductions

Adjustments to Subsidiary Stock Basis

Regs issued August 1994

- Apply for stock basis and E&P determinations in taxable years beginning on or after 1/1/95
- Basis/E&P determined as if regulations in effect for all consolidated return years of group (and prior groups if still reflected)
- Some effects of prior rules still linger (e.g., basis reduction account)

Stock Basis Adjustments

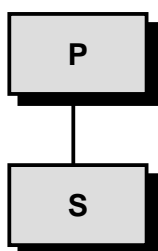
Increases

- Allocable share of sub's taxable income
- Tax-exempt income

Decreases

- Sub's loss generated or absorbed (whichever occurs later)
- Nondeductible, noncapital expenditures, including sub's expiring losses (with certain exceptions)
- Distributions to other members

Example 1



P's basis in S stock:

Cap. contribution:	\$100
S's items in CTI:	<u>100</u>
Adjusted basis:	200

Gain/loss:

Proceeds	\$270
-Basis	<u>(200)</u>
Gain	70

Former regs:

Cap contribution:	\$ 100
Positive E&P:	145
Deprec. Adjustment	<u>(50)</u>
Adjusted basis:	195

Proceeds	\$270
-Basis	<u>(195)</u>
Gain	75

Excluded COD

- New regulations 1.1502-28 governing section 108(b) attribute reduction in consolidated groups; reduce debtor's attributes, then attributes debtor's subsidiaries under "look-through rule", and, finally, reduce attributes of other members available to the debtor (e.g., CNOLs)
- Attribute reduction generally treated as nondeductible, noncapital expenditure requiring stock basis reduction
Exceptions: attributes of common parent; credits
- Excluded COD treated as tax-exempt income, increasing stock basis, to the extent of attribute reduction
 - Pre-8/30/03 effective date of prior temporary regulations: positive adjustment only if attribute reduction reduced stock basis under 1.1502-32
 - Post-8/29/03 effective date of prior temporary regulations: positive adjustment even if attribute reduction does not reduce stock basis in any member

Expiring Losses

- General Rule: Basis reduced by amount of subsidiary's expiring loss carryovers
- Exceptions:
 - SRLY losses of member acquired in taxable year beginning prior to 1/1/95
 - SRLY losses of member joining group in taxable year beginning after 12/31/94 to the extent the group irrevocably "waives" part or all of the losses on the first consolidated return that includes that member

NOTE: Application of SRLY/382 Overlap Rule does not mean a loss is not a SRLY loss.

Waiver of SRLY Losses

- Qualifying Cost Basis Transaction
 - Purchase 80% vote & value within 12 months
 - Loss deemed to expire before sub joins group; therefore, no negative basis adjustment
- Nonqualifying Transaction
 - Loss deemed to expire; stock basis reduced
 - Basis not reduced below sum of sub's net asset basis + loss carryovers that are not waived
- Higher-tier Corporations: additional adjustments if higher-tier corporations join group in same transaction

Adjustments to Stock Basis

- Allocation of Adjustments
 - If positive
 - First to preferred stock to cover distributions and arrearages
 - Then to common stock
 - If negative
 - if related to distribution, allocate to stock to which distribution relates
 - otherwise, allocated only to common stock
- Adjustments "tier-up" the chain

Cumulative Redetermination

- Necessary when subsequent events indicate prior allocation does not reflect current situation (e.g., recapitalization, issuance of additional stock, etc.)
- Required if necessary to determine a person's tax liability
- Generally required only if multiple classes of stock

Anti-avoidance Rule

If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

Excess Loss Accounts

Excess Loss Accounts

- When negative adjustments exceed basis, "excess loss account" ("ELA") is created
- ELA also created upon subsidiary formation if liabilities exceed asset basis
- ELA is treated as "negative basis"

ELA Triggers

- Disposition/deconsolidation of subsidiary
- Worthlessness of subsidiary's assets
- Discharge of indebtedness of subsidiary that is excluded under sec 108 and is not treated as tax-exempt income (i.e., generally does not reduce tax attributes under sec 108(b))
- Deconsolidation/termination of group unless termination is due to acquisition of entire group

ELA: Character of Income

- Ordinary income: All or a portion may be characterized as ordinary income if subsidiary is insolvent
 - Recalculate ELA without regard to distributions that reduced stock basis.
 - Ordinary income to extent of recalculated ELA or extent of sub's insolvency, whichever results in smaller amount of ordinary income
- Capital gain

ELA: Discharge of indebtedness

- Cancellation of debt trigger of ELA: income inclusion limited to excluded COD that is not treated as tax-exempt income (i.e., generally does not reduce tax attributes under 108(b))
- New amended regulation issued March 2005; effective for ELA triggers after 8/29/03
- Elective application to taxable years beginning after 12/31/94

ELA: Effect of restructuring transactions

- Section 332 liquidation (or deemed 332 liquidation): ELA eliminated
- Intragroup acquisitive "D" reorganization: Basis amounts are combined; ELA treated as negative basis for this purpose
- Section 355:
 - ELA of Distributing Corporation allocated among entities based on relative FMVs
 - ELA of distributed subsidiary eliminated. But see §358(g); FSA 200022006.

Circular Basis

Circular Basis

Problem: Absent a special rule, use of subsidiary's loss to offset gain (including ELA trigger) on the disposition of stock of that sub would reduce stock basis, thereby increasing gain, resulting in greater loss absorption, etc. (Similar issue arises if loss recognized on disposition of subsidiary.)

Solution: Use of subsidiary's losses is limited to amount that could be absorbed by determining "tentative CTI" excluding gain with respect to that particular sub's stock. If there is excluded COD income, elimination of the circularity involves a nine-step process.

Loss disallowance
&
Loss duplication

Loss Disallowance Rule

- Reg. 1.337(d)-2 – applicable to dispositions and deconsolidations after 3/6/02
- Reg. 1.1502-20 contained broad loss disallowance rule invalidated by Federal Circuit in *Rite Aid*
- 1.1502-20 or alternative regimes available for dispositions and deconsolidations before 3/7/02; see 1.1502-20(i)

Loss Disallowance Rule: 1.337(d)-2

- Disallows loss recognized on disposition and/or reduces stock basis to FMV upon deconsolidation except “to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset.”
- Notice 2004-58 offers alternative approaches for applying 1.337(d)-2 (e.g., “basis disconformity method”).
- Thus, stock basis calculated under 1.1502-32 may effectively be overstated if subsidiary is disposed at a loss or ceases to be a member at a time when adjusted basis exceeds FMV.
- Successor and anti-avoidance rules also apply.

New regulations §§ 1.1502-35 & -35T

Generally apply to transactions on/after March 7, 2002

- Implement Notice 2002-18.
- Notice 2002-18 stated that regulations implementing it would apply to dispositions occurring on or after March 7, 2002.
- Relief provisions are included for groups that relied on the proposed regulations for transactions occurring between March 7, 2002 and March 14, 2003.

Reg. Sec. 1.1502-35 – Overview

- **Basis redetermination rule:** Reg. Sec. 1.1502-35(b)
 - Immediately before transfer of a member's shares with a basis exceeding fair market value (the "loss member") – the aggregate basis of such is redetermined / reallocated
 - Applies whether or not member remains in group (if any shares are retained)
- **Loss suspension rule:** Reg. Sec. 1.1502-35(c)
 - Only applies if member remains in group
 - Suspension applies when loss otherwise taken into account (-13, etc)
- **Exception:** Regulations generally would not apply if all stock in the member is sold within a single taxable year
- **Loss expiration** for worthless subsidiaries under section 165(g) [elective alternative provision for pre-3/14/03]

Basis Redetermination Rule: 1.1502-35(b)

- Applies to dispositions of member stock
- Applies only where the member's basis in the member's stock exceeds value
- Basis redetermined immediately before transaction, and:
 - After Treas. Reg. § 1.1502-32 adjustments
 - Before the rules of § 1.337(d)-2
 - Before the rules of § 1.1502-35(c) (loss suspension rules)
 - Apply to lower-tier entities first
- Rule applies differently depending on whether the loss member remains a member of the group subsequent to the transaction (a "**Non-Deconsolidating Transfer**") or is deconsolidated pursuant to the transaction ("**Deconsolidating Transfer**").

Loss Suspension Rule: 1.1502-35(c)

- Applied after the application of basis redetermination rule (-35(b)) if the subsidiary remains *a member* of the same group (or successor group)
- Applied when stock loss otherwise taken into account (-13(c), (d))
- Operation of suspended loss account –
 - Reduced by the subsidiary's items of deduction and loss (plus those of lower-tier subsidiaries) allocable to post-disposition period, that gave rise to the suspended loss
 - Allowed (to the extent not reduced) when the subsidiary is no longer a member of the group (or when all of its stock becomes worthless)

Loss Suspension Rule: 1.1502-35(c)

- Loss recognized on a disposition of member stock is suspended to the extent of the **duplicated loss** with respect to the stock, if member remains in group (or a successor group)
- Duplicated loss definition is similar to Treas. Reg. § 1.1502-20
- Attempts to measure potential for future double benefit

1.1502-35(f): Worthlessness

General Rule:

All losses treated as attributable to the worthless subsidiary, after computing taxable income for such year, shall be treated as expired on the first day after the determination of worthlessness.

Election:

In the case of worthlessness that occurred between 3/6/02 and 3/13/03, the group may elect to reattribute the losses to the parent, causing a corresponding reduction to the worthless subsidiary's stock basis.

Overview of Prop. Reg. §1.1502-36

- Integrated rules to address three potential categories of losses:
 - Basis Redetermination Rule (Prop. Reg. §1.1502-36(b)): addresses losses arising from uneconomic allocations under Reg. §1.1502-32;
 - Basis Reduction Rule (Prop. Reg. §1.1502-36(c)): addresses noneconomic “son of mirror” loss; and
 - Attribute Reduction (Prop. Reg. §1.1502-36(d)): addresses duplicated loss.
- Would replace Reg. §1.337(d)-2 (including three safe harbor methods of computing “recognized built-in gain” under Notice 2004-58) as well as Reg. §1.1502-35
- Additional rules (Prop. Reg. §1.1502-13(e)(4)) address the application of IRC Sec. 362(e)(2) inside consolidated groups, with several conforming amendments to other consolidated return regs including -32, -21(b), -80, etc.

Earnings & Profits

Earnings & Profits

- E&P (or deficit) tiers up and is reflected at higher tiers
- Sub's E&P reflected in parent's E&P (*i.e.*, E&P from consolidated return years) remains with the group if the subsidiary leaves
 - Subsidiary's E&P is reduced before it ceases to be a member
 - Exception for acquisition of entire group
 - Special rules for Section 355

Elimination of subsidiary's E&P

- Prevents "dividend stripping" - post-deconsolidation distribution is a return of capital reducing basis under section 301(c)(2)
- Eliminates need for "deemed dividend election" to prevent loss of stock basis adjustments on deconsolidation
- Eliminates need for basis reduction accounts (existing BRAs remain in effect)

Basis Reduction Accounts

- Prior Reg 1.1502-32T
- BRA created if sub ceased to be affiliated in year beginning pre-1/1/95 but some shares still owned by group
- BRA generally = net positive basis adjustments under former -32
- Effect of BRA: Distributions from sub reduce stock basis in retained shares to extent of amount in BRA (even if distribution relates to post-disaffiliation E&P)

Group Structure Change

Group Structure Change - defined

- Occurs if one corporation succeeds another as the parent of a group -
 - Reverse Acquisition
 - "F" Reorg
 - Parent's assets transferred to another member (parent ceases to exist, remaining chain of includible corporations)
- Definition more restrictive for taxable years beginning before 1/1/95

Group Structure Change - consequences

- Parent's basis in former parent determined by allocable portion of "net inside asset basis"
- New regs render net asset basis rule inapplicable in wholly taxable transactions; amendments may be applied retroactively to 1995
- Allocable portion of former parent's E&P is replicated as E&P of new common parent

Allocation of Tax Liability

Tax Allocation

- Investment adjustments: regulations prescribe "immediate payment" complementary method
- Earnings & profits:
 - Elect on first consolidated return or automatically on default method
 - Need IRS consent to change method; change effective prospectively; automatic consent in certain circumstances
 - One time opportunity to switch to immediate payment method for E&P purposes on first return beginning on or after 1/1/95 without consent and without satisfying usual requirements by attaching statement (can elect for all consolidated return years or only beginning in 1995)

Basic Methods

Basic methods allocate consolidated tax liability among profitable members, ignoring loss members.

- Allocate based on separate taxable income (“default method”)
- Allocate based on separate return tax liability
- Hybrid of first two methods
- Other method with IRS consent

Complementary Methods

Complementary methods allocate tax savings to members that generate tax savings for the group - i.e., loss members are compensated by profitable members.

- First, allocate under a Basic Method,
- Then allocate additional amounts (or credits) under a method below:
 - Immediate Payment Method: loss members compensated for use of losses when absorbed
 - Wait-and-see Method: loss members compensated only when they could use the losses themselves
 - Other method with IRS consent

Allocation vs. Payments

- Tax sharing agreements have no effect for federal income tax purposes
- Tax payments not in conformity with allocated tax result in constructive distribution and/or contribution