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**Comparison of the Intercompany Obligation Rules Under
Former Treas. Reg. § 1.1502-13(g) (1995),
Former Prop. Treas. Reg. § 1.1502-13(g) (1998), and
Treas. Reg. § 1.1502-13(g) (2008)**

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I. INTRODUCTION

The purpose of this outline is to compare the prior consolidated return intercompany obligation rules set forth in Treas. Reg. § 1.1502-13(g) against proposed regulations issued in 1998 and final regulations issued in 2008. This outline contains numerous examples designed to illustrate the operation of the prior, proposed, and final regulations. To highlight the differences between these regulations, each example is first analyzed under the prior regulations and then analyzed under the proposed and final regulations where differences exist. Some of these examples are set forth in the regulations, while others present fact patterns that have been developed to illustrate various issues, including issues associated with the "zero basis" problem.

Although not specifically mentioned by name in either the proposed regulations or the recently finalized regulations, we understand, from conversations with individuals at the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS"), that one of the primary purposes of the proposed and final regulations was the elimination of the inadvertent zero basis problem under the prior regulations. However, as illustrated in our examples, the proposed and final regulations do not completely fix that zero basis problem.

For a period of time, it appeared that the IRS was not addressing in private letter rulings the tax effects of Treas. Reg. § 1.1502-13(g). See P.L.R. 200308004 (Nov. 5, 2002); P.L.R. 200234053 (May 22, 2002). See also P.L.R. 200611006 (Dec. 16, 2005); P.L.R. 200542009 (Jun. 28, 2005). However, in certain circumstances, the IRS has ruled that Treas. Reg. § 1.1502-13(g) would not result in the recognition of income, gain, loss or deduction by a member or by the consolidated group in the aggregate. See P.L.R. 201008033 (Nov. 20, 2009) (Ruling 4); P.L.R. 200446011 (July 19, 2004) (Ruling 8); P.L.R. 200345049 (Aug. 2, 2002) (Ruling 9).

II. SUMMARY OF THE INTERCOMPANY REGULATIONS

A. In General

The intercompany transaction regulations of Treas. Reg. § 1.1502-13 generally treat the separate corporations within a consolidated group as divisions of a single entity. However, although the single entity theory controls in determining the character and timing of intercompany items, these regulations utilize a separate entity theory for the purposes of determining the amount and location of intercompany items. The

"matching rule" of Treas. Reg. § 1.1502-13(c) is the primary means of achieving single entity treatment for intercompany transactions. However, when it is no longer possible to treat members of a consolidated group as divisions of a single entity, an "acceleration rule" applies to terminate the deferral of gain or loss initially created by the matching rule. A common example of an event triggering the acceleration rule is the departure of a member from the consolidated group.

The matching rule applies to intercompany obligations in order to determine the timing and amount of interest payments and accruals between members of a consolidated group.¹ The term "intercompany obligation" is defined as an obligation between members of a consolidated group, but only for the period which both parties are members. The IRS issued the consolidated return intercompany obligation rules set forth in Treas. Reg. § 1.1502-13(g) to ensure that the application of the matching and acceleration rule would minimize the effect of transactions involving intercompany obligations on consolidated tax liability.² The regulations issued under Treas. Reg. § 1.1502-13(g) generally apply to three types of transactions involving intercompany obligations:

1. Transactions where an obligation between a consolidated group member and a non-member becomes an intercompany obligation (an "inbound transaction");
2. Transactions where an intercompany obligation ceases to be an intercompany obligation (an "outbound transaction"); and
3. Transactions where an intercompany obligation is assigned or extinguished within the consolidated group (an "intragroup transaction").

The prior intercompany obligation regulations of Treas. Reg. § 1.1502-13(g) were made final on July 12, 1995 (the "1995 Final Regulations") as part of a comprehensive set of regulations issued to address intercompany transactions. In general, the 1995 Final Regulations provided that transactions involving intercompany obligations will be recast as if the obligation were satisfied and, if the obligation remains outstanding, reissued as a new obligation (the so-called "deemed satisfaction-reissuance model" or the "recast" transaction). The IRS issued proposed regulations on December 18, 1998 (the "1998 Proposed Regulations") that

¹ See Treas. Reg. § 1.1502-13(g)(7), Example 1.

² See e.g., Preamble to proposed regulations issued in 2007, 72 F.R. 55139 (Sept. 28, 2007) (indicating that Treasury and the IRS considered modifying the matching and acceleration rules to ensure that transactions involving intercompany obligations clearly reflected consolidated taxable income, but concluded that the deemed satisfaction-reissuance model set forth in Treas. Reg. § 1.1502-13(g) provided the better alternative).

would have modified the mechanics and scope of the deemed satisfaction-reissuance model set forth in the 1995 Final Regulations. The 1998 Proposed Regulations were never finalized. On September 27, 2007, the IRS withdrew the 1998 Proposed Regulations and issued another set of proposed regulations (the “2007 Proposed Regulations”) to simplify the mechanics of the deemed satisfaction-reissuance model and to limit its operation to those instances where its application was considered to be necessary. The IRS published final regulations on December 29, 2008 (the “2008 Final Regulations”), which adopted the substance of the 2007 Proposed Regulations with certain modifications.

The 2008 Final Regulations apply to transactions involving intercompany obligations occurring in consolidated return years beginning on or after December 24, 2008.³ For prior consolidated return years, taxpayers may rely upon the form and timing of the recast transaction as set forth in the 1995 Final Regulations, and as clarified by the 1998 Proposed Regulations.⁴

B. Intercompany Obligations

The 1995 Final Regulations established the deemed satisfaction-reissuance model to account for the tax treatment of outbound transactions, inbound transactions, and intragroup transactions. The 1998 Proposed Regulations clarified both the form and the timing of the recast applied to transactions subject to the regulation, but also applied in instances in which the 1995 Final Regulations did not apply. The 2008 Final Regulations retain the deemed satisfaction-reissuance model, but modify the structure of the recast in significant respects; the 2008 Final Regulations also introduce several exceptions to the application of the deemed satisfaction-reissuance model.

1. Treas. Reg. § 1.1502-13(g)(3): "Outbound" Transactions and Intragroup Transactions in Which Gain or Loss is Realized: 1995 Final Regulations

a. Scope of Recast Transaction

The 1995 Final Regulations recharacterized transactions in which a member realizes a gain or a loss, either directly or indirectly, on an intragroup transfer of an intercompany obligation and transactions in which an intercompany obligation becomes a non-intercompany obligation.

Under the exception set forth in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(4) of the 1995 Final Regulations, it is possible that the deemed satisfaction and reissuance provisions of Treas. Reg.

³ See Treas. Reg. § 1.1502-13(g)(8) (2008).

⁴ See Preamble to Prop. Treas. Reg. § 1.1502-13(g) (2007), 72 Fed. Reg. 55,139 (Sept. 28, 2007).

§ 1.1502-13(g)(3) may not apply where an intercompany obligation becomes a non-intercompany obligation in a transaction in which neither gain nor loss is realized.⁵ If an intercompany obligation becomes a non-intercompany obligation in a transaction in which the transferring member realizes neither gain nor loss (i.e., a transfer at a time when the obligation's fair market value is equal to the transferring member's basis in the obligation), it could be argued that the transaction does not have a significant impact on any person's Federal income tax liability for any year. If this exception applies, the provisions of former Treas. Reg. § 1.1502-13(g)(3) would not apply even though an intercompany obligation has become a non-intercompany obligation.

- b. Deemed Satisfaction -- Under the recharacterization set forth in the 1995 Final Regulations, the debtor is first deemed to pay the creditor member an amount of money in retirement of the obligation. Determining the amount of money deemed paid is dependent upon the type of transaction involved.
- (1) If the debt is sold for an amount of money, the amount deemed paid by the debtor member is the amount of cash actually received by the selling member on the disposition of the note.
 - (2) If the creditor member exchanges the intercompany note for property, then the debtor member is deemed to pay the creditor member an amount of money equal to the issue price (determined under sections 1273 and 1274) of a new obligation issued for the property with terms identical to the terms of the existing note. The critical factor in determining the issue price of a note under sections 1273 and 1274 is whether the note and the property for which it is issued are publicly traded. In the absence of public trading of either the note or the property for which it is issued, the issue price generally equals the note's stated redemption price at maturity regardless of the property's fair market value.⁶ Sections

⁵ Former Treas. Reg. § 1.1502-13(g)(3)(i)(B)(4) (1995) provides that the provisions of Treas. Reg. § 1.1502-13(g)(3) will not apply if treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year.

⁶ The preamble to the 1998 Proposed Regulations provides that the government considered and rejected a proposal under which the amount of the deemed satisfaction would always equal the fair market value of the property received in the exchange. The preamble to the 1998 Proposed Regulations provides that the proposed regulations "retain" the existing rule for determining the amount of the deemed satisfaction where an intercompany obligation is exchanged for property. Thus, the IRS's published position prior to the 2007 Proposed Regulations was that the amount of

1273(b)(4) and 1274(a)(1). Where there is public trading of either the note or the property for which it is issued, the issue price of the note generally equals the fair market value of the property received in the exchange. Section 1273(b)(3).

- (3) If the intercompany obligation becomes a non-intercompany obligation because of the deconsolidation of the debtor or creditor member, the debtor corporation is deemed to pay the creditor member an amount of money equal to the fair market value of the obligation determined immediately before the debtor or creditor becomes a nonmember.
- c. Deemed Reissuance -- If the obligation actually remains outstanding, the debtor is then deemed to issue a new obligation (with a new holding period) to the party holding the obligation.
- (1) In general, the issue price of the new obligation is determined under the rules of sections 1273 or 1274.
 - (2) If the obligation becomes a non-intercompany obligation because the debtor or creditor becomes a nonmember, then the issue price of the obligation equals its fair market value determined immediately after the debtor or creditor becomes a nonmember. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995).
- d. Meaning of “Directly or Indirectly” -- The 1995 Final Regulations applied if a member realizes an amount from an intercompany obligation either “directly or indirectly.” Former Treas. Reg. § 1.1502-13(g)(3)(i) (1995). As the IRS has noted, neither the 1995 Final Regulations nor the preamble to the 1995 Final Regulations discussed the scope of the term “realizes ... indirectly.” See T.A.M.

the deemed satisfaction equaled the issue price (determined under sections 1273 and 1274) of a new note issued for the property received in the exchange. See Preamble to Former Prop. Treas. Reg. § 1.1502-13(g) (1998), REG-105964-98, 1999-1 C.B. 810, 811. However, we understood, from conversations with an individual at the IRS, that it was possible under the 1998 Proposed Regulations that the deemed satisfaction amount may equal the fair market value of the property received in the exchange rather than the issue price (determined under sections 1273 and 1274) of a new note issued for the property received in the exchange where there was a gross disparity between the fair market value of the debt and such issue price (e.g., a disparity caused by the debtor’s insolvency).

Notably, the IRS adopted a fair market value approach in the 2008 Final Regulations, using clear language regarding the determination of the deemed satisfaction amount. See Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).

200006014 (Oct. 22, 1999). As discussed below, the IRS has concluded that transactions in which indirect realization occurs are “transactions in which the amount realized is a function of the inherent attributes of the obligation, but that neither involves the obligation directly nor effects a deconsolidation.” Id.

- (1) In T.A.M. 200006014, Parent was a common parent of a consolidated group including Sub1, Sub2 and Benefits. Sub2 borrowed \$c from Parent in exchange for a Sub2 Note. Immediately thereafter, Parent contributed the Sub2 Note to Benefits in exchange for the newly authorized 100 shares of Benefits voting preferred stock and Benefits’ assumption of certain pension liabilities of Parent. Under the applicable tax accounting principles, however, the assumed pension liabilities were not yet taken into account in the tax system. Parent’s basis in the Benefits stock was thus determined wholly by reference to its basis in the Sub2 Note. Subsequently, Parent sold the 100 shares of Benefits stock to an unrelated Purchaser at a loss.
- (2) Parent calculated the loss on the sale of the Benefits stock by excluding the Sub2 Note from the inside basis of Benefits pursuant to Treas. Reg. § 1.1502-20(c)(2)(vi)(A)(1). Having done so, Parent claimed that the loss disallowance rule of Treas. Reg. § 1.1502-20 did not operate to disallow any of this loss.
- (3) The IRS analyzed the meaning of the clause “realizes ... indirectly.” In doing so, the IRS concluded that “[i]t appears ... that there is but a narrow range of transactions for which such a clause would be necessary.” The IRS effectively determined what transactions should be covered by the clause by determining what transactions did not need to be covered by the clause. The IRS wrote:
 - a) “First, if a transaction actually involves an Intercompany Obligation, there is a direct realization and no need for the ‘indirect’ clause.”
 - b) “Second, if a transaction does not involve a member obligation directly, but rather an interest in the entity holding the obligation, most cases are otherwise covered by § 1.1502-13(g) and so would have no need for the ‘indirect’ clause. For example, if a transaction involves a member obligation that is held by a person or entity that is not a member of the group, § 1.1502-13(g) has no application at all because the obligation is not an Intercompany Obligation. And, if the holder is a member but a disposition of its stock

deconsolidates the holder, the regulation provides for a satisfaction of the obligation at fair market value, so again the 'indirectly' clause is not needed."

- c) "What remains are transactions in which the amount realized is a function of the inherent attributes of the obligation, but that neither involves the obligation directly nor effects a deconsolidation."
- (4) The IRS held that the transaction addressed in T.A.M. 200006014 was a transaction involving an indirect realization under Treas. Reg. § 1.1502-13(g)(3)(i). Because the only economic interest represented by the Benefits stock was the intercompany obligation (the Sub2 Note), and because there would be no loss at all if the pension liabilities were taken into account, the amount realized on the Benefits stock had to be treated as an amount indirectly realized on the Sub2 Note.
- (5) Accordingly, the IRS recharacterized the sale of the Benefits stock as follows:
- a) Sub2 was treated as having satisfied its note for \$c immediately before Parent's sale of the Benefits stock;
 - b) The loss duplication calculation was made immediately after the deemed satisfaction and before any other transaction. The amount of deemed satisfaction represented duplicated loss and was disallowed;
 - c) Sub2 was then treated as having reissued its note to Benefits.
- (6) The IRS also has held that the transaction described in Notice 2001-17, 2001-1 C.B. 730, involves an indirect realization under Treas. Reg. § 1.1502-13(g)(3)(i).
- a) The IRS has taken the position that so-called "contingent liability tax shelter" transactions, which are described in Notice 2001-17, result in a duplication of loss and thus a disallowance under Treas. Reg. § 1.1502-20. The transaction typically involves the transfer of one or more assets with a basis that approximates its value in exchange for stock of the transferee corporation and the transferee's assumption of a contingent liability that would be deductible if paid by the transferor.
 - i) The asset will typically be a security issued by another member of the group. The liability is only slightly less than the basis of the asset.

- ii) Shortly after the exchange, the transferor sells the stock received in the exchange and claims a loss approximating the present value of the contingent liability assumed by the transferee.
- b) The IRS takes the position that, at the time of the loss duplication calculation, the subsidiary holds the proceeds of the member security, not the security itself, thus resulting in a duplicated loss. The IRS reaches this conclusion through a somewhat strained interpretation of Treas. Reg. § 1.1502-13(g).
- i) Under Treas. Reg. § 1.1502-13(g), a member security is deemed satisfied and reissued if a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its rights or obligations under the member security. The deemed satisfaction occurs immediately before the transaction in which the amount is realized, and the deemed reissuance occurs immediately after the transaction.
 - ii) The IRS takes the position that the sale of the stock in Notice 2001-17 transactions triggers Treas. Reg. § 1.1502-13(g) with respect to the member security, because it produces an indirect realization of loss from the assignment of all or part of an interest in the member security.
 - iii) If the transfer of the member security qualifies as a tax-free section 351 exchange, the IRS additionally argues that the stock is a successor asset within the meaning of Treas. Reg. § 1.1502-13(j)(1) and, therefore, Treas. Reg. § 1.1502-13(g) applies to the stock.
 - iv) Next, the IRS takes the position that the member security is deemed satisfied immediately before the stock sale and deemed reissued after the sale, and that the loss duplication calculation is made at the time of the sale. Thus, at the time of the loss duplication calculation, the subsidiary holds the proceeds from the deemed satisfaction of the member security.

- c) In addition to the technical argument based on Treas. Reg. § 1.1502-13(g), the IRS argues that Notice 2001-17 transactions violate the anti-avoidance and anti-stuffing rules of Treas. Reg. § 1.1502-20(e).
 - d) These arguments appear to have become moot, however, as a result of the Federal Circuit's decision in Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001) (holding that the duplicated loss component of Treas. Reg. § 1.1502-20 is invalid), and the issuance of the loss disallowance regulations (see Treas. Reg. §§ 1.337(d)-2, 1.1502-20(i), and 1.1502-35; see also Treas. Reg. § 1.1502-36). Nonetheless, the IRS has identified a number of grounds upon which to attack these transactions. See, e.g., Notice 2001-17, 2001-1 C.B. 730; F.S.A. 200121013 (Feb. 12, 2001); F.S.A. 200122022 (Feb. 23, 2001); CC-2001-033a (June 28, 2001); see also F.S.A. 200217021 (Jan. 17, 2002).
2. Former Prop. Treas. Reg. § 1.1502-13(g)(3) (1998): "Outbound" Transactions and Intragroup Transfers in Which Gain or Loss is Realized: 1998 Proposed Regulations
- a. Scope of Recast Transaction

The 1998 Proposed Regulations, unlike the 1995 Final Regulations, recharacterized all transactions involving the transfer of an intercompany obligation regardless of whether a member realizes an amount of income, gain, deduction or loss as a result of the transfer. The 1998 Proposed Regulations also eliminated the exception contained in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(4) relating to situations where "[t]reating the obligation as satisfied and reissued will not have a significant effect on any person's federal income tax liability for any year." The preamble to the 1998 Proposed Regulations provided that the exception was eliminated due to uncertainty as to its application and scope. The 1998 Proposed Regulations did not alter the treatment accorded transactions in which an intercompany obligation becomes a non-intercompany obligation.
 - b. Deemed Satisfaction -- Under the recharacterization set forth in the 1998 Proposed Regulations, the debtor is first deemed to pay the creditor member an amount of money in retirement of the obligation. Determining the amount of money deemed paid is dependent upon the transaction involved.
 - (1) The 1998 Proposed Regulations retained the rule that if the debt is sold for an amount of money, the amount deemed paid

by the debtor member is the amount of cash actually received by the selling member on the disposition of the note.

- (2) The 1998 Proposed Regulations retained the rule that if the creditor member exchanges the intercompany note for property, then the debtor member is deemed to pay the creditor member an amount equal to the issue price (determined under sections 1273 or 1274) of a note issued in exchange for the property with terms identical to the existing note. In cases in which neither the property nor the obligation are publicly traded, the issue price will generally equal the note's stated redemption price at maturity if the note provides for adequate stated interest. See sections 1273(b)(4) and 1274(a)(1).
 - (3) The 1998 Proposed Regulations retained the rule that where an intercompany obligation becomes a non-intercompany obligation because of the deconsolidation of the debtor or creditor member, the debtor corporation is deemed to pay the member an amount of money equal to the fair market value of the obligation immediately before the debtor or creditor becomes a nonmember.
 - (4) The 1998 Proposed Regulations also clarified the amount of the deemed satisfaction in two situations not specifically covered under the 1995 Final Regulations. First, if a corporation assumes the debtor's liability in exchange for property of the debtor, the debt is treated as satisfied for an amount equal to the issue price (determined under sections 1273 or 1274) of a new debt issued on the date of the transaction, with identical terms, for such property. Second, in a situation in which an intercompany obligation is extinguished, the debt is treated as satisfied for an amount equal to the issue price (determined under sections 1273 or 1274) of a new debt issued on the date of the transaction, to a third party, for property that is not publicly traded.
- c. Deemed Reissuance -- Under the 1998 Proposed Regulations, if the obligation actually remains outstanding following the deemed satisfaction, the creditor member is treated as transferring the deemed satisfaction proceeds to the actual transferee of the note in exchange for the consideration received by the creditor member in the actual transaction. The transferee is then deemed to transfer this amount to the debtor in exchange for a new obligation with terms identical to the existing obligation, except for a new holding period.
- (1) In general, the issue price of the new obligation is determined under the rules of sections 1273 or 1274 (illustrated below).

- (2) If the obligation becomes a nonintercompany obligation because the debtor or creditor becomes a nonmember, then the issue price of the obligation equals its fair market value determined immediately after the debtor or creditor becomes a nonmember. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998).
- d. Meaning of “Directly or Indirectly” -- The 1998 Proposed Regulations did not mention indirect realization. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(i) (1998). However, under Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998), the result in T.A.M. 200006014, supra, would be the same as under Treas. Reg. § 1.1502-13(g)(3)(i):
- (1) Sub2 would be treated as having satisfied its note for \$c immediately before Parent’s sale of the Benefits stock;
 - (2) Parent would be deemed to contribute the proceeds of the satisfaction (i.e., \$c) to Benefits in exchange for the Benefits stock;
 - (3) Benefits would be treated as transferring the deemed proceeds to Sub2 in exchange for a new Sub2 Note.
3. Treas. Reg. § 1.1502-13(g)(3) (2008): "Outbound" Transactions and Intragroup Transactions in Which Gain or Loss is Realized: 2008 Final Regulations
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a. Scope of Recast Transaction

The 2008 Final Regulations retain the general rule contained in the 1998 Proposed Regulations that recharacterizes transactions in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of an intercompany obligation, irrespective of whether gain or loss is actually recognized in the transaction. Moreover, consistent with the 1995 Final Regulations and the 1998 Proposed Regulations, the 2008 Final Regulations generally apply the recast transaction to outbound transactions where an intercompany obligation becomes a non-intercompany obligation.

As in the 1998 Proposed Regulations, the 2008 Final Regulations eliminate the exception contained in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(4) relating to situations where “[t]reating the obligation as satisfied and reissued will not have a significant effect on any person’s federal income tax liability for any year.” However, the 2008 Final Regulations introduce several new exceptions to the application of the recast to intragroup transactions and outbound transactions involving intercompany obligations.

The IRS included these new exceptions to limit the application of the recast transaction to those intragroup and outbound transactions “that have the greatest potential to create distortions of consolidated taxable income.”⁷ However, some of these exceptions are themselves subject to the “tax benefit rule,” which would override the exception if the transaction were “engaged in with a view to shift items of built-in gain, loss, income or deduction from the obligation from one member to another member in order to secure a tax benefit” that the group or its members would not otherwise enjoy in a consolidated or separate return year.⁸ The 2008 Final Regulations define the term “tax benefit” as the “benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance.”⁹ Thus, under the 2008 Final Regulations, if a transaction is described by one of the new exceptions, but still allows the taxpayer to secure a “tax benefit,” the transaction may be recast.

A brief description of new exceptions for intragroup and outbound transactions contained in the 2008 Final Regulations is provided below with an indication of whether the exception is subject to the tax benefit rule described above.

⁷ See Preamble to Prop. Treas. Reg. § 1.1502-13(g) (2007), 72 Fed. Reg. 55,139 (Sept. 28, 2007).

⁸ Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008). The 2008 Final Regulations modified the so-called “material tax benefit” rule contained in the 2007 Proposed Regulations that applied if it was “reasonably foreseeable” that the shifting of items will secure a material tax benefit. See Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2007). The Preamble to the 2008 Final Regulations provides that the “tax benefit rule” was changed in response to comments that the objective standard in the 2007 Proposed Regulations would be difficult to apply.

⁹ Treas. Reg. § 1.1502-13(g)(2)(v) (2008). The 2008 Final Regulations clarify that a tax benefit will include the use of items from an intercompany obligation to reduce the gain or increase the loss on the sale of subsidiary stock, as well as the creation or absorption of tax attributes of a member or a subgroup. An example in the 2008 Final Regulations illustrates the application of the tax benefit rule to a transfer of an intercompany obligation to a subsidiary with a view to reduce gain on the sale of the subsidiary’s stock. Treas. Reg. § 1.1502-13(g)(7) (2008), Example 8. In the example, B, S, and T are members of a consolidated group. S holds a note from B that has depreciated in value. S transfers the B note to T in a transaction intended to qualify for nonrecognition treatment under section 351 but with a view to sell the T stock at a reduced gain. The example provides that the tax benefit rule applies because the assignment of the B note was engaged in with a view to shift built-in loss from the obligation to secure a tax benefit that the group or its members would not otherwise enjoy.

(1) Intercompany Section 332 or 361 Exchange

An intercompany exchange to which section 332 and section 337(a) or section 361(a) applies if the debtor and creditor recognize no amount of income, gain, deduction or loss. This exception is subject to the tax benefit rule. Treas. Reg. §§ 1.1502-13(g)(3)(i)(B)(I) and (C) (2008).

(2) Intercompany 351 Exchange

An intercompany exchange to which section 351 applies if the debtor or creditor recognizes no amount of income, gain, deduction or loss. This exception is subject to the tax benefit rule.

In addition, the above exception for intercompany section 351 exchanges does not apply to transfers that the IRS views as having a significant potential for distortion of consolidated taxable income. The 2008 Final Regulations limit the exception for intercompany section 351 exchanges where the creditor assigns the intercompany obligation and where --

- a) The transferor or transferee has a loss subject to a limitation (e.g., a SRLY) or a dual consolidated loss, but only if the other member is not subject to a comparable limitation;
- b) The transferor or transferee has a special status within the meaning of Treas. Reg. § 1.1502-13(c)(5) that the other member does not also possess;
- c) A member of the group realizes discharge of indebtedness income that is excluded under section 108(a) within the same taxable year as that of the exchange, and the tax attributes attributable to either the transferor or the transferee are reduced under section 108, section 1017, and Treas. Reg. § 1.1502-28 (unless attribute reduction occurs by application of -28(a)(4));
- d) The transferee has a nonmember shareholder;
- e) The transferee issues preferred stock to the transferor in the exchange; or
- f) The stock of the transferee (or higher-tier member other than a higher-tier member of an 80-percent

chain¹⁰ that includes the transferee) is disposed of within 12 months from the assignment of the intercompany obligation unless the transferor, transferee, and the debtor are all in the same 80-percent chain; and all of the stock of the transferee held by members is disposed of to persons that are not members of the group.

Treas. Reg. §§ 1.1502-13(g)(3)(i)(B)(1) and (C) (2008).

(3) Intercompany Assumption Transaction

An intercompany transaction in which all of the debtor's obligations are assumed in connection with the debtor's sale or disposition of property (other than solely money) in an intercompany transaction to which section 1001 applies. This exception is subject to the tax benefit rule. Treas. Reg. §§ 1.1502-13(g)(3)(i)(B)(2) and (C) (2008).

(4) Intercompany Extinguishment Transaction

An intercompany transaction in which an intercompany obligation is extinguished in whole or in part (other than an exchange or deemed exchange for a newly issued intercompany obligation), provided that (i) the adjusted issue price of the obligation is equal to the creditor's basis in the obligation and (ii) the debtor's corresponding item and creditor's intercompany item offset in amount. This exception is subject to the tax benefit rule. Treas. Reg. §§ 1.1502-13(g)(3)(i)(B)(5) and (C) (2008).

(5) Routine Modification of Intercompany Obligation

A modification of an intercompany obligation where the intercompany obligation is extinguished in an exchange (or deemed exchange) for a newly issued obligation with an issue price equal to the adjusted issue price of the extinguished obligation and the creditor's basis in the extinguished obligation.¹¹ This exception is subject to the tax benefit rule. Treas. Reg. §§ 1.1502-13(g)(3)(i)(B)(6) and (C) (2008).

¹⁰ An 80-percent chain is defined as “a chain of two or more corporations in which stock meeting the requirements of section 1504(a)(2) of each lower-tier member is held directly by a high-tier member of such chain.” Treas. Reg. § 1.1502-13(g)(2)(v) (2008).

¹¹ The 2008 Final Regulations clarify that the deemed satisfaction reinsurance model can apply to transactions otherwise exempted as an intercompany section 361, 332, or 351 exchange or as an intercompany assumption transaction if the debtor's obligations are assumed and there is a

(6) Outbound Distribution of Intercompany Obligation

An outbound transaction in which an intercompany obligation is newly issued in an intragroup reorganization in exchange for property and, pursuant to the plan of reorganization, the intercompany obligation is distributed to a nonmember shareholder or creditor in a transaction to which section 361(c) applies. Treas. Reg. §§ 1.1502-13(g)(3)(i)(B)(7) (2008).

(7) Outbound Subgroup Exception

An outbound transaction in which the creditor and debtor both cease to be members of a consolidated group and become members of another consolidated group (but the same other group), provided that neither the creditor nor debtor recognizes any income, loss, deduction, or credit with respect to the transaction. This exception requires that the creditor and debtor have a relationship described in section 1504(a)(1) as in a parent-subsidiary relationship or as connected through common ownership by another member of the group that also becomes a new member of the other consolidated group. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(8) (2008).

b. Deemed Satisfaction and Reissuance -- Under the recharacterization set forth in the 2008 Final Regulations, the debtor is first deemed to pay the creditor member an amount of money in retirement of the intercompany obligation, and then as reissuing a new obligation (with a new holding period but otherwise identical terms) to the creditor for the same amount of cash immediately before the transaction. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).

(1) The deemed satisfaction-reissuance model set forth in the 2008 Final Regulations differs from the approach adopted in the 1995 Final Regulations and the 1998 Proposed Regulations in two fundamental respects.

- a) First, the 2008 Final Regulations provide that the deemed reissuance of the intercompany obligation must be made to the creditor rather than the actual transferee of the intercompany obligation.
- b) Second, under the 2008 Final Regulations, the amount of cash deemed to satisfy the debt and repurchase the

material modification under Treas. Reg. § 1.1001-3(e)(4) and a deemed exchange under Treas. Reg. § 1.1001-3(b). Accordingly, the transaction would also have to satisfy the exception for routine modifications in order for the deemed satisfaction reissuance model not to apply.

reissued debt is generally equal to the fair market value of the intercompany obligation rather than the issue price of the intercompany obligation.

- i) The 2008 Final Regulations provide an exception to the general rule where the creditor realizes an amount with respect to the intercompany obligation that differs from the debt's fair market value, and the transaction is not an exchange or deemed exchange of debt of a member for newly issued debt of a member. If the exception applies, the amount of cash deemed to satisfy the debt and repurchase the reissued debt is treated as equal to the amount realized by the creditor in retiring the original debt. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).
- c. Deemed Satisfaction and Reissuance as Separate Transaction from Actual Transaction – The deemed satisfaction and reissuance of an intercompany debt obligation under the 2008 Final Regulations does not affect the actual outbound or intragroup transaction. Thus, after the deemed satisfaction and reissuance, the parties to the transaction are treated as if they entered into the actual transaction. The 2008 Final Regulations provide that the deemed satisfaction and reissuance is treated as a separate transaction from the actual transaction, and clarify that the deemed satisfaction and reissuance of an intercompany obligation will not cause the obligation to be recharacterized as other than debt for Federal income tax purposes immediately before the actual transaction. Treas. Reg. § 1.1502-13(g)(3)(ii)(B) (2008).
4. Former Treas. Reg. § 1.1502-13(g)(4) (1995), Former Prop. Treas. Reg. § 1.1502-13(g)(4) (1998), and Treas. Reg. § 1.1502-13(g)(5) (2008): "Inbound" Transactions: 1995 Final Regulations, 1998 Proposed Regulations, and 2008 Final Regulations
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In general, the rules relating to "inbound transactions" set forth in the 1995 Final Regulations have not been modified by the 1998 Proposed Regulations and the 2008 Final Regulations. Under these regulations, when a non-intercompany obligation becomes an intercompany obligation (through a member's acquisition of the debt or as a result of the debtor or creditor becoming a member of the consolidated group), the obligation is treated as satisfied for its fair market value (as determined under the principles of Treas. Reg. § 1.108-2(f)) and reissued as a new obligation immediately after it becomes an intercompany obligation. This new obligation has an issue price equal to its fair market value and a stated redemption price equal to the face amount of the note.

Although the general treatment of “inbound transactions” has not been altered in the 1998 Proposed Regulations and 2008 Final Regulations, certain conforming changes have been made. For example, the 2008 Final Regulations provide for a “subgroup” exception similar in substance to that applicable to outbound transactions (described above). The 2008 Final Regulations also introduce a rule designed to prevent the acceleration of deductions for repurchase premiums in certain inbound transactions.

III. EXAMPLES¹²

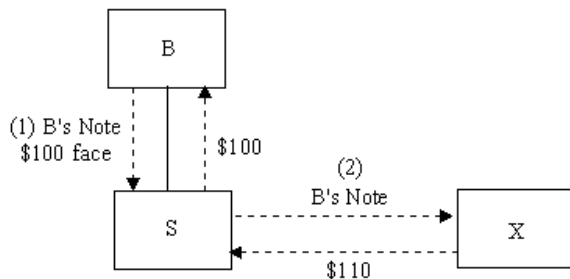
The following assumptions will apply to the examples unless otherwise specified: (1) the notes involved have an initial issue price of \$100; (2) at all times the notes provide for stated interest in excess of AFR payable semi-annually; (3) the notes have a term of five years, at which time the entire principal amount is payable; (4) the notes are not publicly traded; (5) the notes have a fair market value equal to the amount of consideration for which the notes were transferred or exchanged; (6) none of the stock involved in the examples is publicly traded; (7) B represents the borrower (or issuer of the note), S represents the creditor and X represents an unrelated third-party; and (8) B and S are members of an affiliated group filing consolidated returns.

A. Examples From the 1995 Final Regulations, the 1998 Proposed Regulations, and the 2008 Final Regulations

1. Example 1: Sale of Intercompany Obligation Outside the Consolidated Group (Gain Realized On "Outbound" Transaction)

a. Gain Realized On "Outbound" Transaction -- 1995 Final Regulations¹³

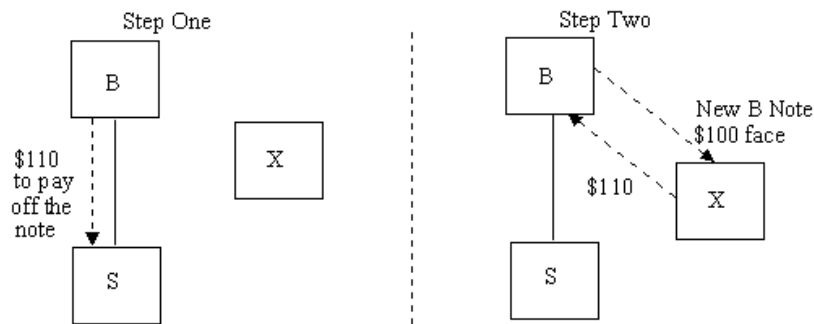
(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S sells the note to X for \$110.

¹²This outline addresses only the federal income tax consequences of the transactions described.

¹³See Former Treas. Reg. § 1.1502-13(g)(5), Example (2)(f) (1995).

(2) Recharacterized Transactions

- a) B is treated as paying S \$110 in satisfaction of the debt immediately before S's actual sale of the note to X. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- b) B is then deemed to issue a new note to X for \$110. The new note has a \$110 issue price and a \$100 stated redemption price at maturity. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995).

(3) Tax Consequences

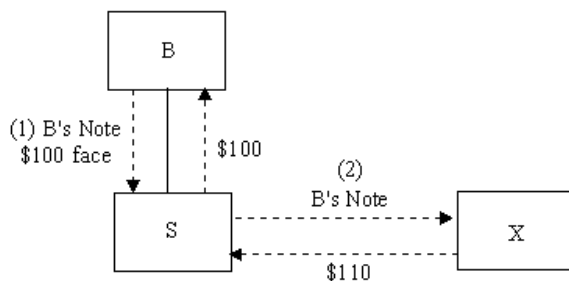
- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note for a premium. S has a \$10 gain on the deemed retirement of B's note. Section 1271(a)(1).
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. The character of B's deduction controls and S's gain is recharacterized as ordinary income. Thus, the net effect on consolidated taxable income ("CTI") is zero. Treas. Reg. § 1.1502-13(c)(4)(i).
- c) Pursuant to the recharacterization, B is treated as issuing a new note to X with an issue price of \$110 and a stated redemption price at maturity of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the

portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a),(d).¹⁴

- d) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).¹⁵

b. Gain Realized On "Outbound" Transaction -- 1998 Proposed Regulations¹⁶

(1) Actual Transactions



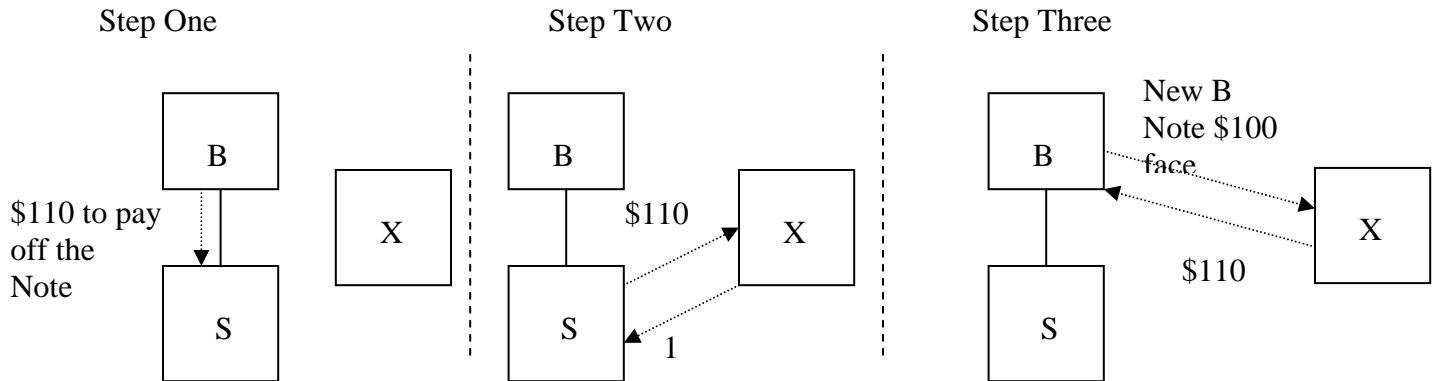
- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S sells the note to X for \$110.

(2) Recharacterized Transactions

¹⁴These regulations were finalized on December 31, 1997, and generally apply to debt instruments issued on or after March 2, 1998.

¹⁵See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

¹⁶See Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example (3)(f) (as redesignated by the 1998 Proposed Regulations).



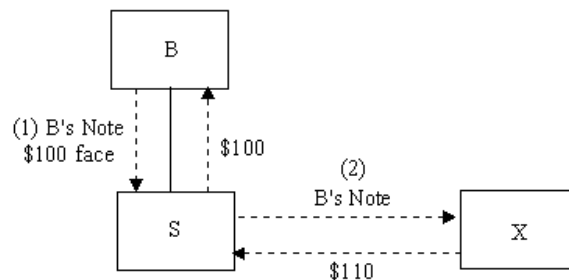
- a) B is treated as paying S \$110 in satisfaction of the debt immediately before S's actual sale of the note to X. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
 - b) S is then treated as transferring the proceeds of the deemed satisfaction to X in exchange for \$110.¹⁷ Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
 - c) B is then deemed to issue a new note to X in exchange for the amount X is deemed to have received from S. The new note has a \$110 issue price and a \$100 stated redemption price at maturity. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998).
- (3) Tax Consequences: Same As Under The 1995 Final Regulations
- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note for a premium. S has a \$10 gain on the deemed retirement of B's note. Section 1271.
 - b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. The character of B's deduction controls and S's gain is recharacterized as ordinary income. Thus, the net effect on consolidated taxable income ("CTI") is zero. Treas. Reg. § 1.1502-13(c)(4)(i).

¹⁷ Where an intercompany obligation is sold for money, this step appears unnecessary. However, where the obligation is transferred for property this step is essential because it locates the property consistently with the actual transaction.

- c) Pursuant to the recharacterization, B is treated as issuing a new note to X with an issue price of \$110 and a stated redemption price at maturity of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).¹⁸
- d) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).¹⁹

c. Gain Realized On "Outbound" Transaction -- 2008 Final Regulations²⁰

(1) Actual Transactions



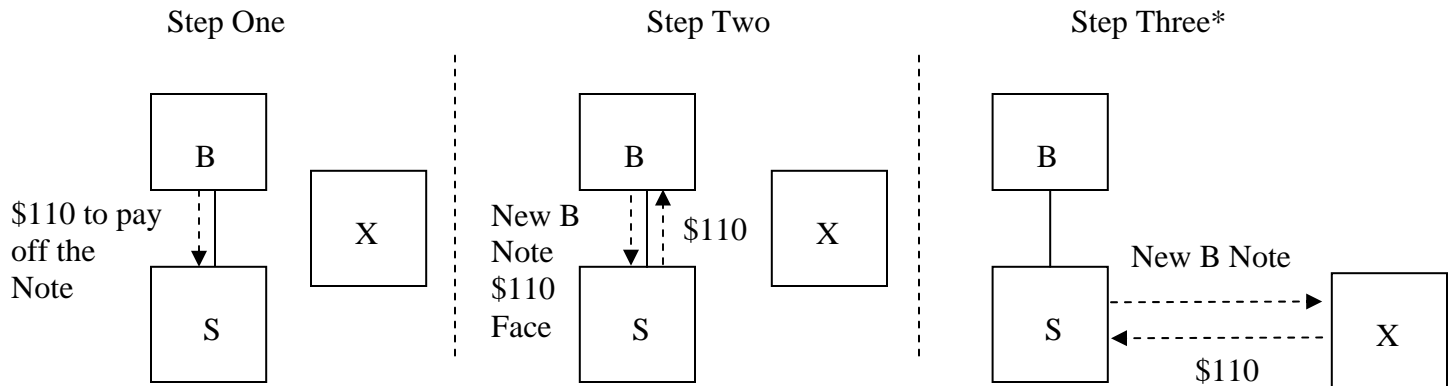
¹⁸These regulations were finalized on December 31, 1997, and generally apply to debt instruments issued on or after March 2, 1998.

¹⁹See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

²⁰See Treas. Reg. § 1.1502-13(g)(7), Example (2)(vii).

- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S sells the note to X for \$110.

(2) Recharacterized Transactions



- a) B is treated as paying S \$110 in satisfaction of the debt immediately before S's actual sale of the note to X. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).
- b) B is treated as reissuing the note to S in exchange for \$110.
- c) S sells the reissued note to X for \$110.*²¹

(3) Tax Consequences

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note for a premium. S has a \$10 gain on the deemed retirement of B's note. Section 1271.
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. The character of B's deduction controls and S's gain is recharacterized as ordinary

²¹ A single asterisk in the text indicates a transaction that actually occurs and is treated as occurring in connection with, or as part of, the recharacterized transactions. The 2008 Final Regulations provide that the deemed satisfaction and reissuance be treated as a separate transaction from the actual transaction.

income. Thus, the net effect on consolidated taxable income ("CTI") is zero. Treas. Reg. § 1.1502-13(c)(4)(i).

- c) Pursuant to the recharacterization, B is treated as issuing a new note to S (rather than X, as under the 1995 Final Regulations and the 1998 Proposed Regulations) with an issue price of \$110 and a stated redemption price at maturity of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).²²
- d) S's sale of the reissued note to X for \$110 will not result in gain or loss recognition because S has a \$110 basis in the reissued note pursuant to the deemed reissuance of the note.
- e) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).²³

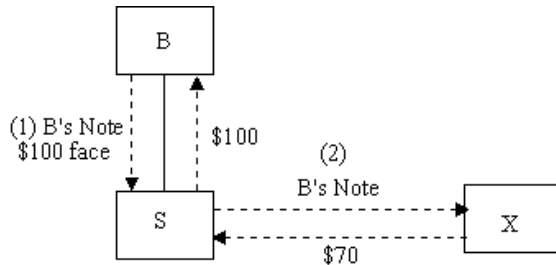
²²These regulations were finalized on December 31, 1997, and generally apply to debt instruments issued on or after March 2, 1998.

²³ See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

2. Example 2: Sale of Intercompany Obligation Outside of the Consolidated Group (Loss Realized On "Outbound" Transaction)

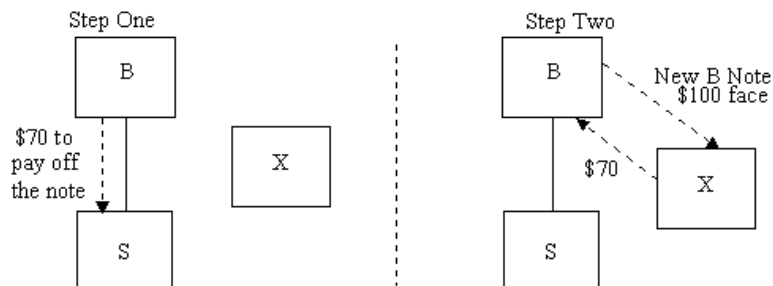
a. Loss Realized On "Outbound" Transaction -- 1995 Final Regulations²⁴

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S sells the note to X for \$70.

(2) Recharacterized Transactions



- a) In year 2, B is treated as paying \$70 to S in satisfaction of the debt immediately before S's sale of the note to X. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- b) B is then deemed to issue a new note to X. The new note has a \$70 issue price and a \$100 stated redemption price at maturity. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995).

(3) Tax Consequences

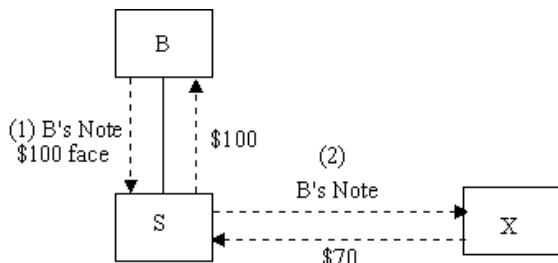
²⁴ See Treas. Reg. § 1.1502-13(g)(5), Example 3.

- a) In year 2, B has \$30 of cancellation of indebtedness ("COD") income on the deemed repurchase of its note at a discount.²⁵ Section 61(a)(12). S has a \$30 loss on the deemed retirement of the note for \$70 under section 1271(a)(1).
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's income and S's loss must be redetermined in order to treat B and S as divisions of a single entity. The character of B's income controls and S's loss will be recharacterized as a loss on a noncapital asset. Thus, the net effect on CTI is zero. Former Treas. Reg. § 1.1502-13(c)(4)(i) (1995).
- c) Pursuant to the recharacterization, B is treated as issuing a new note to X with an issue price of \$70 and a stated redemption price at maturity of \$100. Section 1273. Under the OID rules, \$30 is recharacterized as interest, and X must recognize \$30 of interest income over the term of the note. Sections 61(a)(4) and 1272. B is entitled to a corresponding interest deduction for the amount of the note recharacterized as interest. Section 163(e).

²⁵ Pursuant to Former Treas. Reg. § 1.1502-13(g)(3)(ii)(B) (1995), even if B is insolvent at the time of the discharge, section 108(a) will not apply to exclude B's COD income. See also Treas. Reg. § 1.1502-13(g)(3)(ii)(B) (as in effect prior to the effective date of Former Treas. Reg. § 1.1502-13(g)(3)(ii)(B)); Former Treas. Reg. § 1.1502-13(g)(5), Example (3)(d); F.S.A. 199908005 (Nov. 17, 1998).

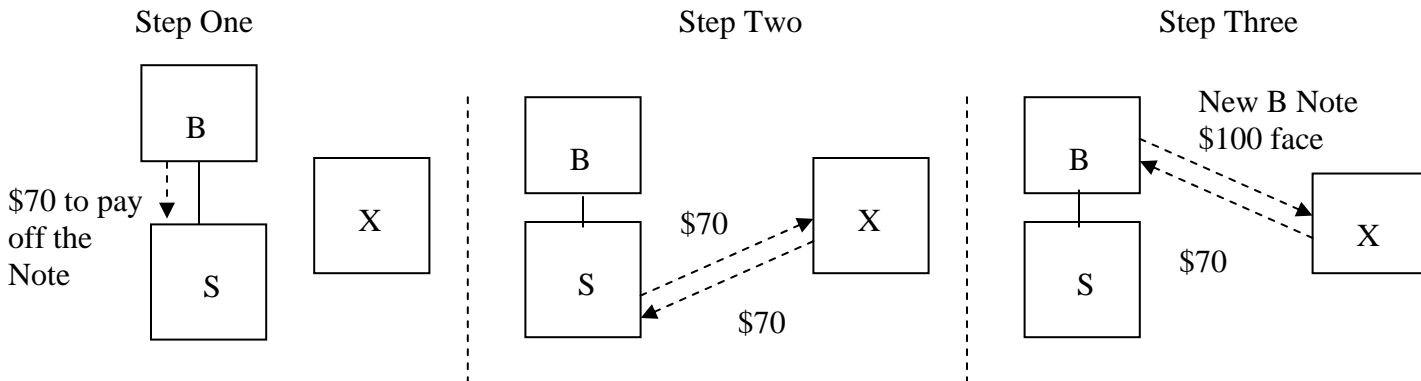
b. Loss Realized On "Outbound" Transaction -- 1998 Proposed Regulations²⁶

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S sells the note to X for \$70 in exchange for \$70.

(2) Recharacterized Transactions



- a) In year 2, B is treated as paying \$70 to S in satisfaction of the debt immediately before S's sale of the note to X. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).

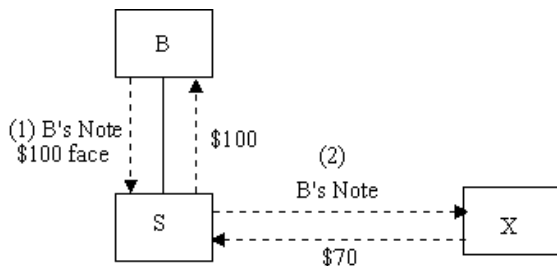
²⁶ See Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 4 (as redesignated by the 1998 Proposed Regulations).

- b) S is then deemed to transfer the proceeds of the deemed satisfaction to X in exchange for \$70. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
 - c) B is then deemed to issue a new note to X in exchange for the amount X is deemed to have received from S (\$70). The new note has a \$70 issue price and a \$100 stated redemption price at maturity. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998).
- (3) Tax Consequences: Same As Under The 1995 Final Regulations
- a) In year 2, B has \$30 of cancellation of indebtedness ("COD") income on the deemed repurchase of its note at a discount.²⁷ Section 61(a)(12). S has a \$30 loss on the deemed retirement of the note for \$70 under section 1271(a)(1).
 - b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's income and S's loss must be redetermined in order to treat B and S as divisions of a single entity. The character of B's income controls and S's loss will be recharacterized as a loss on a noncapital asset. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).
 - c) Pursuant to the recharacterization, B is treated as issuing a new note to X with an issue price of \$70 and a stated redemption price at maturity of \$100. Section 1273. Under the OID rules, \$30 is recharacterized as interest, and X must recognize \$30 of interest income over the term of the note. Sections 61(a)(4) and 1272. B is entitled to a corresponding interest deduction for the amount of the note recharacterized as interest. Section 163(e).

²⁷ Pursuant to Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(B) (1998), even if B is insolvent at the time of the discharge, section 108(a) will not apply to exclude B's COD income.

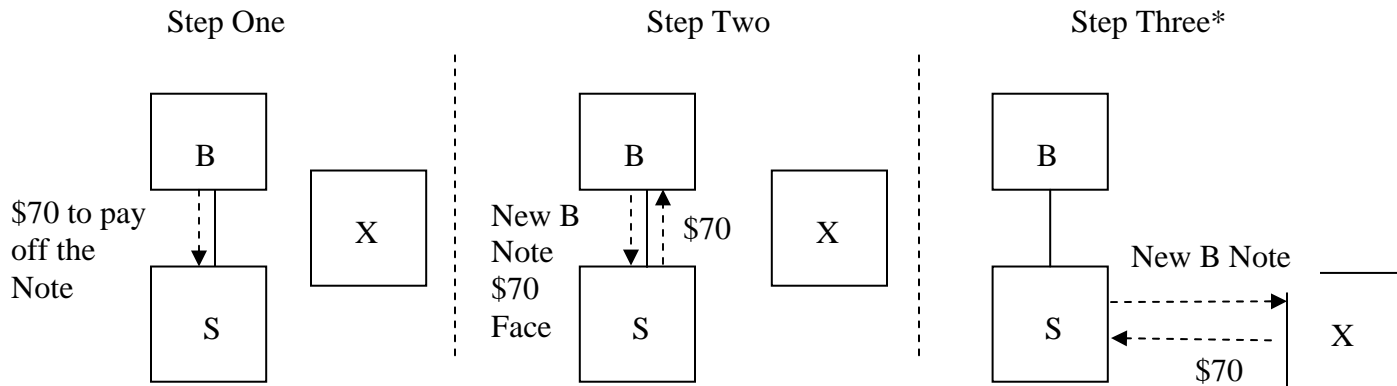
c. Loss Realized On "Outbound" Transaction -- 2008 Final Regulations²⁸

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S sells the note to X for \$110.

(2) Recharacterized Transactions



- a) B is treated as paying S \$70 in satisfaction of the debt immediately before S's actual sale of the note to X. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).
- b) B is treated as reissuing the note to S in exchange for \$70.

²⁸ See Treas. Reg. § 1.1502-13(g)(7) (2008), Example (2)(vii).

- c) S sells the reissued note to X for \$70.*

(3) Tax Consequences

- a) In year 2, B has \$30 of cancellation of indebtedness ("COD") income on the deemed repurchase of its note at a discount.²⁹ Section 61(a)(12). S has a \$30 loss on the deemed retirement of the note for \$70 under section 1271(a)(1).
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's income and S's loss must be redetermined in order to treat B and S as divisions of a single entity. The character of B's income controls and S's loss will be recharacterized as a loss on a noncapital asset. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).
- c) Pursuant to the recharacterization, B is treated as issuing a new note to S (rather than to X, as under the 1995 Final Regulations and the 1998 Proposed Regulations) with an issue price of \$70 and a stated redemption price at maturity of \$100. Section 1273. Under the OID rules, \$30 is recharacterized as interest, and X must recognize \$30 of interest income over the term of the note. Sections 61(a)(4) and 1272. B is entitled to a corresponding interest deduction for the amount of the note recharacterized as interest. Section 163(e).
- d) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).³⁰

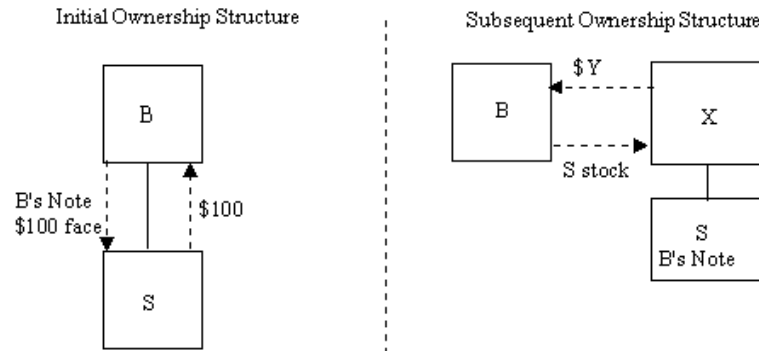
²⁹ Pursuant to Treas. Reg. § 1.1502-13(g)(4)(i)(C) (2008), even if B is insolvent at the time of the discharge, section 108(a) will not apply to exclude B's COD income.

³⁰ See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

3. Example 3: Intercompany Obligation Becomes a Non-Intercompany Obligation ("Outbound" Transaction)

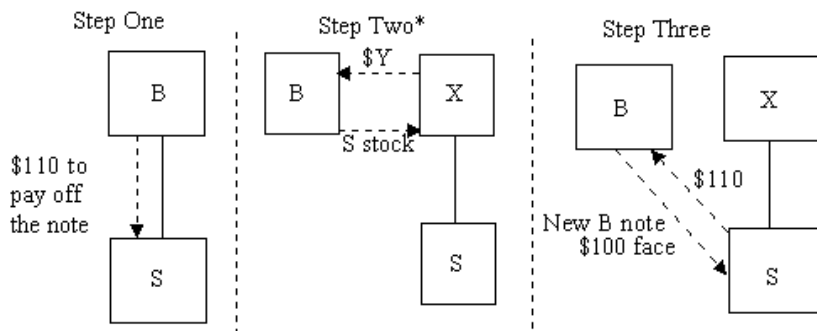
a. "Outbound" Transaction -- The 1995 Final Regulations and the 1998 Proposed Regulations³¹

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, B sells the stock of S to X.
- c) At the time of B's sale of the S stock, the note has a fair market value of \$110.

³¹See Former Treas. Reg. § 1.1502-13(g)(5) (1995), Example (2)(d); Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example (3)(d) (as redesignated by the 1998 Proposed Regulations).

(2) Recharacterized Transactions

*Actual transaction in which S becomes a nonmember.

- a) B is treated as paying S an amount equal to the fair market value of the note (\$110) in satisfaction of the debt immediately before the sale of the S stock to X. Treas. Reg. § 1.1502-13(g)(3)(ii) and Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- b) B sells the stock of S to X.*³²
- c) B is deemed to issue a new note to S immediately after the sale of the S stock to X. The new note has an issue price equal to its fair market value immediately after S becomes a nonmember (\$110) and a \$100 stated redemption price at maturity. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995) and Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998).

(3) Tax Consequences

- a) Under Treas. Reg. § 1.163-7(c), B is entitled to an immediate deduction of \$10 on the deemed repurchase of its note at a premium. S has a \$10 gain on the deemed retirement of its note. Section 1271(a)(1).
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's deduction and S's gain must be redetermined in order to treat B and S as divisions of a single entity. The character of B's

³² The 1995 Final Regulations and the 1998 Proposed Regulations specify that the deemed satisfaction of the note occurs immediately before this actual transaction and that B's deemed issuance of a new B note occurs immediately after this actual transaction. See Former Treas. Reg. § 1.1502-13(g)(3)(ii) & (iii) (1995) and Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) & (iii) (1998).

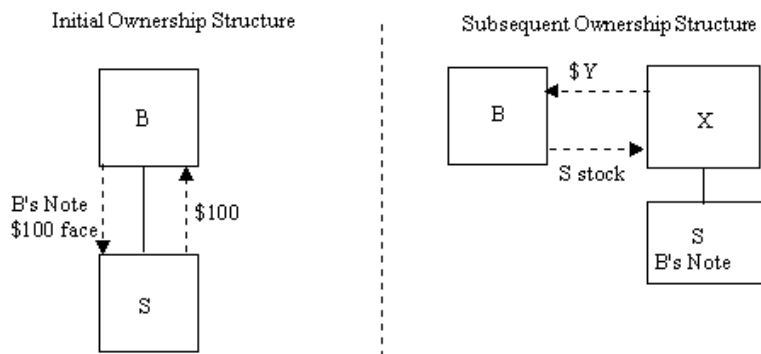
deduction controls and S's gain will be recharacterized as ordinary income. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).

- c) Pursuant to the recharacterization, B is treated as issuing a new note to S with an issue price of \$110 and a stated redemption price at maturity of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).
- d) Pursuant to Treas. Reg. § 1.171-1, S will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, S may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when S takes the interest income into account under S's regular method of accounting. Treas. Reg. § 1.171-2(a).³³

³³See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

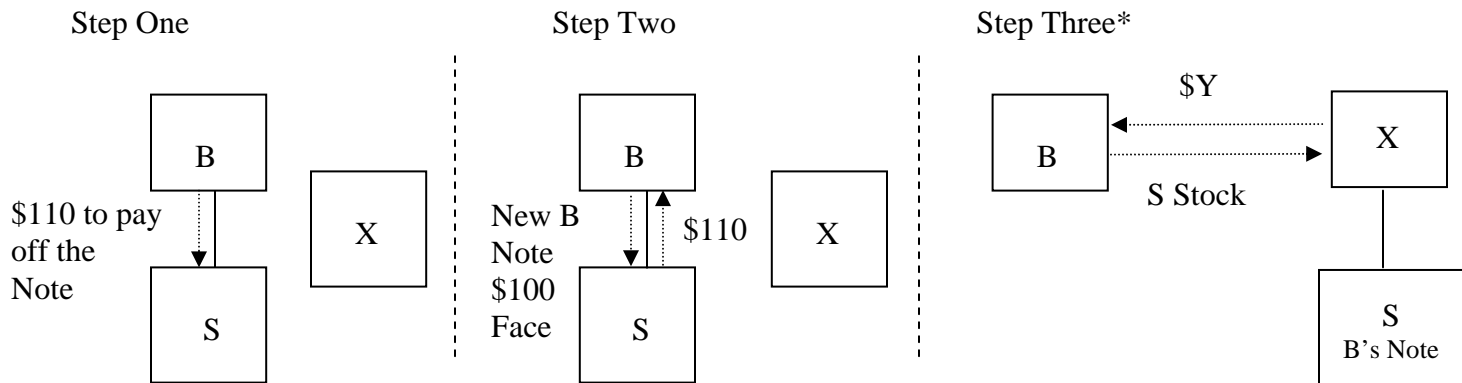
b. "Outbound" Transaction -- 2008 Final Regulations³⁴

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, B sells the stock of S to X.
- c) At the time of B's sale of the S stock, the note has a fair market value of \$110.

(2) Recharacterized Transactions



- a) B is treated as paying S an amount equal to the fair market value of the note (\$110) in satisfaction of the debt immediately before the sale of the S stock to X. Treas. Reg. § 1.1502-13(g)(3)(ii) (2008).

³⁴See Treas. Reg. § 1.1502-13(g)(7) (2008), Example (2)(iii).

b) B is deemed to issue a new note to S immediately before the sale of the S stock to X. The new note has an issue price equal to its fair market value immediately after S becomes a nonmember (\$110) and a \$100 stated redemption price at maturity. Treas. Reg. § 1.1502-13(g)(3)(iii) (2008).

c) B sells the stock of S to X.*

(3) Tax Consequences

a) Under Treas. Reg. § 1.163-7(c), B is entitled to an immediate deduction of \$10 on the deemed repurchase of its note at a premium. S has a \$10 gain on the deemed retirement of its note. Section 1271(a)(1).

b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's deduction and S's gain must be redetermined in order to treat B and S as divisions of a single entity. The character of B's deduction controls and S's gain will be recharacterized as ordinary income. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).

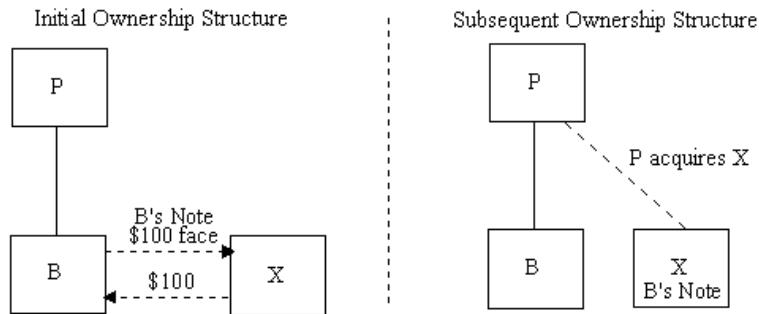
c) Pursuant to the recharacterization, B is treated as issuing a new note to S with an issue price of \$110 and a stated redemption price at maturity of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).

d) Pursuant to Treas. Reg. § 1.171-1, S will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, S may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when S takes the interest income into account under S's regular method of accounting. Treas. Reg. § 1.171-2(a).³⁵

³⁵See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

4. Example 4: Non-Intercompany Obligation Becomes an Intercompany Obligation ("Inbound" Transaction) -- 1995 Final Regulations, the 1998 Proposed Regulations, and the 2008 Final Regulations³⁶

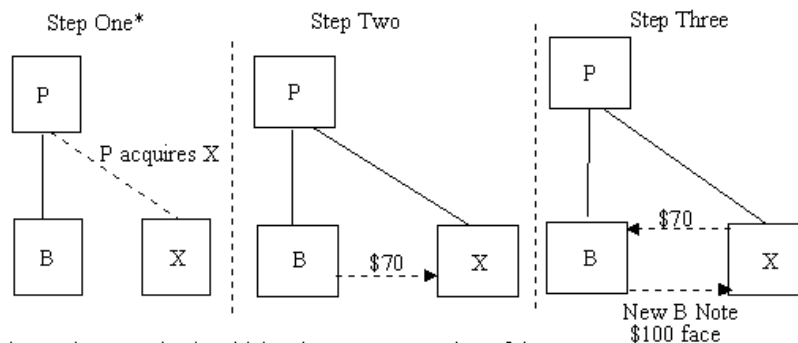
a. Actual Transaction



- (1) During year 1, B borrows \$100 from X and issues a \$100 note to X. X is not a member of P's consolidated group.
- (2) During year 2, P purchases all of X's outstanding stock. At the time of the purchase, B's note has a fair market value of \$70.

³⁶See Former Treas. Reg. § 1.1502-13(g)(5) (1995), Example 4; Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 5 (as redesignated by the 1998 Proposed Regulations); Treas. Reg. § 1.1502-13(g)(7) (2008), Example 10.

b. Recharacterized Transactions



*Actual transaction in which X becomes a member of the group.

- (1) In year 2, P acquires the stock of X, so that X becomes a member of the P group.*
- (2) B is treated as paying X \$70 in satisfaction of the note immediately after X becomes a member of the P group. Treas. Reg. § 1.1502-13(g)(5)(ii)(A) (2008).
- (3) B is then deemed to issue a new note to X in exchange for \$70. The new note has an issue price of \$70 and a stated redemption price at maturity of \$100. Treas. Reg. § 1.1502-13(g)(5)(ii)(A) (2008).³⁷

c. Tax Consequences

- (1) B has \$30 of COD income under section 61(a)(12). X has a \$30 capital loss under section 1271(a)(1).
- (2) The tax attributes of these transactions are taken into account on a separate entity basis (the attribute redetermination provisions of the matching rule do not apply). Treas. Reg. § 1.1502-13(g)(6)(i)(B) (2008).
- (3) The new note deemed issued by B to X is an intercompany obligation that has \$30 of OID. Section 1273. X will accrue interest income over the term of the note based on the \$30 of OID. Sections 61(a)(4) and 1272. B will accrue a corresponding interest deduction over the term of the note under section 163(e).

³⁷ Pursuant to Treas. Reg. § 1.1502-13(g)(6)(i)(A) (2008), if § 1.1502-13(g)(4) applies, then section 108(e)(4) will not apply.

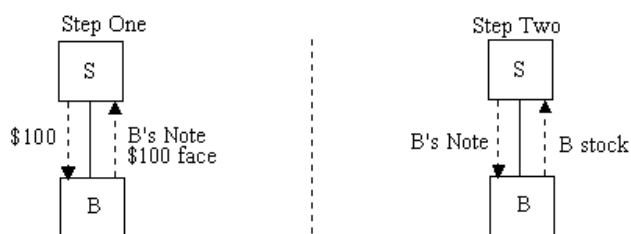
- (4) Note that the actual transaction is recharacterized in the same way under the 1995 Final Regulations, the 1998 Proposed Regulations, and the 2008 Final Regulations, and the tax consequences are the same under all three sets of regulations.

B. Additional Examples

1. Example 1: Capital Contribution of B's Note by Creditor Member to B

- a. Capital Contribution of B's Note by Creditor Member to B -- 1995 Final Regulations³⁸
-

(1) Actual Transactions



- a) During year 1, B borrows \$100 from S and issues a \$100 note to S.
- b) During year 2, S transfers B's note to B as a contribution to capital. At the time of the contribution, B's note has a fair market value of \$110.³⁹

(2) Regulatory Exception for Conversion of Debt to Equity

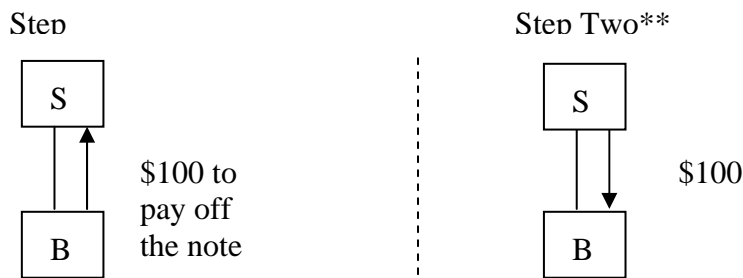
- a) Former Treas. Reg. § 1.1502-13(g)(3)(i)(B)(3) (1995) provided that the general deemed satisfaction and reissuance rules do not apply where "[t]he amount realized is from the conversion of an obligation into stock of the obligor." This special rule appears to apply to the transaction, since S's contribution of B's note to B effectively converts B's liability into stock of B.

³⁸ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

³⁹ Although the nonrecognition rules of section 351 should apply to this transaction, S realizes gain equal to the difference of S's basis in the B note (\$100) and the value of the B stock deemed to be received by S in exchange for the note (\$110).

- b) However, we understand that the drafters of the former intercompany transaction rules intended for this special rule to apply only to the conversion of convertible debt instruments into stock of the obligor where the debt was convertible, by its terms, from the date of issue. Thus, the drafters intended that a contribution of debt to capital, such as the transaction set forth in this example, would be subject to the deemed satisfaction and reissuance rules.

(3) Recharacterized Transactions



**This transaction is not provided for by the regulations, but appears necessary to locate money and property consistently with the actual transaction.

- a) B should be treated as satisfying the note immediately before S's contribution of the note to B for an amount of money equal to the issue price (determined under sections 1273 or 1274) of a new note issued in exchange for the B stock S is deemed to receive as a result of the contribution. Former Treas. Reg. § 1.1502-13(g)(3)(ii). Because the B stock is not publicly traded, the issue price of the new note should equal the new note's stated redemption price at maturity (\$100).
- b) In order to locate money and property in accordance with the actual transaction, S should then be treated as contributing \$100 of cash to the capital of B.**⁴⁰

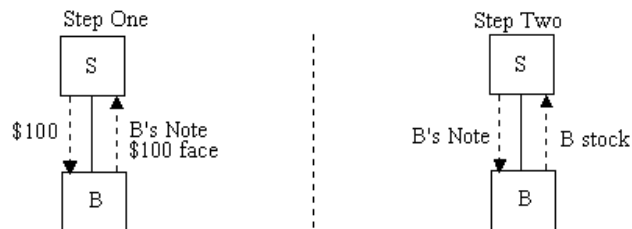
⁴⁰A double asterisk in the text indicates a transaction that is not provided for by the regulations, but appears necessary to locate money and property consistently with the actual transaction.

- c) Because B's note is no longer outstanding, the reissuance provisions of Former Treas. Reg. § 1.1502-13(g)(3)(iii) do not apply.

(4) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) S's contribution of the note should be viewed as a section 351 transaction. Therefore, S should take a \$100 basis in the B stock it is deemed to acquire. Section 358.
- c) Because S does not actually receive additional B stock in the section 351 transaction, S's basis in its B stock is increased by \$100 (the amount of the contribution). See Treas. Reg. § 1.1502-32.
- b. Capital Contribution of B's Note by Creditor Member to B -- 1998 Proposed Regulations⁴¹

(1) Actual Transactions



- a) During year 1, B borrows \$100 from S and issues a \$100 note to S.
- b) During year 2, S transfers B's note to B as a contribution to capital. At the time of the contribution, B's note has a fair market value of \$110.

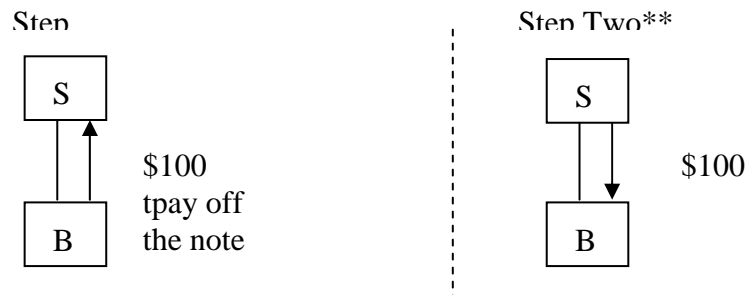
(2) Regulatory Exception for Conversion of Debt to Equity

Former Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(3) (1998) provided that the general deemed satisfaction and reissuance

⁴¹ This example is not contained in the 1998 Proposed Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

rules of Treas. Reg. § 1.1502-13(g)(3) do not apply where "[t]he amount realized is from the conversion of an obligation (under the terms of the instrument) into stock of the obligor." This exception would apply to the transaction if the terms of B's note provide for the conversion into B stock. However, if the terms of B's note do not specifically provide for the conversion, the general deemed satisfaction and reissuance rules of Former Prop. Treas. Reg. § 1.1502-13(g)(3) (1998) would apply to the transaction.

(3) Recharacterized Transactions



** This transaction is not provided for by the regulations, but appears necessary to locate money and property consistently with the actual transaction.

- a) Assuming that the exception for conversions of an obligation into stock of the obligor does not apply, B is treated as satisfying the note immediately before S's contribution of the note to B for an amount of money equal to the issue price (determined under section 1273 and 1274) of a new debt issued on the date of the transaction, with identical terms, for property that is not publicly traded (\$100). Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- b) In order to locate money and property in accordance with the actual transaction, S then should be treated as contributing \$100 of cash to the capital of B.**
- c) Because B's note is no longer outstanding, the reissuance provisions of Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998) do not apply.

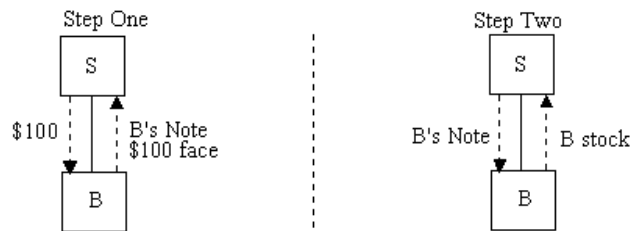
(4) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.

- b) S's contribution of the note should be viewed as a section 351 transaction. Therefore, S should take a \$100 basis in the B stock it is deemed to acquire. Section 358.
- c) Because S does not actually receive additional B stock, S's basis in its B stock is increased by \$100 (the amount of the contribution). See Treas. Reg. § 1.1502-32.

c. Capital Contribution of B's Note by Creditor Member to B -- 2008 Final Regulations⁴²

(1) Actual Transactions



- a) During year 1, B borrows \$100 from S and issues a \$100 note to S.
- b) During year 2, S transfers B's note to B as a contribution to capital. At the time of the contribution, B's note has a fair market value of \$110.

⁴² See Treas. Reg. § 1.1502-13(g)(7) (2008), Example 6.

(2) Regulatory Exception for Intercompany Extinguishments

- a) Treas. Reg. § 1.1502-13(g)(3)(i)(B)(5) (2008) provides that the general deemed satisfaction-reissuance rule of Treas. Reg. § 1.1502-13(g)(3) does not apply to an intercompany transaction where an intercompany obligation is extinguished (other than an exchange or deemed exchange for a newly issued obligation), provided that (i) the creditor's basis in the note is equal to the adjusted issue price of the note and (ii) the debtor's corresponding item and the creditor's intercompany item with respect to the obligation will offset in amount.
- b) However, notwithstanding the exception for intercompany extinguishments described above, the general deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) does apply if the tax benefit rule applies. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).
- c) The tax benefit rule applies if the extinguishment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit that the group or its members would otherwise not enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008). The 2008 Final Regulations define the term "tax benefit" as the benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. Treas. Reg. § 1.1502-13(g)(2)(v) (2008).
- d) As a result of the extinguishment, B would be entitled to an immediate \$10 deduction on the satisfaction of its note at a premium under Treas. Reg. § 1.163-7(c). Although S would not normally recognize any gain on the contribution of the appreciated note under section 351, under Treas. Reg. § 1.1502-13(g)(4)(i)(C) (2008), any gain or loss from the intercompany obligation is not subject to section 351(a)(1). As a result, S would have a \$10 intercompany gain on the contribution of the intercompany obligation, and S's intercompany item would be offset by B's corresponding item. Thus, assuming that the tax benefit rule does not apply, the exception for intercompany extinguishments in Treas. Reg. § 1.1502-

13(g)(3)(i)(B)(5) (2008) would apply because the intercompany obligation was extinguished (and a new obligation was not issued) in a transaction in which S's basis in the note is equal to the issue price of the note (\$100), and S's intercompany item and B's corresponding item offset in amount. Accordingly, the deemed satisfaction-reissuance rule does not apply to this transaction.

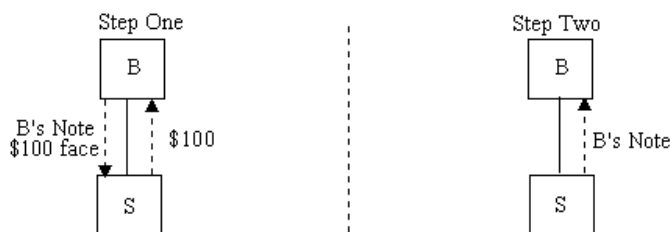
(3) Tax Consequences

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note at a premium.
- b) In year 2, S would recognize \$10 of gain on the contribution of the appreciated note to B as section 351(a)(1) would not apply to the contribution of the intercompany obligation. Treas. Reg. § 1.1502-13(g)(4)(i)(C) (2008).
- c) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's deduction and S's gain must be redetermined. The character of B's deduction controls and S's gain is recharacterized as ordinary income. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).

2. Example 2: Distribution of B's Note

a. Distribution of B's Note -- 1995 Final Regulations⁴³

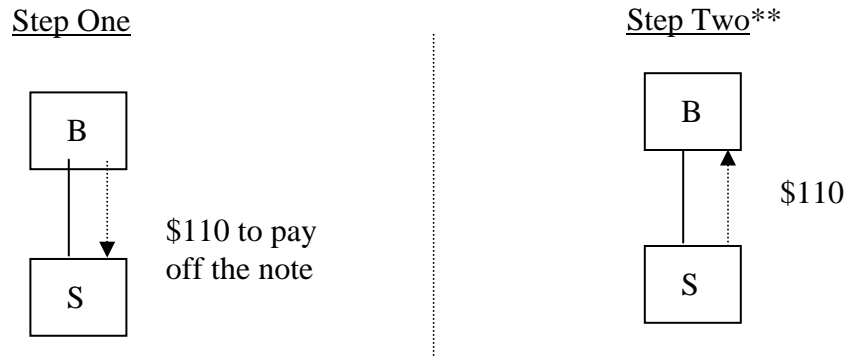
(1) Actual Transactions



⁴³ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

- a) During year 1, B borrows \$100 from S and issues a \$100 note to S.
- b) During year 2, S distributes the note to B. At the time of the distribution, B's note has a fair market value of \$110.⁴⁴

(2) Recharacterized Transactions



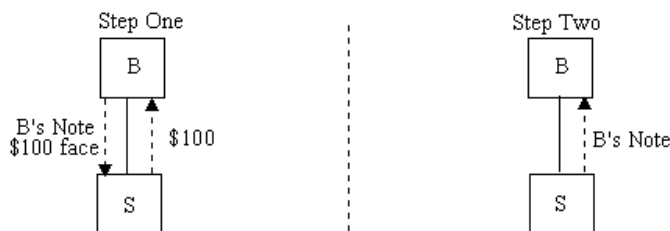
- a) B is treated as satisfying the debt immediately before the distribution for an amount of money equal to the fair market value of the note. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- b) Because B's note is no longer outstanding, the reissuance provisions of Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995) do not apply.
- c) S is deemed to distribute \$110 to B.**

**This transaction is not provided for by the regulations, but appears necessary to locate money and property consistently with the actual transaction.

⁴⁴ Under Treas. Reg. § 1.301-1(m), the cancellation of the indebtedness of a shareholder is treated as a distribution of property to that shareholder. Under section 301(b)(1), the amount of the distribution is equal to the fair market value of the note. See Rev. Rul. 2004-79, 2004-2 C.B. 106. If the fair market value of the note was \$100 at the time of the distribution, Former Treas. Reg. § 1.1502-13(g)(3) (1995) would not apply. Former Treas. Reg. § 1.1502-13(g)(3) (1995) only becomes applicable to intragroup transfers if a member realizes an amount (other than zero) of income, gain, deduction or loss, directly or indirectly from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation. Former Treas. Reg. § 1.1502-13(g)(3)(i)(A). The determination of the fair market value of the note is based upon facts and circumstances. Factors impacting this determination include the prevailing interest rate, the remaining term of the note, and the creditworthiness of the obligor.

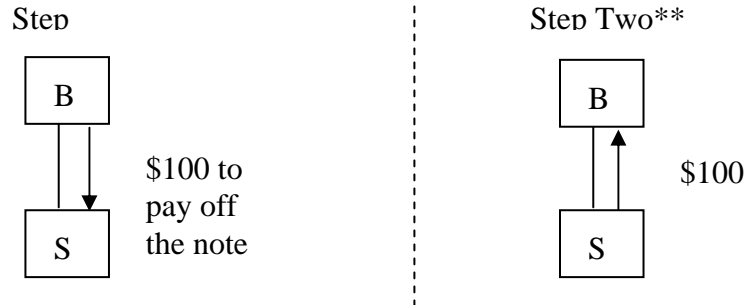
(3) Tax Consequences

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note at a premium. S has a \$10 gain on the deemed retirement of B's note. Section 1271(a)(1).
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's deduction and S's gain must be redetermined. The character of B's deduction controls and S's gain is recharacterized as ordinary income. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).
- c) S's deemed distribution of the note should be viewed as a distribution the character of which is determined under section 301.
- d) B's basis in the S stock is increased by \$10 and decreased by \$110 (the amount of the distribution). See Treas. Reg. § 1.1502-32.

b. Distribution of B's Note -- 1998 Proposed Regulations⁴⁵(1) Actual Transactions

- a) During year 1, B borrows \$100 from S and issues a \$100 note to S.
- b) During year 2, S distributes the note to B. At the time of the distribution, B's note has a fair market value of \$110.

⁴⁵ This example is not contained in the 1998 Proposed Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

(2) Recharacterized Transactions

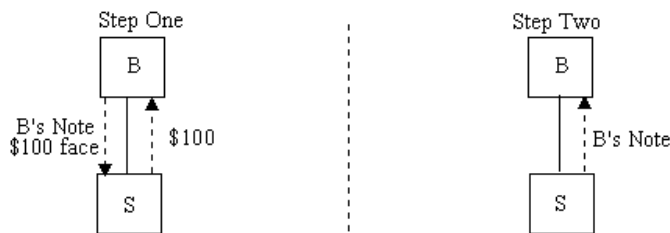
**This transaction is not provided for by the regulations, but appears necessary to locate money and property consistently with the actual transaction.

- a) B is treated as satisfying the debt immediately before the distribution for \$100, the issue price of a new debt issued on the date of the transaction, with identical terms, for property that is not publicly traded. See Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).⁴⁶
- b) Because B's note is no longer outstanding, the reissuance provisions of Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998) do not apply.
- c) S is deemed to distribute \$100 to B.**

⁴⁶Under Treas. Reg. § 1.301-1(m), the cancellation of the indebtedness of a shareholder is treated as a distribution of property to that shareholder. Under section 301(b)(1), the amount of the distribution is equal to the fair market value of the note. Thus, it would appear that B should be treated as paying S \$110. However, the 1998 Proposed Regulations override this treatment. The proposed regulations provide that where an intercompany obligation is extinguished, B is deemed to satisfy its note to S for an amount equal to the issue price (determined under sections 1273 and 1274) of a new note issued to a third party in exchange for property that is not publicly traded. Thus, S should be viewed as distributing \$100 to B as opposed to \$110. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) S's deemed distribution of the note should be viewed as a distribution the character of which is determined under section 301.
- c) B's basis in the S stock is decreased by \$100 (the amount of the distribution). See Treas. Reg. § 1.1502-32.

c. Distribution of B's Note -- 2008 Final Regulations⁴⁷(1) Actual Transactions

- a) During year 1, B borrows \$100 from S and issues a \$100 note to S.
- b) During year 2, S distributes the note to B. At the time of the distribution, B's note has a fair market value of \$110.

(2) Regulatory Exception for Intercompany Extinguishments

- a) Treas. Reg. § 1.1502-13(g)(3)(i)(B)(5) (2008) provides that the general deemed satisfaction-reissuance rule of Treas. Reg. § 1.1502-13(g)(3) does not apply to an intercompany transaction where an intercompany obligation is extinguished (other than an exchange or deemed exchange for a newly issued obligation), provided that (i) the creditor's basis in the note is equal to the adjusted issue price of the note and (ii) the debtor's corresponding item and the creditor's

⁴⁷ This example is not contained in the 2008 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

intercompany item with respect to the obligation will offset in amount.

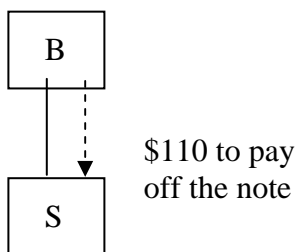
- b) However, notwithstanding the exception for intercompany extinguishments described above, the general deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) does apply if the tax benefit rule applies. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).
- c) The tax benefit rule applies if the extinguishment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit that the group or its members would otherwise not enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008). The 2008 Final Regulations define the term “tax benefit” as the benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. Treas. Reg. § 1.1502-13(g)(2)(v) (2008).
- d) Application of the exception for intercompany extinguishments to a distribution of a note to the debtor may be unclear under the 2008 Final Regulations.
 - i) As a result of the distribution of B’s note, S would realize a \$10 gain under section 311(b).
 - ii) In general, the tax consequences of a distribution to a shareholder are determined under section 301. However, pursuant to the consolidated return intercompany transaction regulations, B would not include the amount of the distribution as income, provided that there is a corresponding negative adjustment in B’s basis in the S stock under Treas. Reg. § 1.1502-32. Treas. Reg. § 1.1502-13(f)(2)(ii).
 - iii) It is uncertain how B should account for the extinguishment of its note in a distribution described in section 301. The IRS position appears to be that the extinguishment of B’s note in connection with the distribution should be treated as if B repurchased the note at fair market value. See Rev. Rul. 2004-79, 2004-2 C.B. 106.

- iv) If the extinguishment is treated as a deemed repurchase (without taking into account the deemed satisfaction-reissuance rule), then B would be entitled to claim a \$10 deduction on the repurchase of its note at a premium. Treas. Reg. § 1.163-7(c).
- v) In this event, it appears that the exception for intercompany extinguishments would apply because (i) the intercompany obligation is extinguished in an intercompany transaction (and a new note is not issued in the exchange or deemed exchange), (ii) S's (the creditor's) basis in the note is equal to the adjusted issue price of the note, and (iii) B's (the debtor's) corresponding item and S's (the creditor's) intercompany item with respect to the obligation will offset in amount.
- vi) Thus, assuming that the tax benefit rule does not apply, the deemed satisfaction-reissuance rule should not apply to this transaction.

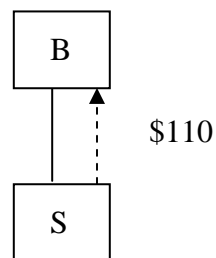
(3) If The Exception For Intercompany Extinguishments Does Not Apply and the Deemed Satisfaction-Reissuance Rule Does Apply

a) Recharacterized Transactions

Step One



Step Two**



- i) B is treated as satisfying the debt immediately before the distribution for an amount of money equal to the fair market value of the note. Treas. Reg. § 1.1502-13(g)(3)(ii) (2008).
- ii) Because B's note is no longer outstanding, the reissuance provisions of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) do not apply.

iii) S is deemed to distribute \$110 to B.**

**This transaction is not provided for by the regulations, but appears necessary to locate money and property consistently with

b) Tax Consequences: Same As Under The 1995 Final Regulations

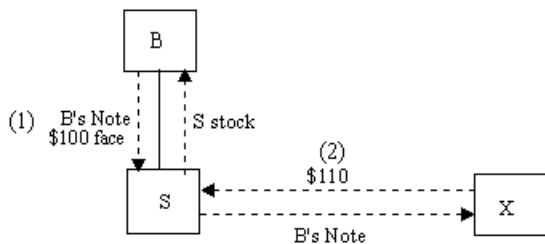
- i) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note at a premium. S has a \$10 gain on the deemed retirement of B's note. Section 1271(a)(1).
- ii) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's deduction and S's gain must be redetermined. The character of B's deduction controls and S's gain is recharacterized as ordinary income. Thus, the net effect on CTI is zero. Treas. Reg. § 1.1502-13(c)(4)(i).
- iii) S's deemed distribution of the note should be viewed as a distribution the character of which is determined under section 301.
- iv) B's basis in the S stock is increased by \$10 and decreased by \$110 (the amount of the distribution). See Treas. Reg. § 1.1502-32.

3. Example 3: Issuance of Note in Exchange for Stock Followed by Sale of the Note Outside the Consolidated Group ("Outbound" Transaction with Zero Basis Issues)

a. "Outbound" Transaction with Zero Basis Issues -- 1995 Final Regulations⁴⁸

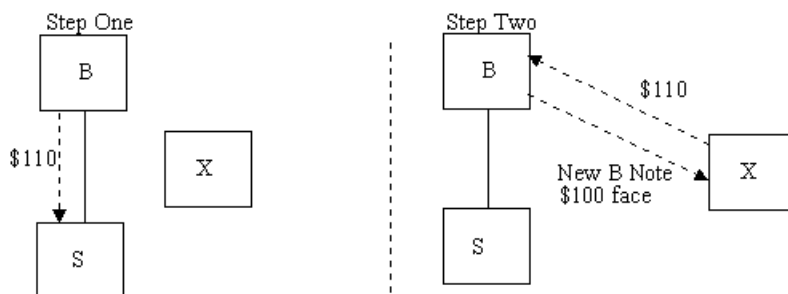
(1) Actual Transactions

⁴⁸ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.



- a) During year one, B issues its note to S in exchange for stock of S.
- b) During year two, S sells the note to X for \$110.

(2) Recharacterized Transactions



- a) B is treated as paying S \$110 in satisfaction of the debt B immediately before S's actual sale of the note to X. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- b) B is then deemed to issue a new note to X. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995). The new note has a \$110 issue price and a \$100 stated redemption price at maturity.

(3) Tax Consequences

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note at a premium.
- b) Because S received B's note in a section 351 transaction, section 362 provides that S succeeds to B's basis in the note. Therefore, S could be viewed as having a zero basis in the note. Rev. Rul. 81-187,

1981-2 C.B. 167; Rev. Rul. 68-629, 1968-2 C.B. 154.⁴⁹

- c) If S is treated as having a zero basis in B's note, S will have a \$110 gain on the deemed retirement of B's note. Section 1271(a)(1).
- d) Competing Views of the Operation of the Matching Rule
 - i) Partial Exclusion Position: Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. In this case, B has a loss of \$10 on the deemed acquisition of its note at a premium, and S thus should have \$10 of gain to offset this loss. However, as noted above, S may have a gain of \$110. In order to get to the same result as if B and S were divisions of a single entity, \$100 of S's gain would need to be excluded.
 - ii) IRS's Apparent Position: We understand that in at least one case the IRS has taken the position that the matching rule does not operate to exclude income, but may be used only to redetermine the character of an intercompany item. Thus, it appears that \$10 of S's gain would be recharacterized under the matching rule as ordinary income (to match B's \$10 of deduction) and the remaining \$100 of S's gain would be capital gain.
 - iii) Total Exclusion Position: The IRS's position appears to be incorrect. Treas. Reg. § 1.1502-13(c)(6)(i) provides for the redetermination

⁴⁹ However, the Ninth Circuit held in Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), that in the context of a section 351 contribution to a C corporation that is operating a business, a contributor has a basis in its own note equal to the face amount of the note. Thus, S would take a \$100 basis in the note acquired from B under section 362. If S is viewed as having a \$100 basis in B's note, then S's gain on the deemed satisfaction is \$10. Under the matching rule, this gain is recharacterized as ordinary income in order to treat B and S as divisions of a single entity. See also Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989); Treas. Reg. §§ 1.1502-13(c)(4)(i), 1.1502-13(f)(6), and 1.1032-3. But see Kanter v. Commissioner, 337 F.3d 833 (7th Cir. 2003) (distinguishing Peracchi), rev'd on other grounds, 125 SCt. 1270 (2005); Alderman v. Commissioner, 55 T.C. 662 (1971).

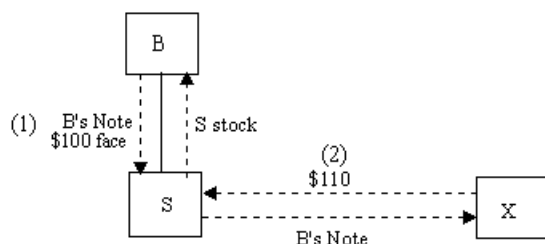
and exclusion of items. Thus, the matching rule appears to exclude both B & S's intercompany items entirely. Under this "all or nothing" approach, all of S's gain on the sale of the note would be excluded from income and B's deduction would be recharacterized as a nondeductible and noncapitalizable expense.

- e) Pursuant to the recharacterization, B is treated as reissuing the note with an issue price of \$110 and a stated redemption price of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).
- f) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).⁵⁰

⁵⁰See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

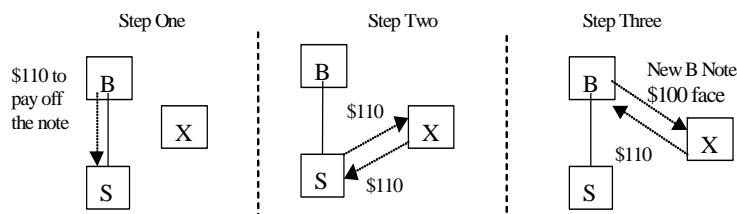
b. "Outbound" Transaction with Zero Basis Issues -- 1998 Proposed Regulations⁵¹

(1) Actual Transactions



- a) During year one, B issues its note to S in exchange for stock of S.
- b) During year two, S sells the note to X for \$110.

(2) Recharacterized Transactions



- a) B is treated as paying S \$110 in satisfaction of the debt immediately before S's actual sale of the note to X. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- b) S is then treated as transferring the proceeds of the deemed satisfaction (\$110) to X in exchange for the actual consideration paid to S. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- c) B is then deemed to issue a new note to X in exchange for the amount X is treated as receiving from S (\$110). Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii)

⁵¹ This example is not contained in the 1998 Proposed Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

(1998). The new note has a \$110 issue price and a \$100 stated redemption price at maturity.

(3) Tax Consequences: Same As Under the 1995 Final Regulations

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note at a premium.
- b) Because S received B's note in a section 351 transaction, section 362 provides that S succeeds to B's basis in the note. Therefore, S could be viewed as having a zero basis in the note. Rev. Rul. 81-187, 1981-2 C.B. 167; Rev. Rul. 68-629, 1968-1 C.B. 154.⁵²
- c) If S is treated as having a zero basis in B's note, S will have a \$110 gain on the deemed retirement of B's note. Section 1271(a)(1).
- d) Competing Views of the Operation of the Matching Rule
 - i) Partial Exclusion Position: Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. In this case, B has a loss of \$10 on the deemed acquisition of its note at a premium, and S thus should have \$10 of gain to offset this loss. However, as noted above, S may have a gain of \$110. In order to get to the same result as if B and S were divisions of a single entity, \$100 of S's gain would need to be excluded.

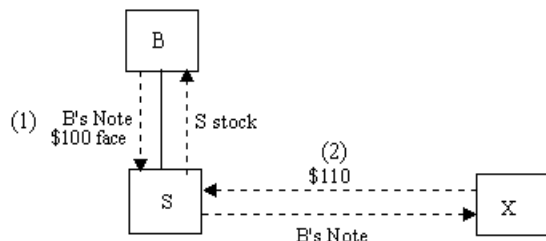
⁵²However, the Ninth Circuit held in Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), that in the context of a section 351 contribution to a C corporation that is operating a business, a contributor has a basis in its own note equal to the face amount of the note. Thus, S would take a \$100 basis in the note acquired from B under section 362. If S is viewed as having a \$100 basis in B's note, then S's gain on the deemed satisfaction is \$10. Under the matching rule, this gain is recharacterized as ordinary income in order to treat B and S as divisions of a single entity. See also Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989); Treas. Reg. §§ 1.1502-13(c)(4)(i), 1.1502-13(f)(6), and 1.1032-3. But see Kanter v. Commissioner, 337 F.3d 833 (7th Cir. 2003) (distinguishing Peracchi), rev'd on other grounds, 125 S.Ct. 1270 (2005); Alderman v. Commissioner, 55 T.C. 662 (1971).

- ii) IRS's Apparent Position: We understand that in at least one case the IRS has taken the position that the matching rule does not operate to exclude income, but may be used only to redetermine the character of an intercompany item. Thus, it appears that \$10 of S's gain would be recharacterized under the matching rule as ordinary income (to match B's \$10 of deduction) and the remaining \$100 of S's gain would be capital gain.
- iii) Total Exclusion Position: The IRS's position appears to be incorrect. Treas. Reg. § 1.1502-13(c)(6)(i) provides for the redetermination and exclusion of items. Thus, the matching rule appears to exclude both B & S's intercompany items entirely. Under this "all or nothing" approach, all of S's gain on the sale of the note would be excluded from income and B's deduction would be recharacterized as a nondeductible and noncapitalizable expense.
- e) Pursuant to the recharacterization, B is treated as reissuing the note with an issue price of \$110 and a stated redemption price of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).
- f) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).⁵³

⁵³See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

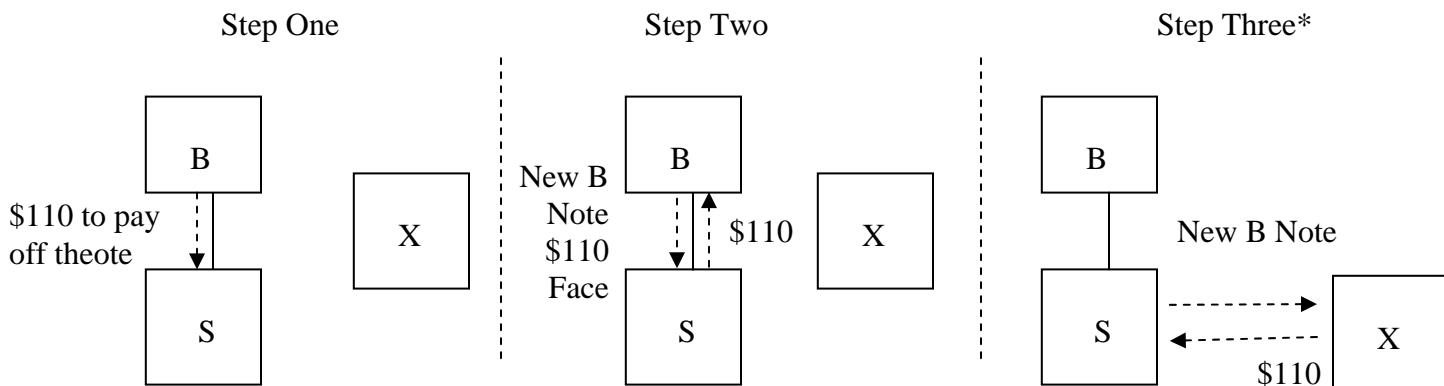
c. "Outbound" Transaction with Zero Basis Issues -- 2008 Final Regulations⁵⁴

(1) Actual Transactions



- a) During year one, B issues its note to S in exchange for stock of S.
- b) During year two, S sells the note to X for \$110.

(2) Recharacterized Transactions



- a) B is treated as paying S \$110 in satisfaction of the debt immediately before S's actual sale of the note to X. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).
- b) B is treated as reissuing the note to S in exchange for \$110.
- c) S sells the reissued note to X for \$110.*

⁵⁴ This example is not contained in the 2008 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

(3) Tax Consequences

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note at a premium.
- b) Because S received B's note in a section 351 transaction, section 362 provides that S succeeds to B's basis in the note. Therefore, S could be viewed as having a zero basis in the note. Rev. Rul. 81-187, 1981-2 C.B. 167; Rev. Rul. 68-629, 1968-1 C.B. 154.⁵⁵
- c) If S is treated as having a zero basis in B's note, S will have a \$110 gain on the deemed retirement of B's note. Section 1271(a)(1).
- d) Competing Views of the Operation of the Matching Rule
 - i) Partial Exclusion Position: Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. In this case, B has a loss of \$10 on the deemed acquisition of its note at a premium, and S thus should have \$10 of gain to offset this loss. However, as noted above, S may have a gain of \$110. In order to get to the same result as if B and S were divisions of a single entity, \$100 of S's gain would need to be excluded.
 - ii) IRS's Apparent Position: We understand that in at least one case the IRS has taken the position that the matching rule does not operate to exclude income, but may be used

⁵⁵ However, the Ninth Circuit held in Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), that in the context of a section 351 contribution to a C corporation that is operating a business, a contributor has a basis in its own note equal to the face amount of the note. Thus, S would take a \$100 basis in the note acquired from B under section 362. If S is viewed as having a \$100 basis in B's note, then S's gain on the deemed satisfaction is \$10. Under the matching rule, this gain is recharacterized as ordinary income in order to treat B and S as divisions of a single entity. See also Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989); Treas. Reg. §§ 1.1502-13(c)(4)(i), 1.1502-13(f)(6), and 1.1032-3. But see Kanter v. Commissioner, 337 F.3d 833 (7th Cir. 2003) (distinguishing Peracchi), rev'd on other grounds, 125 SCt. 1270 (2005); Alderman v. Commissioner, 55 T.C. 662 (1971).

only to redetermine the character of an intercompany item. Thus, it appears that \$10 of S's gain would be recharacterized under the matching rule as ordinary income (to match B's \$10 of deduction) and the remaining \$100 of S's gain would be capital gain.

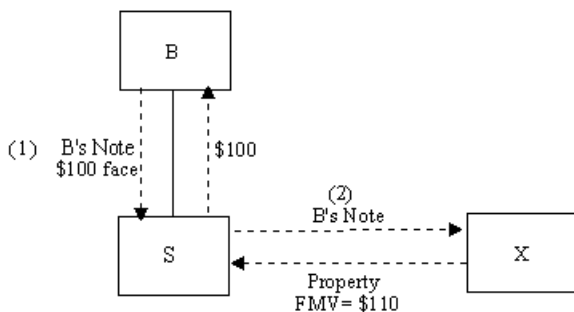
- iii) Total Exclusion Position: The IRS's position appears to be incorrect. Treas. Reg. § 1.1502-13(c)(6)(i) provides for the redetermination and exclusion of items. Thus, the matching rule appears to exclude both B & S's intercompany items entirely. Under this "all or nothing" approach, all of S's gain on the sale of the note would be excluded from income and B's deduction would be recharacterized as a nondeductible and noncapitalizable expense.
- e) B is treated as reissuing the note with an issue price of \$110 and a stated redemption price of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).
- f) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).⁵⁶

⁵⁶See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

4. Example 4: Exchange Of Intercompany Obligation For Property (Gain Realized On "Outbound" Transaction)

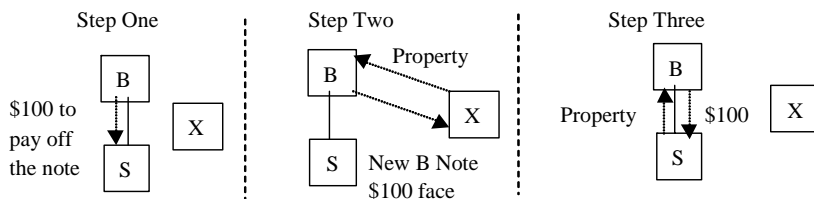
a. Gain Realized On "Outbound" Transaction – 1995 Final Regulations⁵⁷

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues to S a \$100 note.
- b) During year two, S transfers B's note to X in exchange for property with a fair market value of \$110.

(2) Recharacterized Transactions



- a) B is treated as satisfying the debt immediately before the exchange for an amount of money equal to the issue price (determined under sections 1273 or 1274) of a new note issued for the property. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995). Because the property is not publicly traded, the issue price should

⁵⁷ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

equal the note's stated redemption price at maturity (\$100). Sections 1273(b)(4) and 1274(a)(1).

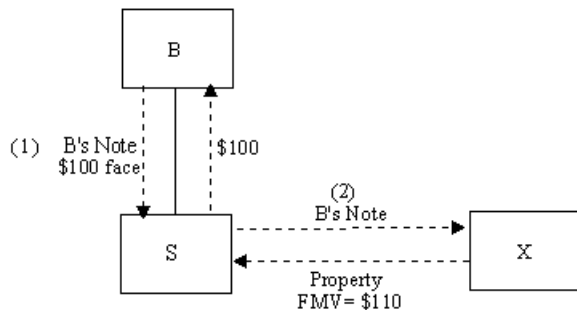
- b) B is then deemed to issue a new note to X. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995). Under sections 1273(b)(4) and 1274(a)(1), the new note has an issue price of \$100.
- c) In order to locate the property with its actual owner, B should be deemed to sell the property to S for the \$100 that B was deemed to transfer to S in Step One.**

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to the recharacterization, B is deemed to issue a new note to X in exchange for the property. B's new note issued to X is treated as having a \$100 issue price and a \$100 stated redemption price at maturity. Section 1274(a)(1). B takes a \$100 basis in the property. Section 1012.
- c) B has no gain on the sale of the property to S. Section 1001.
- d) S has a \$100 cost basis in the property. Section 1012.

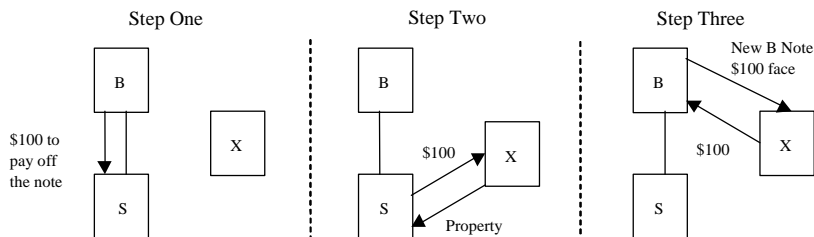
b. Gain Realized On "Outbound" Transaction – 1998 Proposed Regulations⁵⁸

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues to S a \$100 note.
- b) During year two, S transfers B's note to X in exchange for property with a fair market value of \$110.

(2) Recharacterized Transactions



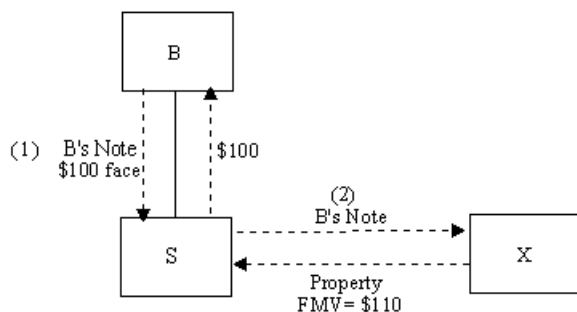
- a) B is treated as satisfying the debt immediately before the exchange for \$100, the amount of money equal to the issue price of a new debt issued on the date of the transaction, with identical terms, for the property S receives from X. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).

⁵⁸ This example is not contained in the 1998 Proposed Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

- b) S is then deemed to transfer the proceeds of the deemed satisfaction to X in exchange for the property. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
 - c) B is then deemed to issue a new note to X in exchange for the \$100 S was deemed to transfer to X in exchange for the property. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998). Under sections 1273(b)(4) and 1274(a)(1), the new note has an issue price of \$100 and a stated redemption price at maturity of \$100.
- (3) Tax Consequences: Same As Under 1995 Final Regulations
- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
 - b) S has a \$100 cost basis in the property. Section 1012.
 - c) Pursuant to the recharacterization, B is deemed to issue a new note to X in exchange for the proceeds of the deemed satisfaction that S was deemed to transfer to X in exchange for the property. B's new note issued to X is treated as having a \$100 issue price. Sections 1273(b)(4) and 1274(a)(1).

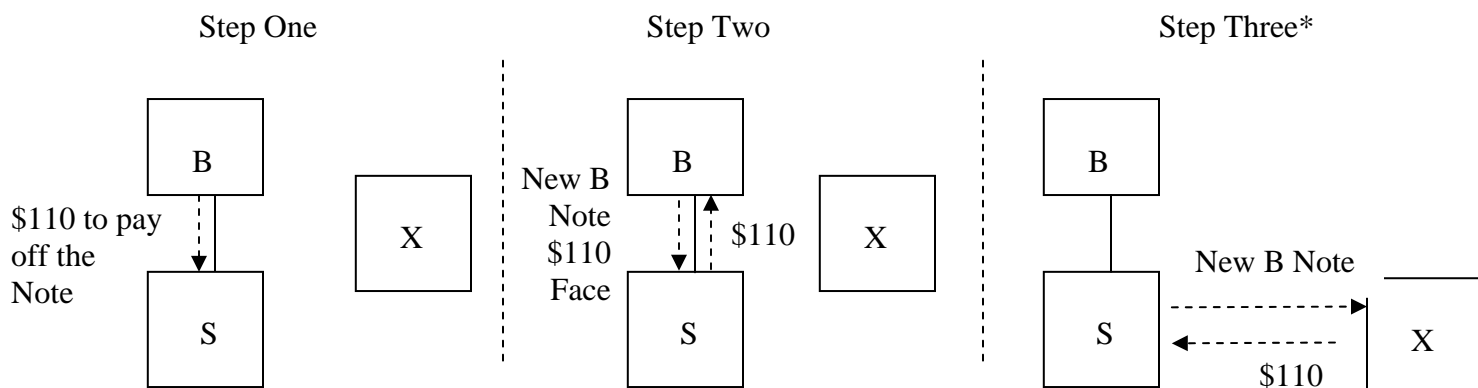
c. Gain Realized On "Outbound" Transaction – 2008 Final Regulations⁵⁹

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues to S a \$100 note.
- b) During year two, S transfers B's note to X in exchange for property with a fair market value of \$110.

(2) Recharacterized Transactions



⁵⁹ This example is not contained in the 2008 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

- a) B is treated as paying S \$110 in satisfaction of the debt immediately before S's actual sale of the note to X. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) (2008).
- b) B is treated as reissuing the note to S for \$110.
- c) S sells the reissued note to X for \$110.*

(3) Tax Consequences

- a) In year 2, under Treas. Reg. § 1.163-7(c), B is entitled to an immediate \$10 deduction on the deemed repurchase of its note for a premium. S has a \$10 gain on the deemed retirement of B's note. Section 1271.
- b) Under the matching rule of Treas. Reg. § 1.1502-13(c)(1)(i), the character of B's loss and S's gain must be redetermined in order to treat B and S as divisions of a single entity. The character of B's deduction controls and S's gain is recharacterized as ordinary income. Thus, the net effect on consolidated taxable income ("CTI") is zero. Treas. Reg. § 1.1502-13(c)(4)(i).
- c) Pursuant to the recharacterization, B is treated as issuing a new note to S with an issue price of \$110 and a stated redemption price at maturity of \$100. Section 1273. Under Treas. Reg. § 1.163-13(c), B generally will have bond issuance premium. B generally will determine its deduction for interest that is allocable to an accrual period by offsetting the portion of the bond issuance premium that is allocable to such period. Treas. Reg. § 1.163-13(a), (d).⁶⁰
- d) S's sale of the reissued note to X for \$110 will not result in gain or loss recognition because S has a \$110 basis in the reissued note pursuant to the deemed reissuance of the note.
- e) Pursuant to Treas. Reg. § 1.171-1, X will have amortizable bond premium. Pursuant to sections 171(a)(1) and 171(e) and Treas. Reg. §§ 1.171-1(a) and 1.171-2, X may elect to amortize the bond premium by generally offsetting qualified stated interest income allocable to an accrual period with the portion of the bond premium that is allocable to such

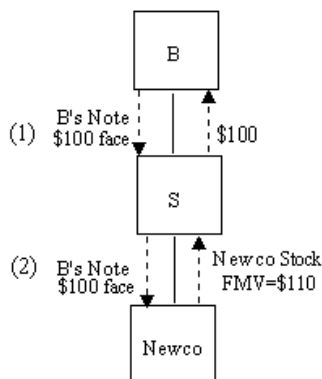
⁶⁰These regulations were finalized on December 31, 1997, and generally apply to debt instruments issued on or after March 2, 1998.

accrual period. This offset generally occurs when X takes the interest income into account under X's regular method of accounting. Treas. Reg. § 1.171-2(a).⁶¹

5. Example 5: Intercompany Borrowing Followed by Section 351 Contribution of the Note To Lower Tier Subsidiary

a. Intercompany Borrowing Followed by Section 351 Contribution of the Note To Lower Tier Subsidiary -- 1995 Final Regulations⁶²

(1) Actual Transactions



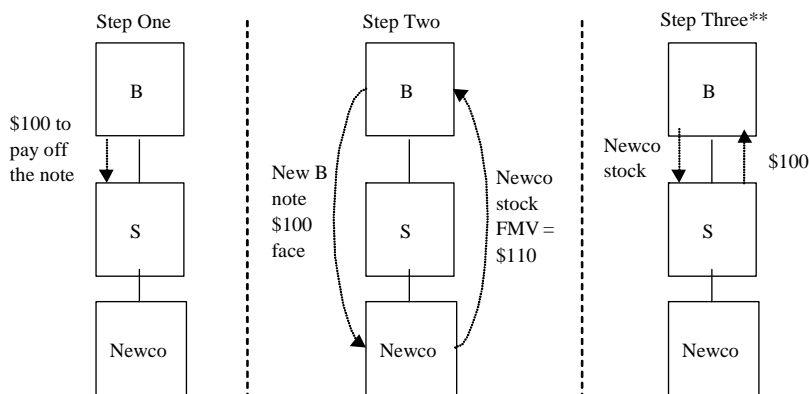
- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S contributes the note to a lower tier subsidiary, Newco, in exchange for stock of Newco. The transaction satisfies the requirements of section 351.

⁶¹ See Treas. Reg. §§ 1.171-4 and 1.171-5 for rules relating to the election to amortize bond premium on taxable bonds.

⁶² This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario. However, as set forth below, this example is contained in the 1998 Proposed Regulations and the 2008 Final Regulations.

- c) At the time of the contribution to Newco, the note has a fair market value of \$110.⁶³

(2) Recharacterized Transactions



**This transaction is not provided for by the regulations, but appears necessary to locate property and money consistently with the actual transaction.

- B is treated as paying S \$100 in satisfaction of the debt immediately before S's contribution of B's note to Newco. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- B is then deemed to issue a new note to Newco in exchange for the Newco stock actually issued to S. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995). The new note B is deemed to issue has an issue price of \$100 and a stated redemption price of \$100. Section 1274(a)(1).
- In order to locate the property with its actual owner, B is deemed to sell the Newco stock to S for the \$100 S was deemed to have received from B in Step One.**

⁶³S has a realized gain of \$10. However, this gain is not recognized pursuant to section 351. Because S has a realized gain, the deemed satisfaction and reissuance provisions of Former Treas. Reg. § 1.1502-13(g)(3) (1995) apply. If the note has a fair market value equal to S's basis at the time of S's contribution of the note to Newco, S would not realize a gain or loss on the transaction and the provisions of Former Treas. Reg. § 1.1502-13(g)(3) (1995) would not apply.

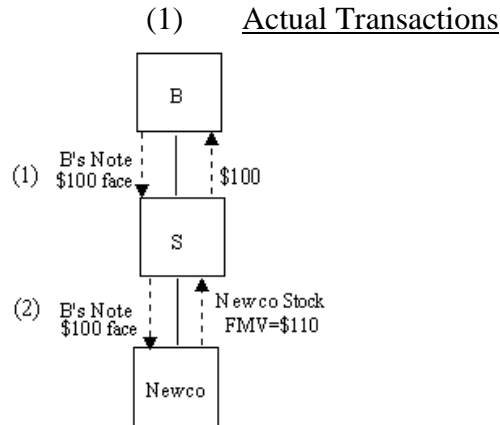
(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to the recharacterization, B is treated as issuing a new note to Newco in exchange for the Newco stock. This contribution should be viewed as a tax-free contribution to Newco. Section 351.⁶⁴ B may be viewed as having a zero basis in the note it is deemed to issue to Newco. As a result, B may take a zero basis in the Newco stock received in the exchange under section 362. Moreover, under section 358, Newco succeeds to B's basis in the note. Thus, Newco may be viewed as having a zero basis in B's note.⁶⁵
- c) B would then have an intercompany gain of \$100 on the deemed sale of the Newco stock to S. Section 1001. Under section 1012, S has a \$100 basis in the Newco stock acquired in the deemed purchase from B.

⁶⁴ Pursuant to the stock aggregation rules of Treas. Reg. § 1.1502-34, even though B transfers the Newco stock to S immediately after receiving it, B's deemed issuance of its new note in exchange for Newco stock should qualify for nonrecognition treatment under section 351.

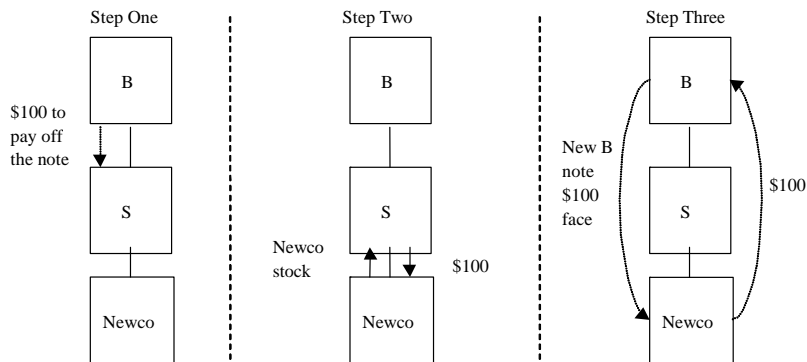
⁶⁵ This example illustrates the inadvertent or unintended zero basis problem that the 1998 Proposed Regulations sought to eliminate. See Preamble to Former Prop. Treas. Reg. § 1.1502-13(g) (1998).

b. Intercompany Borrowing Followed by Section 351 Contribution of the Note To Lower Tier Subsidiary -- 1998 Proposed Regulations⁶⁶



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S contributes the note to a lower tier subsidiary, Newco, in exchange for stock of Newco. The transaction satisfies the requirements of section 351.
- c) At the time of the contribution to Newco, the note has a fair market value of \$110.

⁶⁶ Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 2(a) and (b). By “clarifying the form and timing of the deemed recast” the proposed regulations eliminate the inadvertent zero basis problem illustrated in the prior example.

(2) Recharacterized Transactions

- a) B is treated as satisfying the debt immediately before the exchange for \$100, the amount of money equal to the issue price of a new debt issued on the date of the transaction, with identical terms, for the Newco stock issued to S. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- b) S is deemed to transfer the proceeds of the deemed satisfaction to Newco in exchange for Newco stock. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- c) B is then deemed to issue a new note to Newco in exchange for the \$100 S was deemed to transfer to Newco in exchange for the Newco stock actually issued to S. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998). The new note B is deemed to issue has an issue price of \$100 and a stated redemption price of \$100. Section 1273(b)(4).

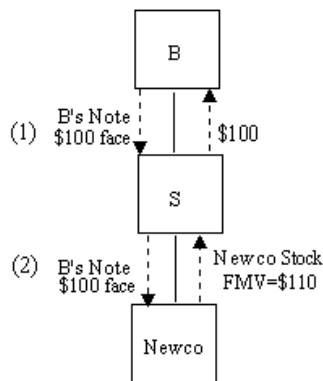
(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) S has a \$100 basis in the Newco stock.
- c) Pursuant to the recharacterization, B is deemed to issue a new note to Newco in exchange for the proceeds of the deemed satisfaction, which were deemed transferred from S to Newco in exchange for the Newco stock. B's new note issued to Newco is

treated as having a \$100 issue price. Sections 1273(b)(4) and 1274(a)(1).

c. Intercompany Borrowing Followed by Section 351 Contribution of the Note To Lower Tier Subsidiary -- 2008 Final Regulations⁶⁷

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S contributes the note to a lower tier subsidiary, Newco, in exchange for stock of Newco. The transaction satisfies the requirements of section 351.
- c) At the time of the contribution to Newco, the note has a fair market value of \$110.

(2) Regulatory Exception for Intercompany Exchanges

- a) Treas. Reg. § 1.1502-13(g)(3)(i)(B)(I) (2008) provides that the general deemed satisfaction-reissuance rule of Treas. Reg. § 1.1502-13(g)(3) does not apply to an intercompany exchange to which section 351 applies, provided that the creditor and the debtor recognize no income, gain, deduction or loss.
- b) However, notwithstanding the exception for intercompany section 351 exchanges described above, the general deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) does apply if the tax

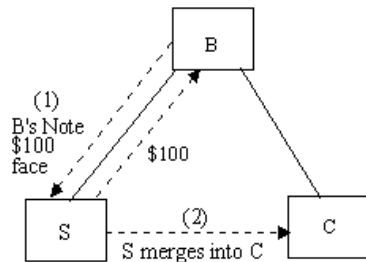
⁶⁷ Treas. Reg. § 1.1502-13(g)(7) (2008), Example 4(i) and (ii).

benefit rule applies. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).

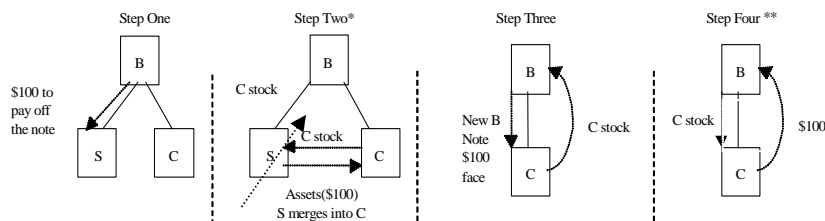
- i) The tax benefit rule applies if the assignment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit that the group or its members would otherwise not enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).
- ii) The 2008 Final Regulations define the term “tax benefit” as the benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. Treas. Reg. § 1.1502-13(g)(2)(v) (2008).
- c) The exception for intercompany section 351 exchanges also does not apply in certain situations where the IRS views there to be a significant potential for distortion. See Treas. Reg. § 1.1502-13(g)(3)(i)(B)(I)(i) to (vi).
- d) Neither S nor B recognize any gain or loss as a result of the section 351 exchange. Assuming that the tax benefit rule does not apply, and the exchange is not described in the regulations as a transaction with a significant potential for distortion, the exception for intercompany exchanges in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(I) (2008) applies and the deemed satisfaction-reissuance rule thus does not apply to the transaction.

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the section 351 exchange.
- b) S has a \$100 basis in the Newco stock.
- c) Newco has a basis of \$100 in the transferred note.

6. Example 6: Merger of Creditor Corporationa. Merger of Creditor Corporation -- 1995 Final Regulations⁶⁸(1) Actual Transactions

- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S merges into C, another member of the consolidated group, in a section 368(a)(1)(A) merger. The fair market value of the note at the time of the merger is \$110.
- c) Pursuant to the merger, S is deemed to transfer all of its assets to C in exchange for C stock and to liquidate immediately thereafter (transferring the C stock it receives in the merger to B).

(2) Recharacterized Transactions

⁶⁸ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

- a) B is treated as paying S an amount equal to the issue price of a new note, with identical terms, issued for the C stock S is deemed to receive immediately before S merges into C. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995). Because the C stock is not publicly traded, the note should have an issue price of \$100. Section 1273(b)(4).
- b) In the merger, S is treated as transferring all of its assets to C in exchange for C stock and then distributing such C stock to B in a liquidating distribution.*
- c) Immediately after S merges into C, B is treated as issuing a new note to C in exchange for the C stock S was deemed to receive in the merger. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (2005). Under sections 1273(b)(4) and 1274(a)(1), the new note has an issue price of \$100 and a stated redemption price at maturity of \$100.
- d) C is then deemed to pay B \$100 in redemption of the stock B was deemed to acquire in the reissuance of its note. The amount of this redemption payment equals the amount B is treated as paying S in the Step One satisfaction of B's note.**

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to the recharacterization, B is deemed to issue a new note to C. B's new note issued to C is treated as having a \$100 issue price. Sections 1273(b)(4) and 1274(a)(1).
- c) The deemed reissuance of B's note should be viewed as a tax-free exchange with C. Section 351. B may take a zero basis in the C stock under section 358. Rev. Rul. 81-187, 1981-2 C.B. 167; Rev. Rul. 74-503, 1974-2 C.B. 117. Because C received B's note in a section 351 transaction, section 362 provides that C

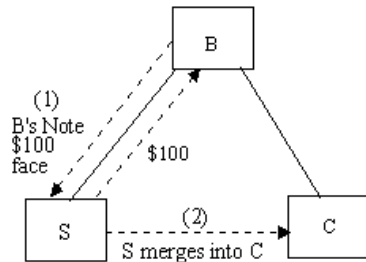
succeeds to B's basis in the note. Therefore, C could be viewed as having a zero basis in the note.⁶⁹

- d) C's deemed payment of \$100 in redemption of the C stock that C was deemed to issue to B in Step Three should be treated as a distribution to B, the treatment of which is determined under sections 301 and Treas. Reg. § 1.1502-13(g).
- e) If C takes a zero basis in B's note, C will recognize gain when principal payments are received on B's note. Section 1271(a)(1).
- f) However, it is possible that C's gain will be redetermined to be excluded from gross income under Treas. Reg. § 1.1502-13(c)(1)(i) and -13(c)(6)(i). See also Former Treas. Reg. § 1.1502-13(g)(3)(ii)(B)(I) (1995) (providing that Treas. Reg. § 1.1502-13(c)(6)(ii) does not apply to prevent intercompany income or gain realized from intercompany obligations from being excluded from gross income).

⁶⁹ This example also illustrates the inadvertent or unintended zero basis problem that the proposed regulations seek to eliminate. See Preamble to Former Prop. Treas. Reg. § 1.1502-13(g) (1998).

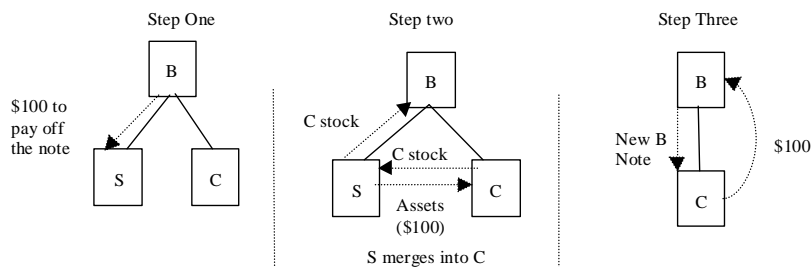
b. Merger of Creditor Corporation -- 1998 Proposed Regulations⁷⁰

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S merges into C, another member of the consolidated group, in a section 368(a)(1)(A) merger. The fair market value of the note at the time of the merger is \$110.
- c) Pursuant to the merger, S is deemed to transfer all of its assets to C in exchange for C stock and to liquidate immediately thereafter (transferring the C stock it receives in the merger to B).

(2) Recharacterized Transactions



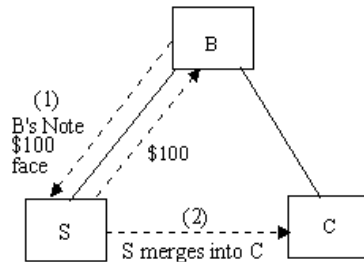
⁷⁰ This example is not contained in the 1998 Proposed Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

- a) B is treated as satisfying the debt immediately before the exchange for \$100, the amount of money equal to the issue price of a new debt issued on the date of the transaction, with identical terms, for the property S receives from C. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- b) S is then deemed to transfer the proceeds of the deemed satisfaction to C along with its other assets pursuant to the merger.⁷¹ Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- c) Immediately after S merges into C, B is treated as issuing a new note to C in exchange for \$100, the amount of the deemed satisfaction that was transferred to C in the merger with S. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998). Under section 1273(b)(4), the new note has an issue price of \$100 and a stated redemption price at maturity of \$100.

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to the recharacterization, B is deemed to issue a new note to C. B's new note issued to C is treated as having a \$100 issue price. Sections 1273(b)(4) and 1274(a)(1).

⁷¹ In the prior example, an inadvertent zero basis problem arose as a result of C's deemed redemption of the C stock B was treated as receiving in the recast called for under the 1995 Final Regulations. Consistent with the proposed regulation's objective of eliminating the inadvertent zero basis problem, the recast set forth in this example does not include S's deemed receipt of C stock in the merger. S is simply treated as transferring the deemed proceeds of the redemption to C along with its other assets in the merger.

c. Merger of Creditor Corporation -- 2008 Final Regulations⁷²(1) Actual Transactions

- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S merges into C, another member of the consolidated group, in a section 368(a)(1)(A) merger. The fair market value of the note at the time of the merger is \$110.
- c) Pursuant to the merger, S is deemed to transfer all of its assets to C in exchange for C stock and to liquidate immediately thereafter (transferring the C stock it receives in the merger to B).

(2) Regulatory Exception for Intercompany Exchanges

- a) Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1) (2008) provides that the general deemed satisfaction-reissuance rule of Treas. Reg. § 1.1502-13(g)(3) does not apply to an intercompany exchange to which section 361 applies, provided that the creditor and debtor recognize no income, gain, deduction or loss.
- b) However, notwithstanding the exception for intercompany exchanges described above, the general deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) does apply if the tax benefit rule applies. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).
 - i) The tax benefit rule applies if the assignment is engaged in with a view to shift items of built-

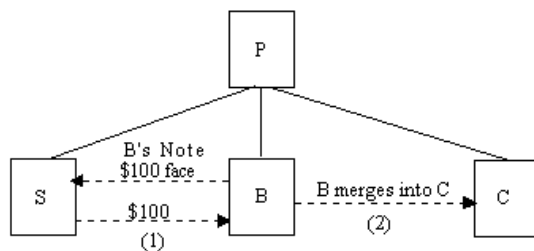
⁷² This example is not contained in the 2008 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit that the group or its members would otherwise not enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).

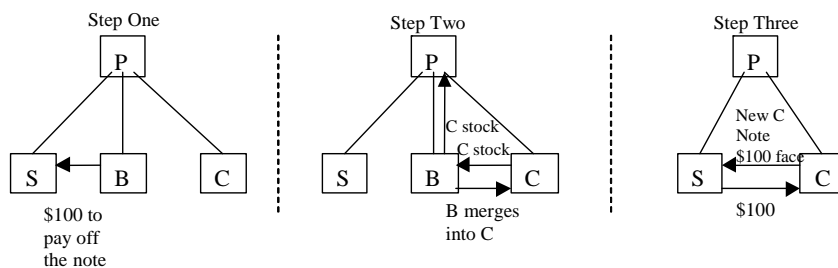
- ii) The 2008 Final Regulations define the term “tax benefit” as the benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. Treas. Reg. § 1.1502-13(g)(2)(v) (2008).
- c) Neither B nor S would recognize an amount of income, gain, deduction or loss as a result of the merger. Assuming that the tax benefit rule does not apply, the exception for intercompany exchanges in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1) (2008) applies and the deemed satisfaction-reissuance rule thus does not apply to the transaction.

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) C holds a note with a \$100 issue price.

7. Example 7: Merger of Debtor Corporationa. Merger of Debtor Corporation -- 1995 Final Regulations⁷³(1) Actual Transactions

- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, B merges into C, another member of the consolidated group, in a merger qualifying as a reorganization within the meaning of section 368(a)(1)(A). At the time of the merger, the note has a fair market value of \$110.
- c) Pursuant to the merger, B is treated as transferring its assets and liabilities to C in exchange for C stock and then distributing such C stock to P in a liquidating distribution.

(2) Recharacterized Transactions

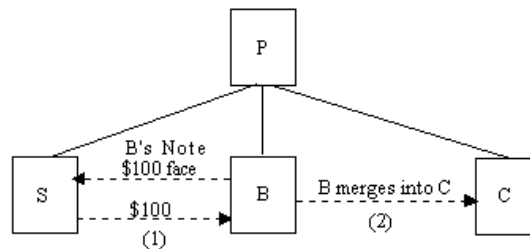
⁷³ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

- a) B is treated as paying S an amount of money equal to the issue price of a new note, with identical terms, issued for the C stock B is treated as receiving immediately before B merges into C. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995). Because the C stock is not publicly traded, the new note should have an issue price of \$100. Section 1273(b)(4).
- b) B then merges into C, distributing the C stock it acquires in the merger to P.*
- c) Immediately after B merges into C, C is treated as issuing a new note to S in exchange for either \$100 of cash or the C stock B was deemed to receive in the merger. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995).
 - i) It is uncertain whether in Step Three C should be treated as receiving from S \$100 of cash or the C stock B was deemed to receive in the merger because the reissuance provision of Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995) states that when a debt is transferred in exchange for property (as opposed to money) the new debt is treated as being issued for that property.
 - ii) However, in this case nothing was transferred to B by reason of C's assumption of B's obligation to pay off the note originally issued to S. Under section 61(a)(12), the assumption of a debt results in COD income to the taxpayer relieved of the liability. When C assumes B's liabilities, B is relieved of the obligation to repay the debt incurred upon issuance of the original note to S in exchange for \$100. Thus, C's assumption of B's liabilities could be viewed as equivalent to a cash payment. Accordingly, when C issues the new note to S, C should be treated as receiving money equal to the amount of money B was deemed to pay S in Step One (\$100).⁷⁴

⁷⁴The alternative is that C is issuing the note to S in exchange for C stock that S had to acquire from either P or C.

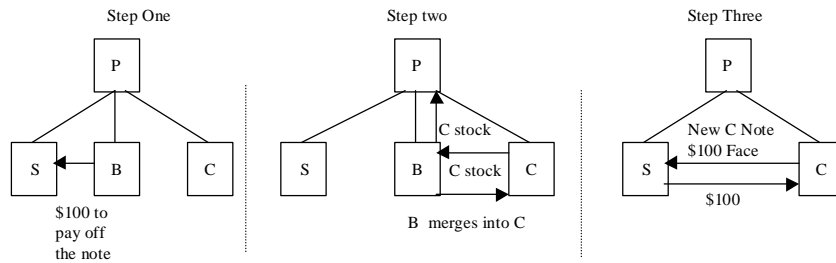
(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to the recharacterization, C is deemed to issue a new note to S. C should be treated as receiving \$100 in exchange for its note. If C is treated as receiving \$100 of cash, the new note has a \$100 issue price. Section 1273(b)(2).

b. Merger of Debtor Corporation -- 1998 Proposed Regulations⁷⁵(1) Actual Transactions

- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, B merges into C, another member of the consolidated group, in a merger qualifying as a reorganization within the meaning of section 368(a)(1)(A). At the time of the merger, the note has a fair market value of \$110.
- c) Pursuant to the merger, B is treated as transferring its assets to C (including its liability on its note) in exchange for C stock and then distributing such C stock to P in a liquidating distribution.

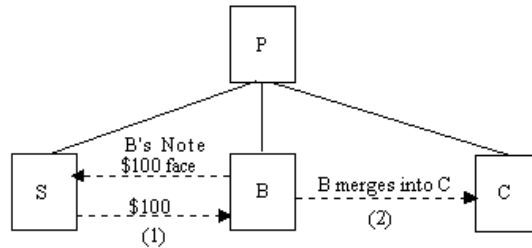
⁷⁵ This example is not contained in the 1998 Proposed Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

(2) Recharacterized Transactions

- B is treated as satisfying the debt immediately before the exchange for \$100, the amount of money equal to the issue price (determined under section 1273 or 1274) of a new debt issued on the date of the transaction, with identical terms, for the property C receives from B. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(ii) (1998).
- B then merges into C distributing the C stock it acquires in the merger to P.*
- Immediately after B merges into C, C is treated as issuing a new note to S in exchange for the \$100 that S was deemed to receive in the deemed satisfaction. Former Prop. Treas. Reg. § 1.1502-13(g)(3)(iii) (1998).

(3) Tax Consequences

- In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- Pursuant to the recharacterization, C is deemed to issue a new note to S. C is treated as receiving \$100 in exchange for its note. The new note has a \$100 issue price. Sections 1273(b)(4) and 1274(a)(1).

c. Merger of Debtor Corporation -- 2008 Final Regulations⁷⁶(1) Actual Transactions

- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, B merges into C, another member of the consolidated group, in a merger qualifying as a reorganization within the meaning of section 368(a)(1)(A). At the time of the merger, the note has a fair market value of \$110.
- c) Pursuant to the merger, B is treated as transferring its assets to C (including its liability on its note) in exchange for C stock and then distributing such C stock to P in a liquidating distribution.

(2) Regulatory Exception for Intercompany Exchanges

- a) Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1) (2008) provides that the general deemed satisfaction-reissuance rule of Treas. Reg. § 1.1502-13(g)(3) does not apply to an intercompany exchange to which section 361 applies, provided that the creditor and debtor recognize no income, gain, deduction or loss.
- b) However, notwithstanding the exception for intercompany exchanges described above, the general deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) does apply if the tax benefit rule applies. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).
 - i) The tax benefit rule applies if the assignment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the

⁷⁶ This example is not contained in the 2008 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario.

obligation from one member to another member in order to secure a tax benefit that the group or its members would otherwise not enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).

- ii) The 2008 Final Regulations define the term “tax benefit” as the benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. Treas. Reg. § 1.1502-13(g)(2)(v) (2008).
- c) Neither B nor S would recognize an amount of income, gain, deduction or loss as a result of the merger. Assuming that the tax benefit rule does not apply, the exception for intercompany exchanges in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1) (2008) applies and the deemed satisfaction-reissuance rule thus does not apply to the transaction.⁷⁷

(3) Tax Consequences

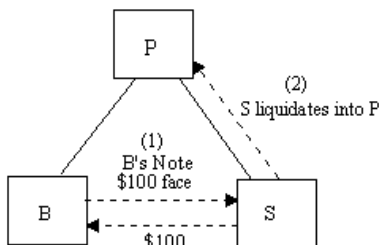
- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) C is the obligor on the note with a \$100 issue price.

⁷⁷ Note that if the transfer of the debtor’s obligation in connection with the merger results in a significant modification of the original obligation under Treas. Reg. § 1.1001-3(e)(4) and a deemed exchange under Treas. Reg. § 1.1001-3(b), then the merger would have to satisfy the routine modification exception in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(6) in order for the deemed satisfaction reissuance model not to apply.

8. Example 8: Section 332 Liquidation Of Creditor Corporation

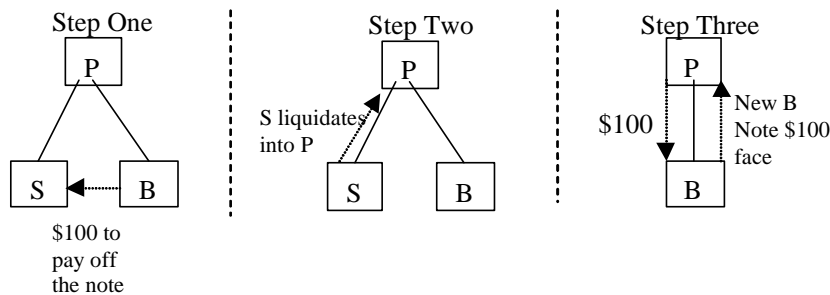
a. Section 332 Liquidation Of Creditor Corporation -- 1995 Final Regulations⁷⁸

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S liquidates into P in a transaction qualifying for nonrecognition treatment under section 332. In the liquidation, S transfers all of its assets to P. At the time of the liquidation, B's note has a fair market value of \$110.

(2) Recharacterized Transactions (Alternative One)⁷⁹



⁷⁸ This example is not contained in the 1995 Final Regulations; it represents our analysis of how the regulations appear to apply to the following scenario. However, as set forth below, this example is set forth in the 1998 Proposed Regulations and 2008 Final Regulations.

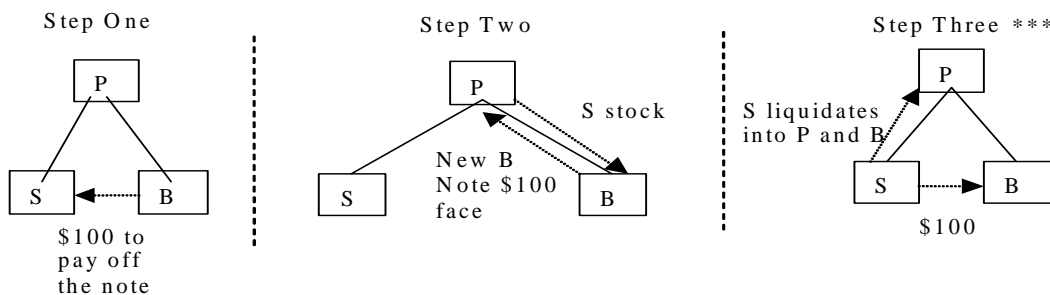
⁷⁹ There appear to be several possible recharacterizations, none of which is wholly consistent with the regulatory language and none of which appears more preferable than the others.

- a) B is treated as paying S \$100 in satisfaction of the debt immediately before S liquidates into P. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- b) S liquidates into P.*
- c) Immediately after S liquidates into P, B is deemed to issue a new note to P. Former Treas. Reg. § 1.1502-13(g)(3)(iii) (1995). It is unclear what B should be treated as receiving from P in exchange for the new note. Because S goes out of existence following the liquidation, one alternative recharacterization would be to treat B as issuing the new note to P in exchange for the consideration B was deemed to pay S in Step One (\$100).

(3) Tax Consequences (Alternative One)

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to sections 332 and 337 respectively, neither S nor P recognizes gain as a result of S's liquidating distribution to P.
- c) Pursuant to this alternative recharacterization, B is deemed to issue a new note to P in exchange for an amount of money equal to the amount B was deemed to transfer to S in Step One (\$100). The new note has an issue price of \$100 and a stated redemption price at maturity of \$100. Section 1273(b)(2).

(4) Recharacterized Transactions (Alternative Two)



***This step includes the actual transaction in which S liquidates. However, whereas the actual liquidation is into P, this recharacterized liquidation is into both P and B in order to locate money and property consistently with the actual transaction (i.e., S's liquidation distribution to B).

- a) B is treated as paying S \$100 in satisfaction of the debt immediately before S's liquidation into P. Former Treas. Reg. § 1.1502-13(g)(3)(ii) (1995).
- b) B is then deemed to issue a new note to P, in exchange for the property acquired by S in the actual transfer of the note (i.e., S stock in the liquidation).
- c) S is then treated as liquidating and distributing \$100 in cash to B and the remainder of its assets to P. Pursuant to the recharacterization, S makes liquidating distributions to both P and B (rather than only to P as in the actual transaction) in order to locate money and property consistently with the actual transaction.

(5) Tax Consequences (Alternative Two)

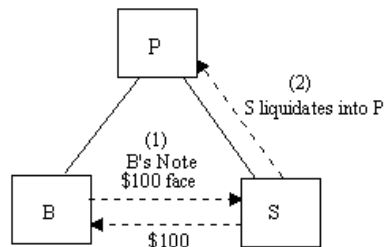
- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to sections 332 and 337, respectively, neither S nor P recognizes gain as a result of S's liquidating distribution to P.
- c) Pursuant to this alternative recharacterization, B is treated as issuing a new note to P in exchange for S stock. The note has a \$100 issue price and a stated redemption price at maturity of \$100. Sections 1273(b)(4) and 1274(a)(1).
- d) Under Treas. Reg. § 1.1001-1(g)(1), P should have an amount realized equal to the difference between the issue price of B's note (\$100) and its basis in the S stock it is deemed to transfer to B in exchange for B's new note. Under the matching rule of Treas. Reg. § 1.1502-13(c)(1), any gain realized pursuant to this exchange should be deferred. Any loss P realizes on the deemed sale of the S stock to B should be redetermined as a noncapital, nondeductible amount. See Treas. Reg. § 1.1502-13(f)(7), Example 5. Under section 1012, P takes a \$100 basis in B's note.
- e) B should be treated as having a \$100 cost basis in the S stock received upon issuance of its note to P. See Crane v. Commissioner, 331 U.S. 1 (1947); section 1012.

- f) Neither P nor B recognizes gain upon receipt of the liquidating distribution from S pursuant to section 332 and Treas. Reg. § 1.1502-34.⁸⁰
- g) Pursuant to section 337, S should not recognize any gain on the distribution of appreciated property to P if P is an "80%" distributee within the meaning of section 332(c). However, if the \$100 of cash deemed distributed to B exceeds 20% of S's total assets, then P would fail to be an 80% distributee and S would have to recognize any gain on the distribution of appreciated assets to P. Section 336. B should be treated as the member succeeding to S's gain. The gain would be deferred and later taken into account under the matching and acceleration rules as the assets leave the consolidated group or P depreciates them. See Treas. Reg. § 1.1502-13(j)(9), Examples 6 and 7. But see Prop. Treas. Reg. § 1.1502-13(j)(2)(ii), (9)(i), Examples 6 and 7, REG-131128-04 (Feb. 21, 2005) (modifying the rules by which group members succeed to intercompany items of a liquidating lower tier member, and causing both P and B to succeed to a portion of S's gain in this Alternative Two).
- h) S will not recognize any gain on the deemed distribution of \$100 of cash to B because S has a basis in cash equal to the amount of the cash distributed.

⁸⁰Even if neither P nor B is an 80% distributee within the meaning of section 332(c) on a stand-alone basis, for the purposes of section 332, both P and B are treated as 80% distributees pursuant to Treas. Reg. § 1.1502-34.

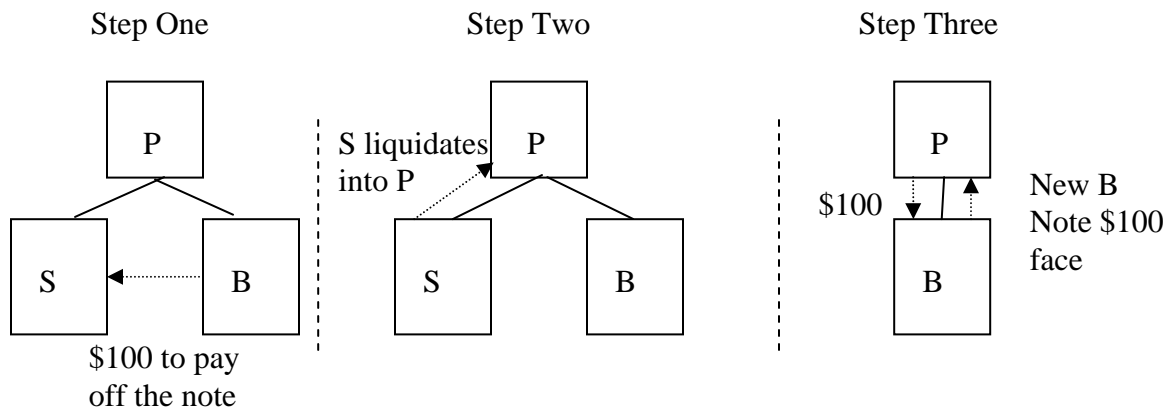
b. Section 332 Liquidation Of Creditor Corporation -- 1998 Proposed Regulations⁸¹

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S liquidates into P in a transaction qualifying for nonrecognition treatment under section 332. In the liquidation, S transfers all of its assets to P. At the time of the liquidation, B's note has a fair market value of \$110.

(2) Recharacterized Transactions



- a) B is treated as satisfying the debt immediately before the exchange for \$100, the amount of money equal to the issue price (determined under section 1273 or 1274) of a new debt issued on the date of the transaction, with identical terms, for the property S receives from P. Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 2(c).

⁸¹ This example is set forth at Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 2(c).

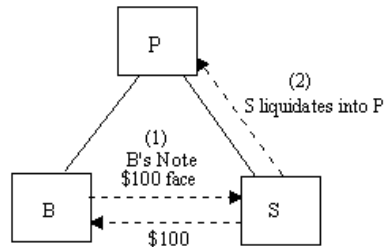
- b) S liquidates into P, transferring the proceeds of the deemed satisfaction to P along with its other assets. Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 2(c).
- c) Immediately after S liquidates into P, B is deemed to issue a new note to P in exchange for \$100, the proceeds of the deemed satisfaction, which were deemed to be transferred to P pursuant to the liquidation. Former Prop. Treas. Reg. § 1.1502-13(g)(5) (1998), Example 2(c).

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) Pursuant to sections 332 and 337, respectively, neither S nor P recognizes gain as a result of S's liquidating distribution to P.
- c) Pursuant to the recharacterization, B is deemed to issue a new note to P in exchange for \$100, the proceeds of the deemed satisfaction, which were transferred to P pursuant to the liquidation. The new note has an issue price of \$100 and a stated redemption price at maturity of \$100. Section 1273(b)(4).

c. Section 332 Liquidation Of Creditor Corporation -- 2008 Final Regulations⁸²

(1) Actual Transactions



- a) During year one, B borrows \$100 from S and issues a \$100 note to S.
- b) During year two, S liquidates into P in a transaction qualifying for nonrecognition treatment under section 332. In the liquidation, S transfers all of its assets to P. At the time of the liquidation, B's note has a fair market value of \$110.

(2) Regulatory Exception for Intercompany Exchanges

- a) Treas. Reg. § 1.1502-13(g)(3)(i)(B)(I) (2008) provides that the general deemed satisfaction-reissuance rule of Treas. Reg. § 1.1502-13(g)(3) does not apply to an intercompany exchange to which section 332 applies, provided that the creditor and debtor recognize no income, gain, deduction or loss.
- b) However, notwithstanding the exception for intercompany exchanges described above, the general deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii) (2008) does apply if the tax benefit rule applies. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).
 - i) The tax benefit rule applies if the assignment is engaged in with a view to shift items of built-in gain, loss, income, or deduction from the obligation from one member to another member in order to secure a tax benefit that the group or its members would otherwise not enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C) (2008).

⁸² This example is set forth at Prop. Treas. Reg. § 1.1502-13(g)(7) (2007), Example 4(iv).

- ii) The 2008 Final Regulations define the term “tax benefit” as the benefit of a net reduction in income or gain, or a net increase in loss, deduction, credit, or allowance. Treas. Reg. § 1.1502-13(g)(2)(v) (2008).
- c) Neither B nor S would recognize an amount of income, gain, deduction or loss as a result of the section 332 liquidation. Assuming that the tax benefit rule does not apply, the exception for intercompany exchanges in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(I) (2008) applies and the deemed satisfaction-reissuance rule thus does not apply to the transaction.

(3) Tax Consequences

- a) In year 2, neither B nor S recognizes an amount of income, deduction, gain, or loss as a result of the deemed satisfaction.
- b) P holds the note with a \$100 issue price.