

**TAX EXECUTIVES INSTITUTE  
HOUSTON CHAPTER**

**Houston, Texas  
February 4, 2009**

**The Final Unified Loss Rule Regulations**

Greg Kidder  
Steptoe & Johnson LLP  
Washington, DC

Lisa Zarlenga  
Steptoe & Johnson LLP  
Washington, DC

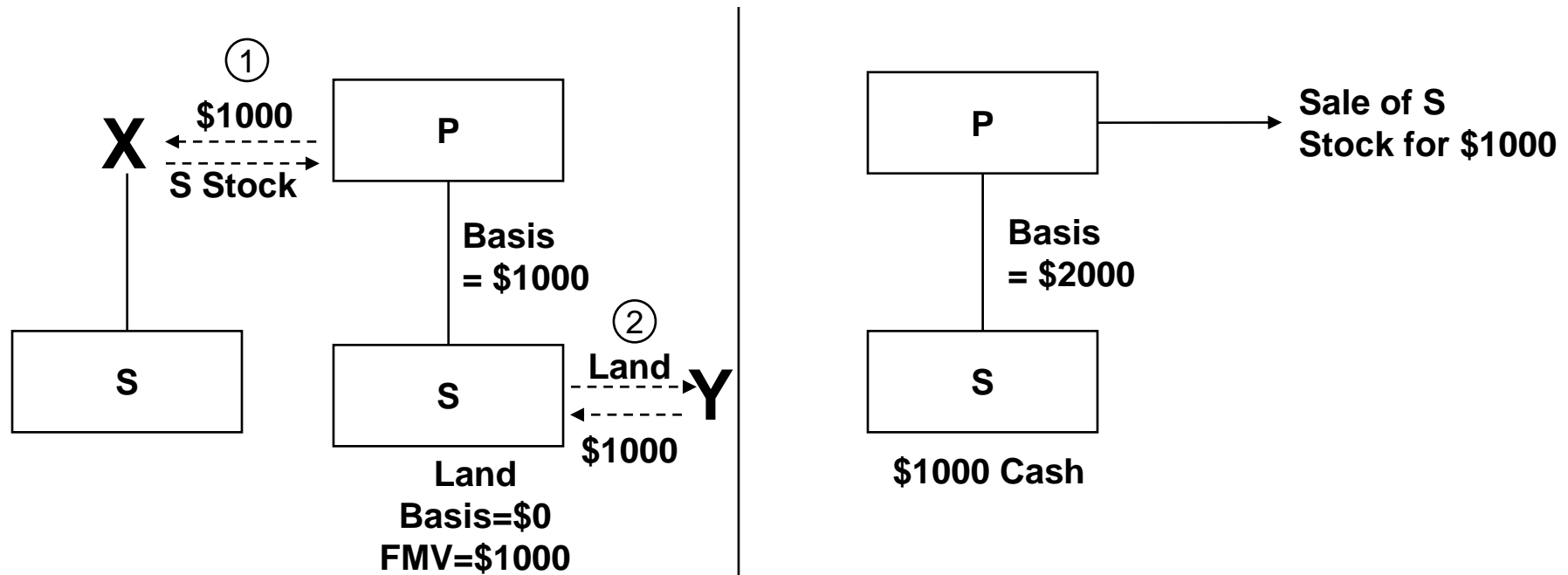
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# Background

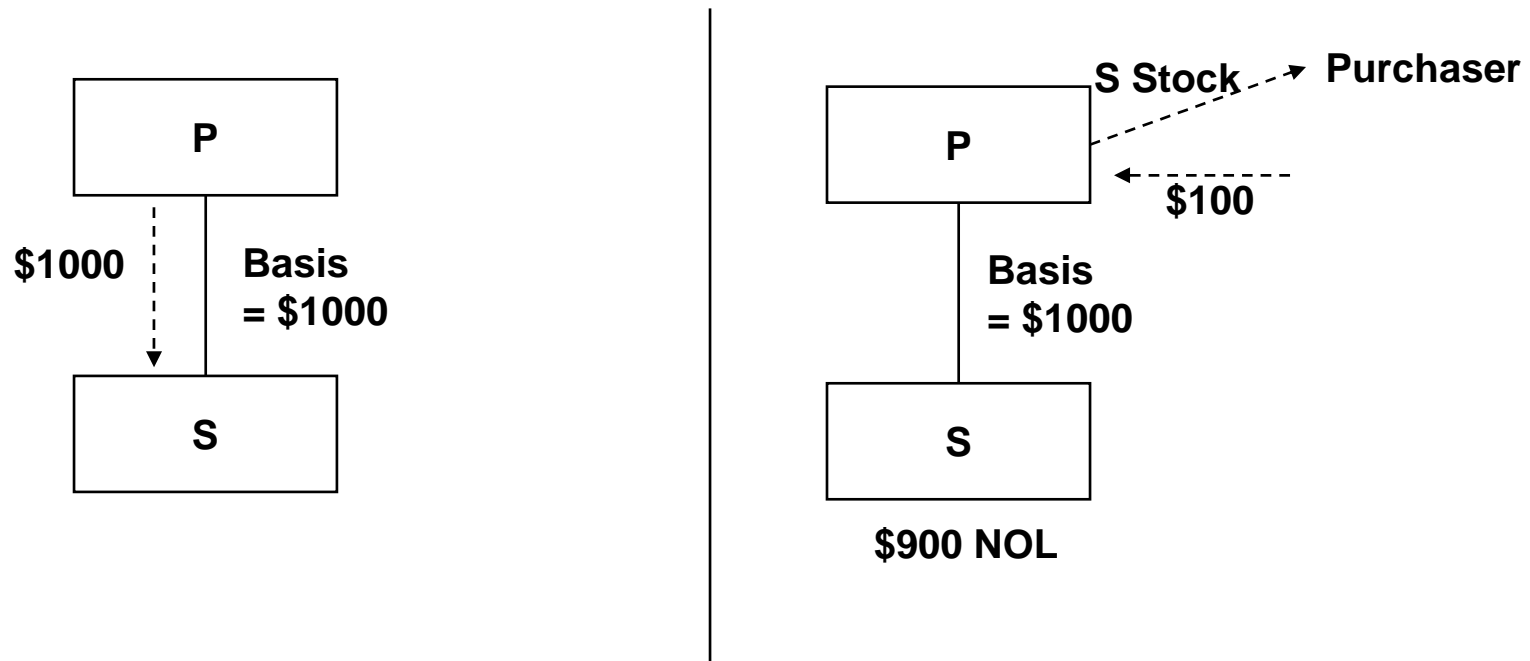
# Background

## “Son-of-Mirrors” Transaction



P purchases the stock of S for \$1,000 from X. S's only asset is land with a value of \$1,000 and a tax basis of \$0. P causes S to sell the land to Y for its fair market value of \$1,000, generating \$1,000 of gain and causing P's basis in the S stock to increase to \$2,000 (disregarding taxes). P subsequently sells the S stock for its fair market value of \$1,000 and generates a \$1,000 loss that is attributable to the recognition of the built-in gain inherent in S's land (i.e., the excess of the fair market value of the land over its tax basis in S's hands).

# Background “Duplicated Loss”



P contributes \$1,000 to newly formed S. S loses \$900 of the \$1,000, generating a \$900 NOL that is not absorbed by the P group. P sells the stock of S to Purchaser for its fair market value of \$100, recognizing a \$900 loss. S is allocated the \$900 NOL from the P group.

# Unified Rule on Loss on Subsidiary Stock

- On January 23, 2007, the IRS and Treasury published proposed regulations under sections 358, 362(e)(2) and 1502 that provide for a unified rule for losses on subsidiary stock.
- These regulations became final, with certain modifications, on September 10, 2008.
- The final regulations apply only to corporations filing consolidated returns.
- The regulations have two principal purposes:
  - The first is to prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation of noneconomic loss on S stock. See Treas. Reg. § 1.1502-36(a)(2).
  - The second is to prevent members (including former members) of the group from collectively obtaining more than one tax benefit from a single economic loss. See Treas. Reg. § 1.1502-36(a)(2).
- The prior rules that addressed these concerns were contained in Treas. Reg. § 1.337-2(d) (for noneconomic losses) and Treas. Reg. § 1.1502-35 (for duplicated losses).
- Treas. Reg. § 1.1502-36 replaces Treas. Reg. § 1.337(d)-2 (including Notice 2004-58) and Treas. Reg. § 1.1502-35 (however, loss suspension and reimportation rules will continue to apply to transactions entered into prior to the final regulations).

# Unified Loss Rule – In General

- The regulations consist of three principal rules that apply when a member transfers a loss share of subsidiary stock:
  - The “basis redetermination” rule that redetermines members’ bases in subsidiary stock by reallocating § 1.1502–32 adjustments (to adjust for disproportionate reflection of gains and losses in the bases of members’ shares). See Treas. Reg. § 1.1502–36(b).
  - The “basis reduction” rule that reduces members’ bases in transferred loss shares (but not below value) by the lesser of (i) the amount of net positive investment adjustments (“PIAs”) applied to the bases of those shares, or (ii) the share’s disconformity amount (to address noneconomic stock loss). See Treas. Reg. § 1.1502–36(c).
  - The “attribute reduction” rule that reduces the subsidiary’s attributes to prevent the duplication of a loss recognized on, or preserved in the basis of, transferred stock (to address duplicated loss). See Treas. Reg. § 1.1502–36(d).
- Generally, these three rules apply in the order described.

# Unified Loss Rule – Timing

- The regulations apply upon the “transfer” of a loss share of subsidiary stock. Treas. Reg. § 1.1502-36(a)(3)(i). A transfer occurs upon the earliest of:
  - The date M ceases to own the share as a result of a transaction in which, but for these rules, M would recognize income, gain, loss, or deduction with respect to the share;
  - The date M and S cease to be members of the same group;
  - The date that a nonmember acquires the share for M; and
  - The last day of the taxable year during which the share becomes worthless.
  - A transfer does not include a nonrecognition transaction to which section 381(a) or a section 355 distribution. It also does not include a section 332 liquidation, as long as only one member owns stock of the liquidating subsidiary. The final regulations apply the Unified Loss Rule to 332 liquidations into multiple members.
- The final regulations clarify that the Unified Loss Rule applies if, after taking into account the effects of all rules of law applicable as of the transfer (even those that would not be given effect until after the transfer), the transferred share is a loss share. Treas. Reg. § 1.1502.36(a)(3)(i).
- Intercompany Transfers – The final regulations coordinate the Unified Loss Rule with the intercompany transaction rules of Treas. Reg. § 1.1502-13.
  - If a member transfers a share of subsidiary stock to another member and the gain or loss is deferred under Treas. Reg. § 1.1502-13, the Unified Loss Rule applies to the transfer when the intercompany item is taken into account. Treas. Reg. § 1.1502-36(e)(3).
  - The regulations permit taxpayers to elect to apply this rule to intercompany transactions that occur before the effective date but are triggered after the effective date.

# Basis Redetermination Rule

# Basis Redetermination

- The basis redetermination rule reduces the extent to which there is disparity in members' bases in shares of S stock. See Treas. Reg. §1.1502-36(b)(1)(i).
- The rule is intended to prevent the operation of the investment adjustment system from creating a noneconomic or duplicated loss when members hold S shares with disparate bases.
- The rule operates by reallocating previously applied investment adjustments.
- The rule does not alter the aggregate amount of basis in shares of S stock held by members or the aggregate amount of investment adjustments applied to shares of S stock.

# Basis Redetermination

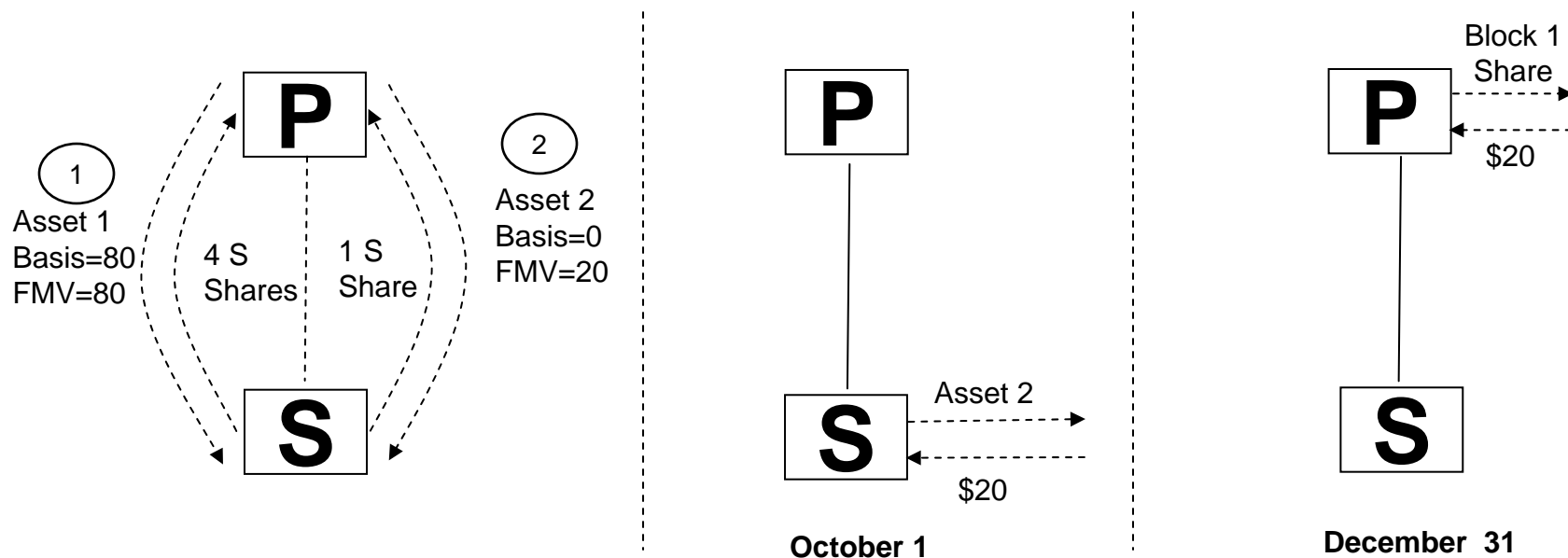
- The basis redetermination rule applies when a member transfers a share of subsidiary (S) stock and, after the application of all other provisions of the Code and regulations, the share is a loss share. It subjects all members' shares of S stock to redetermination. See Treas. Reg. §1.1502-36(b)(2).
- Under the basis redetermination rule, investment adjustments (exclusive of distributions) that were previously applied to members' bases in S stock are generally reallocated in a manner that, to the greatest extent possible, eliminates basis disparity on all shares. See Treas. Reg. §1.1502-36(b)(2)(i)(B), (ii) and (iii)(A).
  - The final regulations provide that the reallocation may be made using any reasonable method or formula that is consistent with the purposes of the rule.
- The basis reduction rule operates by first removing PIAs (but not in excess of the share's basis) from the bases of transferred loss shares of S common stock.
  - The final regulations modified the proposed regulations to omit the reallocation of PIAs applied to preferred shares, because such adjustments are unlikely to reflect noneconomic losses.
- Then, to the extent of any remaining loss on the transferred shares, negative investment adjustments are removed from shares of S common stock that are not transferred loss shares and applied to reduce the loss on transferred loss shares (first to preferred shares, then to common shares).
- Finally, the PIAs removed from the transferred loss shares of S common stock are allocated and applied (first to preferred then to common) after the negative items have been reallocated.

# Basis Redetermination

- There are limits to redetermination --
  - No adjustments can be reallocated to shares that were not held by members in the year taken into account, as members' shares would not have been able to receive those adjustments in the original allocation.
  - An investment adjustment cannot be reallocated to the extent that it was previously used.

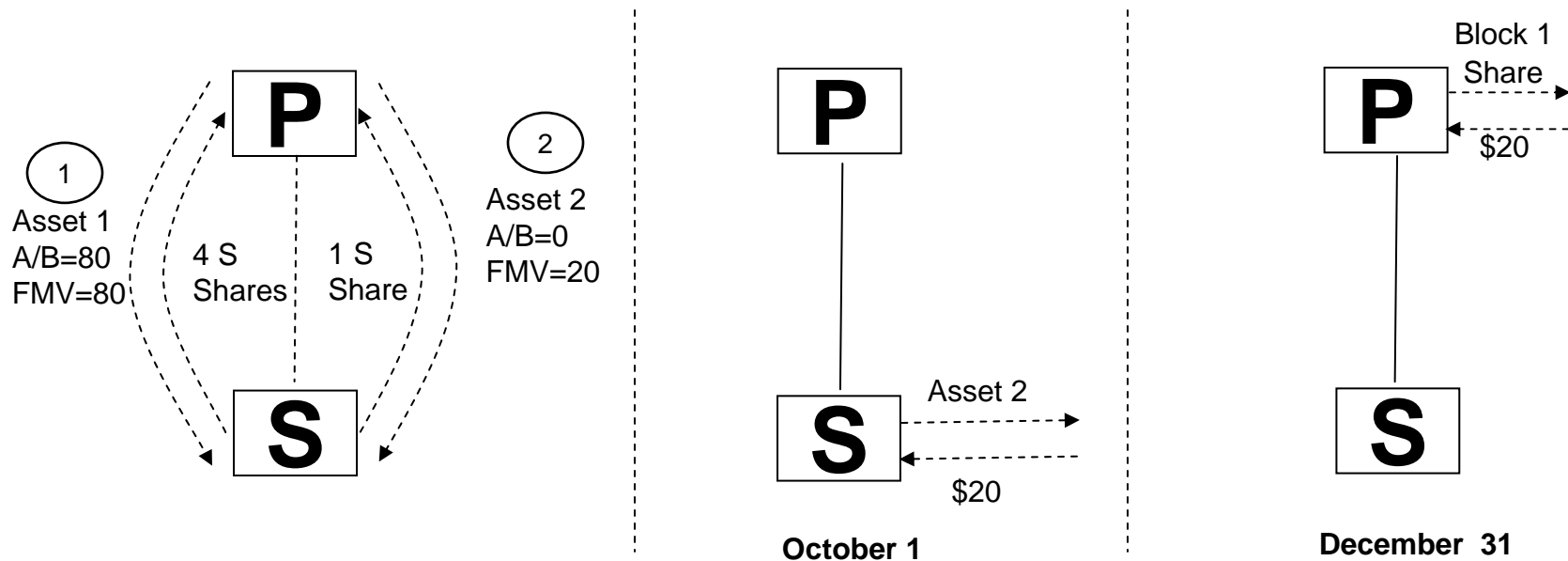
See Treas. Reg. § 1.1502-36(b)(2)(iii).
- The rule contains two safe harbors that excuse taxpayers from reallocating basis in situations in which redetermination is deemed unnecessary --
  - When members' bases in shares of S common stock are equal (that is, there is no disparity) and members' basis in shares of S preferred stock reflect no gain or loss. See Treas. Reg. § 1.1502-36(b)(1)(ii)(A). (This rule was clarified from its "no potential for redetermination" formulation in the proposed regulations.)
  - When the group disposes of its entire interest in the subsidiary to one or more nonmembers, if all members' shares of S stock become worthless, or a combination thereof, in one fully taxable transaction. See Treas. Reg. § 1.1502-36(b)(1)(ii)(B). (This was clarified from its "disposition of entire interest" formulation in the proposed regulations.)
    - However, P may still elect to redetermine a basis even if this safe harbor applies.

# Basis Redetermination – Example 1



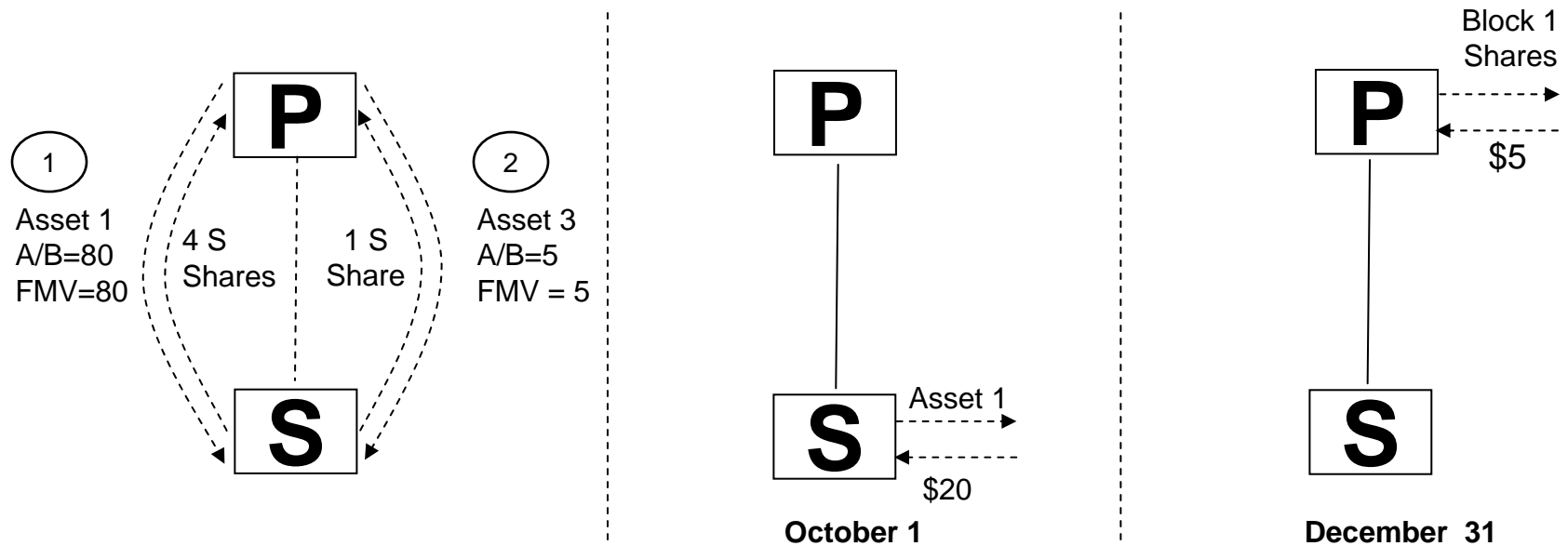
**Facts:** P owns two assets, Asset 1 and Asset 2. On January 1, year 1, P receives four shares of S common stock (the Block 1 shares) in exchange for Asset 1, which has a basis and value of \$80. The exchange qualifies under section 351 and, therefore, under section 358, P's aggregate basis in the Block 1 shares is \$80 (\$20 per share). On July 1, year 1, P receives another share of S common stock (the Block 2 share) in exchange for Asset 2, which has a basis of \$0 and value of \$20. This exchange also qualifies as a section 351 exchange and, under section 358, P's basis in the Block 2 share is \$0. On October 1, year 1, S sells Asset 2 for \$20. On December 31, year 1, P sells one of its Block 1 shares for \$20. P's basis in each Block 1 share is \$24 (P's original \$20 basis increased under § 1.1502-32 by \$4, the share's allocable portion of the \$20 gain recognized on the sale of Asset 2). In addition, P's basis in its Block 2 share is \$4 (P's original \$0 basis increased under § 1.1502-32 by \$4 (the share's allocable portion of the \$20 gain recognized on the sale of Asset 2)). P's sale of the Block 1 share is a transfer of a loss share.

# Basis Redetermination – Example 1 (cont.)



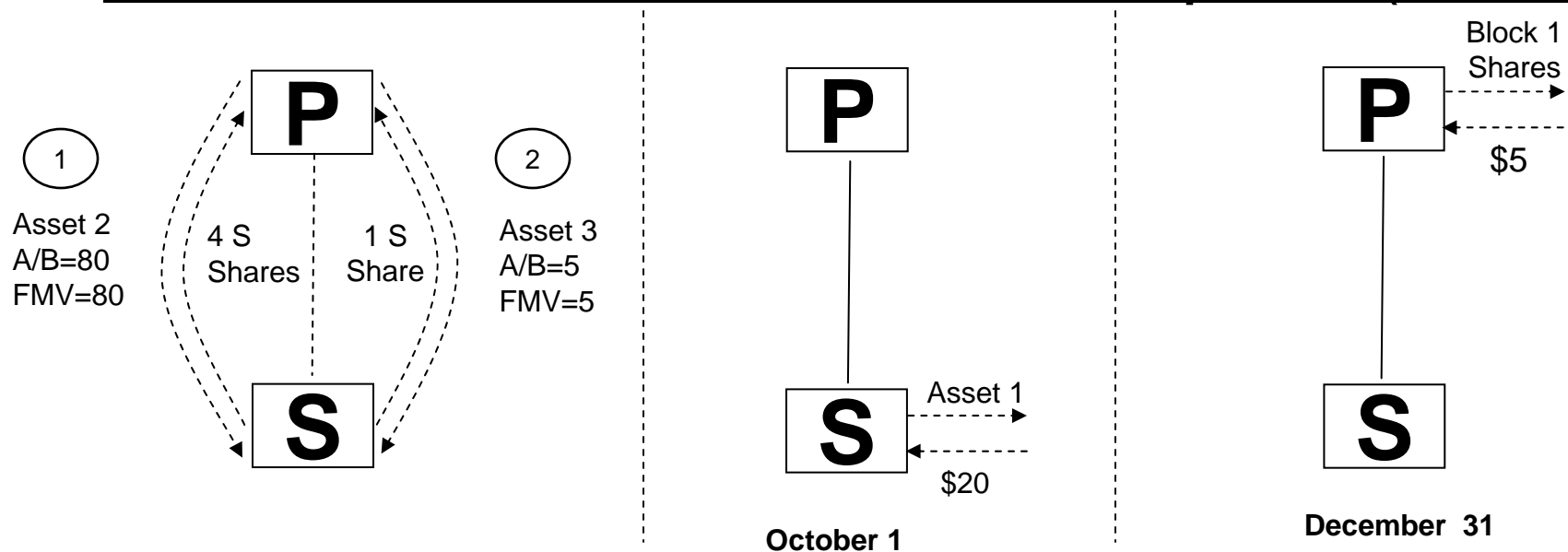
**Result:** P's basis in the transferred loss share is reduced, but not below value, by removing PIAs applied to the basis of the share. Accordingly, P's basis in the transferred Block 1 share is reduced by \$4 (the amount of the PIA applied to the share), from \$24 to \$20. No further reduction to the basis of the share is required because the basis of the share is then equal to value. The PIA removed from the transferred loss share is reallocated and applied to increase P's bases in its S shares in a manner that reduces basis disparity to the greatest extent possible. Accordingly, the \$4 PIA removed from the Block 1 share is reallocated and applied to the basis of the Block 2 share, increasing it from \$4 to \$8. See Treas. Reg. §1.1502-36(b)(3), Ex. 1(i).

# Basis Redetermination – Example 2



**Facts:** The facts are the same as above, except that, at the time of the second contribution, the value of Asset 1 had declined to \$20 and so, instead of contributing Asset 2, P contributed Asset 3 to S in exchange for the Block 2 share. At the time of that exchange, Asset 3 had a basis and value of \$5. On October 1, year 1, S sells Asset 1 for \$20, recognizing a \$60 loss that is absorbed by the group. On December 31, year 1, P sells one of its Block 1 shares for \$5. P's basis in each Block 1 share is \$8 (P's original \$20 basis in each share decreased under § 1.1502-32 by \$12, the share's allocable portion of the \$60 loss recognized on the sale of Asset 1). P's basis in its Block 2 share is an excess loss account of \$7 (its original basis of \$5 reduced by \$12, the share's portion of the loss recognized on Asset 1). P's sale of the Block 1 share is a transfer of a loss share.

# Basis Redetermination – Example 2 (cont.)



**Result:** P's basis in the transferred Block 1 share is reduced, but not below value, by reallocating negative investment adjustments from shares that are not transferred loss shares. In total, there were \$48 of negative investment adjustments applied to shares that are not transferred loss shares. Accordingly, P's basis in the Block 1 share is reduced by \$3, from \$8 to its value of \$5. The negative investment adjustments applied to the transferred share are reallocated from (and therefore cause an increase in the basis of) S shares that are not transferred loss shares in a manner that reduces basis disparity to the greatest extent possible. Thus, the \$3 negative investment adjustment reallocated and applied to the transferred Block 1 share is reallocated entirely from the Block 2 share, increasing the basis in the Block 2 share from an excess loss account of \$7 to an excess loss account of \$4. Treas. Reg. §1.1502-36(b)(2), Ex. 1(ii).

What if, on December 31, P sold all of its S shares?

# Basis Reduction

## Basis Reduction

- The basis reduction rule reduces M's basis in a transferred share of S stock in order to prevent noneconomic stock loss and thereby promote the clear reflection of the group's income.
- The effect of the basis reduction rule is to limit the reduction to M's basis in the S share to the amount of net unrealized appreciation reflected in the share's basis immediately before the transfer.
- The rule also limits the reduction to M's basis in the S share to the portion of the share's basis that is attributable to investment adjustments made pursuant to the consolidated return regulations.

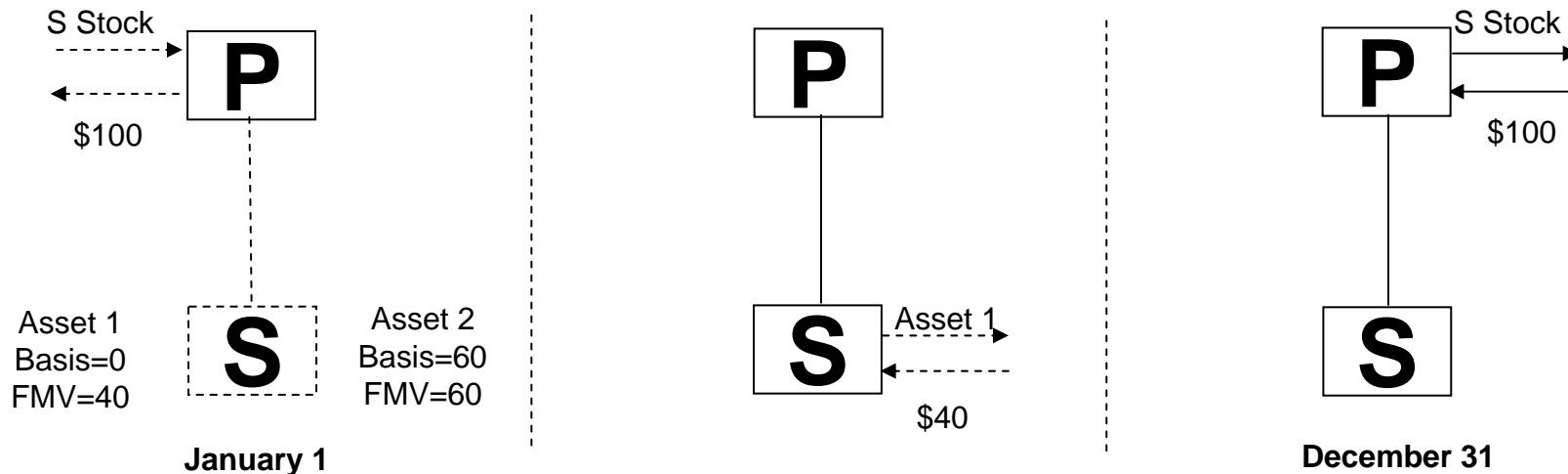
# Basis Reduction

- The basis reduction rules apply if, after basis redetermination, any member's transferred share is a loss share (even if the share only became a loss share as a result of the application of the basis redetermination rule). See Treas. Reg. § 1.1502-36(c)(2).
- The rule operates by reducing the basis of each transferred loss share (but not below value) by the lesser of the share's disconformity amount and its net PIA.
- A share's disconformity amount is the excess of its basis over its allocable portion of S's net inside attributes, determined at the time of the transfer. See Treas. Reg. § 1.1502-36(c)(4).
  - The term net inside attributes is defined as the sum of S's loss carryovers, deferred deductions, cash, and asset basis, reduced by S's liabilities. See Treas. Reg. § 1.1502-36(c)(5).
  - The final regulations modify the definition of loss carryover to include (and therefore not to be reduced by) the amount of losses waived under Treas. Reg. § 1.1502-32(b)(4). Treas. Reg. § 1.1502-36(f)(6).
  - If S holds stock of a lower-tier subsidiary (S1) that was not transferred in the transaction, S's net inside attribute amount is computed by treating S's basis in S1 stock as "tentatively reduced" by the lesser of the S1 share's net PIA and its disconformity amount.
    - When determining the disconformity amount of a share of subsidiary stock, no tentative reduction is made to the basis of lower-tier shares that were transferred in the transaction (without regard to whether S retained the shares after the transaction, such as when S1 is transferred because S and S1 cease to be members of the same group but S continues to hold S1 stock).
    - The tentative basis reduction rule does not apply to shares that are lower tier to any shares that were transferred in the transaction.
- A share's net PIA is computed as the greater of zero and the sum of all investment adjustments (excluding distributions) applied to the basis of the transferred loss share, including by reason of prior basis reallocations. Treas. Reg. § 1.1502-36(c)(3).

## Basis Reduction – Netting Rule

- For purposes of computing the basis reduction required under Treas. Reg. §1.1502-36(c), the basis of each transferred loss share of S stock is treated as reduced proportionately (as to loss) by the amount of income or gain taken into account by members with respect to transferred shares of S stock, provided that:
  - The shares are transferred in one transaction; and
  - The gain is taken into account as of the transaction. See Treas. Reg. §1.1502-36(c)(7).
- The netting rule is supplemented by the intercompany rule of Treas. Reg. § 1.1502-36(e)(3) so that intercompany gains or losses on S shares that are triggered by transfer of other S shares may be netted together. See Treas. Reg. § 1.1502-36(c)(7)(ii), Example (ii).

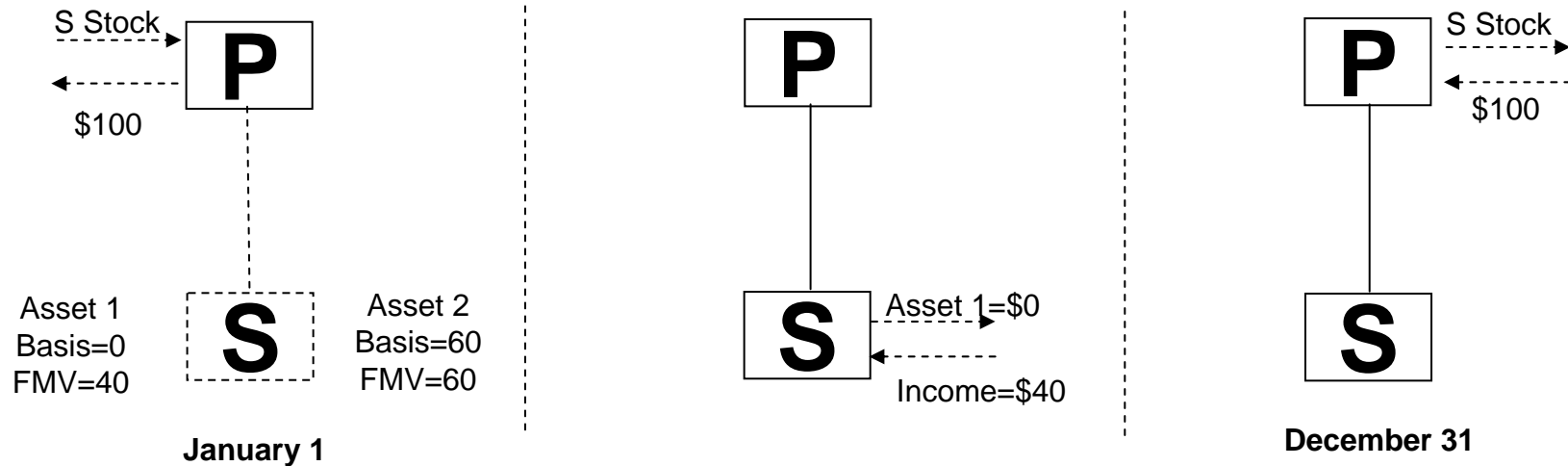
# Basis Reduction – Example 1



**Facts:** On January 1, year 1, P purchases the sole outstanding share of S stock for \$100. At that time, S owns two assets, Asset 1 with a basis of \$0 and a value of \$40, and Asset 2 with a basis and value of \$60. In year 1, S sells Asset 1 for \$40. On December 31, year 1, P sells its S share for \$100. P's basis in the S share is \$140 (P's original \$100 basis increased under § 1.1502-32 to reflect the \$40 gain recognized on the sale of Asset 1). P's sale of the S share is a transfer of a loss share.

**Result:** The share's net PIA is the \$40 adjustment for the gain on Asset 1. The share's disconformity amount is also \$40, the excess of its basis (\$140) over the allocable portion of S's net inside attribute amount (\$100). S's net inside attribute amount is the sum of S's money (\$40 from the sale of Asset 1) and S's basis in Asset 2 (\$60), or \$100. The basis in the share is reduced by the lesser of the net PIA or disconformity amount (\$40), from \$140 to \$100, immediately before the sale. See Treas. Reg. §1.1502-36(c)(8), Ex. 1(i).

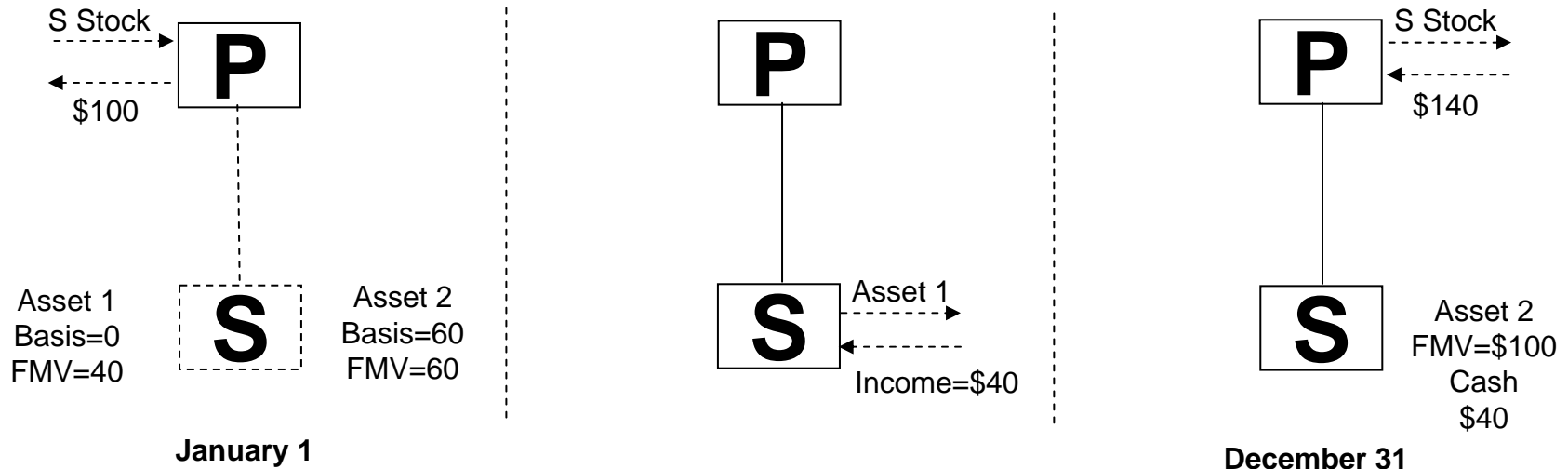
## Basis Reduction – Example 2



**Facts:** Same facts as Example 1, except that, instead of selling Asset 1, the value of Asset 1 is consumed in the production of \$40 of income in year 1 (reducing the value of Asset 1 to \$0).

**Result:** Because the net PIA includes items of income as well as items of gain, the result is the same as above. Treas. Reg. §1.1502-36(c)(8), Ex. 1(ii).

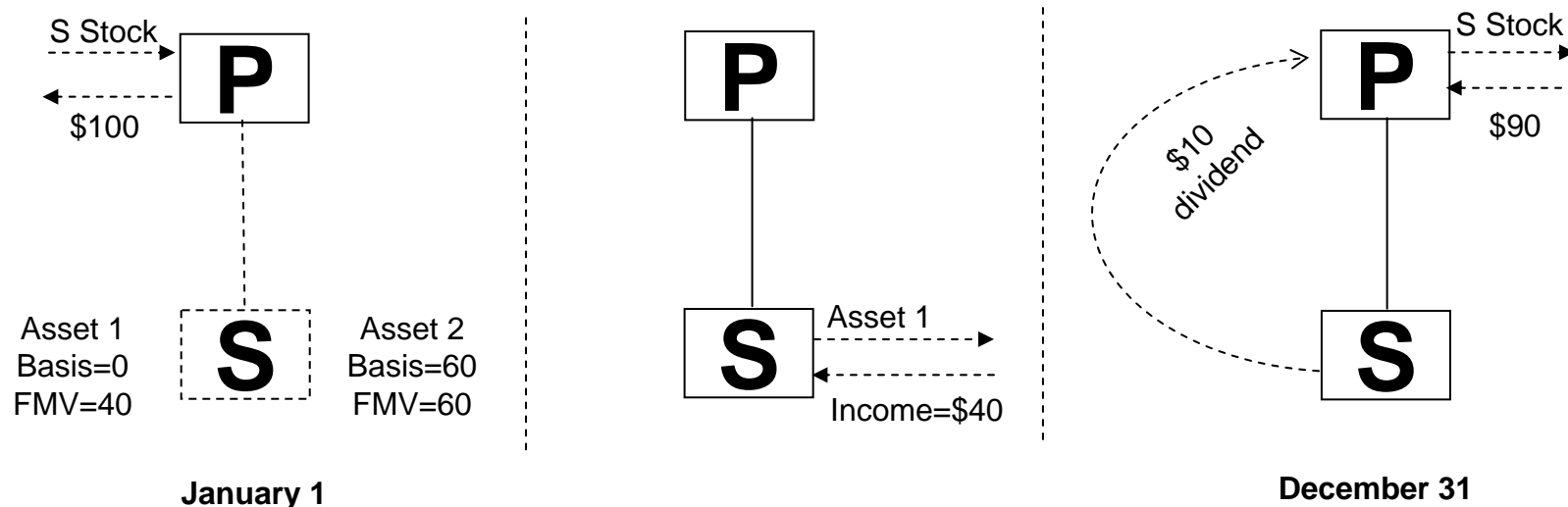
# Basis Reduction – Example 3



**Facts:** Same facts as in Example 1, except that, in addition, the value of Asset 2 increases to \$100 before the stock is sold. As a result, P sells the S share for \$140.

**Result:** Because P's sale of the S share is not a transfer of a loss share, the basis reduction rule does not apply to the transfer, notwithstanding that P's basis in the S share was increased by the gain recognized on Asset 1. See Treas. Reg. §1.1502-36(c)(8), Ex. 1(iii).

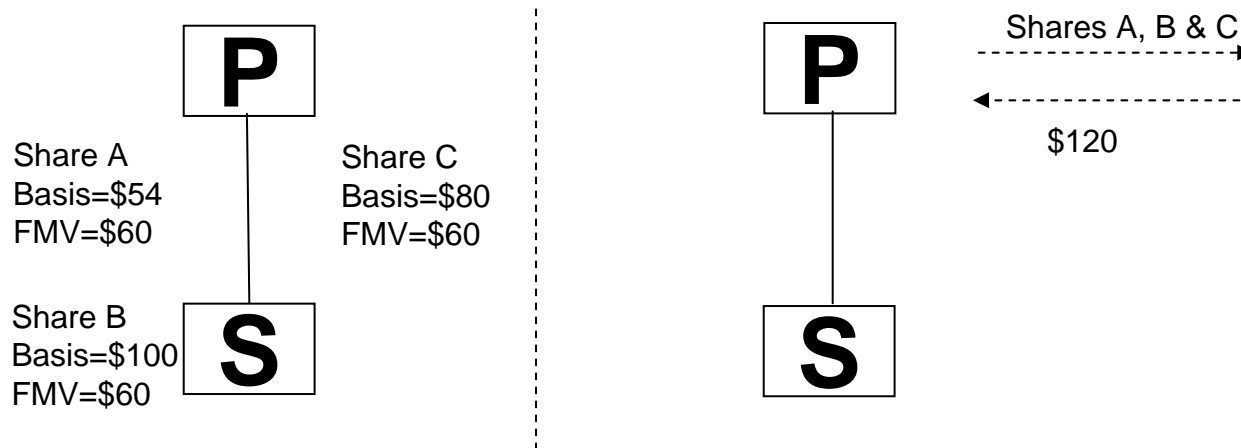
## Basis Reduction – Example 4



**Facts:** Same facts as Example 1, except that, in addition, S distributes a \$10 dividend before the end of year 1. As a result, the value of the share decreases and P sells the share for \$90. P's basis in the S share is \$130 (P's original \$100 basis increased by \$30 under §1.1502-32 (the net of the \$40 gain recognized on the sale of Asset 1 and the \$10 dividend declared and distributed)). P's sale of the S share is a loss share.

**Result:** The basis in the share is reduced by \$40, from \$130 to \$90, immediately before the sale. The lesser of the share's net positive adjustment (\$40) and its disconformity amount (\$40) is \$40. The share's disconformity amount is the excess of its basis (\$130) over its allocable portion of S's net inside attribute amount. S's net inside attribute amount is the sum of S's money (\$30, the \$40 sale proceeds minus the \$10 distribution) and S's basis in Asset 2 (\$60), or \$90. See Treas. Reg. §1.1502-36(c)(8), Ex. 1(iv).

# Basis Reduction – Example 5



**Facts:** P owns the only three outstanding shares of S common stock. Share A has a basis of \$54, Share B has a basis of \$100, and Share C has a basis of \$80. In the same transaction, P sells the three S shares to X for \$60 each. P realizes a gain of \$6 on Share A, a loss of \$40 on Share B, and a loss of \$20 on Share C. P's sale of Shares B & C are transfers of loss shares.

**Result:** P treats its bases in Shares B & C as reduced proportionately by the \$6 gain taken into account with respect to Share A. Thus, \$4 of gain ( $\$40/\$60 \times \$6$ ) is allocated to Share B, and \$2 of gain ( $\$20/\$60 \times \$6$ ) is allocated to share C. As a result, P computes its basis reduction by treating its basis in Share B as \$94 (\$100 less \$6) and its basis in Share C as \$78 (\$80 less \$2). See Treas. Reg. § 1.1502-36(c)(7).

What if P sold Share A to another member?

## Attribute Reduction

- The “attribute reduction” rule reduces S’s attributes to the extent they duplicate a net loss on shares of S stock transferred by members in a single transaction.
- The rule furthers single entity principles by preventing S from using deductions and losses to the extent that the group or its members (including former members) have either used, or preserved for later use, a corresponding loss in S shares.
- The rule applies without regard to whether S ceases to be a member after the transfer of its shares.

# Attribute Reduction

- If any transferred share remains a loss share after application of the basis reduction rule, the subsidiary's attributes (including the consolidated attributes attributable to the subsidiary) are subject to reduction. See Treas. Reg. § 1.1502-36(d)(2).
- S's attributes are reduced by the "attribute reduction amount," which is computed as the lesser of the net stock loss and the aggregate inside loss. See Treas. Reg. § 1.1502-36(d)(3).
- Net stock loss is the excess of the sum of the bases (after application of the basis reduction rule) of all S shares transferred by members in the same transaction over the value of such shares.
- S's aggregate inside loss is the excess of S's net inside attributes over the value of all of the S shares.
  - Net inside attributes generally has the same meaning as in the basis reduction rule, subject to special rules for lower-tier subsidiaries.
  - In addition, unlike in the basis reduction rule, losses waived under Treas. Reg. § 1.1502-32(b)(4) are not included. See Treas. Reg. § 1.1502-46(f)(6).

## Attribute Reduction – 5 Percent Exception

- Under the final regulations, the attribute reduction rule does not apply to the transfer if the total attribute reduction amount is less than five percent of the aggregate value of the subsidiary shares that are transferred by members in the transaction.
- However, the final regulations allow taxpayers to elect to apply the attribute reduction rule, notwithstanding that their total attribute reduction amount is less than five percent of the aggregate value of the transferred shares.
  - If this election is made, the attribute reduction rule will apply with respect to the entire attribute reduction amount determined in the transaction, and thus applies with respect to all members transferring shares, and all shares transferred, in the transaction.

# Attribute Reduction

- Under the final regulations, S's attributes available for reduction are (i) capital loss carryovers (Category A); (ii) net operating loss carryovers (Category B); (iii) deferred deductions (Category C); and (iv) basis of assets other than assets identified in § 1.338-6(b)(1) (i.e., cash and cash equivalents) (Category D). Treas. Reg. § 1.1502-36(d)(4).
- Categories A, B & C – S's attribute reduction amount is first allocated and applied to reduce the attributes in Category A, Category B, and Category C.
  - Unlike in the proposed regulations, if S's attribute reduction amount is less than S's total attributes in Category A, B, and C, P may specify the allocation of S's attribute reduction among such attributes.
  - If P does not specify, the default order is first to reduce capital loss carryovers, then to reduce NOL carryovers, and then to reduce deferred deductions. This represents a change from the proposed regulations, which reduced NOLs before capital losses.
  - Regardless of the order in which the attributes in these categories are reduced, they are reduced in full before any reduction is made to asset basis.

# Attribute Reduction

- Category D – Any attribute reduction amount remaining after reducing categories A, B, and C reduce asset basis in the reverse order of the residual method of allocating consideration under section 1060 (except Category I assets, which are cash and cash equivalents).
  - The final regulations delete the category of publicly traded assets contained in the proposed regulations.
- Excess Attribute Reduction Amount – A special rule applies if the attribute reduction amount exceeds the attributes available for reduction and the subsidiary has a liability that has not been taken into account.
  - In this case, to the extent of S's liabilities not taken into account before the transfer, the excess attribute reduction amount is suspended and applied to prevent the deduction or capitalization of payments later made by S or another person with respect to such liabilities. See Treas. Reg. § 1.1502-36(d)(4)(ii)(c)(1).
  - Any attribute reduction amount in excess of this suspended amount is disregarded and has no further effect. Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(2).

# Attribute Reduction – Lower-Tier Subsidiaries

- When S holds stock of lower-tier subsidiaries, the attribute reduction amount is computed in a manner that identifies the maximum potential amount of loss duplication and attributes are reduced to that extent.
- The computation of S's attribution reduction amount is determined by applying the following rules --
  - All of S's shares of S1 stock are treated as a single share (generally referred to as the S1 stock).
  - S's basis in S1 stock is its "deemed basis" in that stock. The deemed basis is equal to the greater of S's actual aggregate basis in the S1 shares (adjusted for any gain or loss recognized on a transfer of the S1 shares) and the S1 shares' allocable portion of S1's net inside attributes.
  - If S owns (directly or indirectly) stock of subsidiaries in multiple tiers, S's deemed basis is determined first with respect to lowest-tier subsidiaries.

See Treas. Reg. § 1.1502-36(d)(5)(i).

## Attribute Reduction – Lower-Tier Subsidiaries

- S's attribute reduction amount is allocated between each deemed single share of lower-tier subsidiary stock and S's other Category D assets.
- For this purpose, S's basis in each deemed single share of subsidiary stock is equal to the deemed basis in the S1 stock reduced by --
  - The value of S's transferred shares of S1 stock;
  - The nontransferred S1 shares' allocable portion of the excess of S1's non-loss assets over S1's liabilities; and
  - The nontransferred lower-tier subsidiary shares' allocable portions of lower-tier non-loss assets (net of liabilities).

See Treas. Reg. § 1.1502-36(d)(5)(ii).

# Attribute Reduction – Lower-Tier Subsidiaries

- The attribute reduction amount allocated to S's S1 stock is generally apportioned among, and applied to reduce S's bases in S's individual S1 shares such that –
  - No allocated amount is apportioned to a share of transferred S1 stock if gain is recognized on its transfer (recognition transfer);
  - The allocated amount is apportioned among all of S's other shares of S1 stock in a manner that first reduces loss in and disparity among S's basis in loss shares of S1 preferred stock, and then reduces the disparity among S's basis in S1 common stock (other than those transferred in a recognition transfer);
  - The allocated amount that is apportioned to an S1 share is applied to reduce the basis of that share if the share is either a preferred share or a common share that is transferred other than in a recognition transfer; and
  - The allocated amount that is apportioned to S1 shares is applied to reduce the basis of such shares without regard to value if such shares are common shares that are not transferred in the transaction.

See Treas. Reg. § 1.1502-36(d)(5)(iii).

- Any portion of S's attribute reduction amount that is allocated to S1 stock, whether or not it is apportioned or applied to reduce the basis of any S1 shares, tiers down and becomes an attribute reduction amount of S1. Treas. Reg. § 1.1502-36(d)(5)(iv).

# Attribute Reduction – Lower-Tier Subsidiaries

- Special rules apply to prevent over-reduction in lower-tier attributes or lower-tier stock basis.
  - Conforming Limitation – The tier-down attribute reduction to S1's attributes is limited to the excess of S1's net inside attribute amount allocable to all S1 shares held by members (whether or not transferred), over the sum of:
    - Any direct S1 attribute reduction amount;
    - The value of all S1 shares transferred by members in recognition transfers;
    - The sum of all members' bases in any shares of S1 stock transferred other than in a recognition transfer, reduced by any direct S1 attribute reduction amount computed with respect to the transfer of such S1 shares; and
    - The sum of all members' bases in any nontransferred shares of S1 stock held as of the transaction.

Treas. Reg. § 1.1502-36(d)(5)(v)(B).

- Stock Basis Restoration – Stock adjustments may be reversed to the extent necessary to restore members' bases in subsidiary stock to conform the basis of each member's share of subsidiary stock to the share's allocable portion of the subsidiary's net inside attribute amount. See Treas. Reg. § 1.1502-36(d)(5)(iv).

# Attribute Reduction – Election To Prevent Attribute Reduction

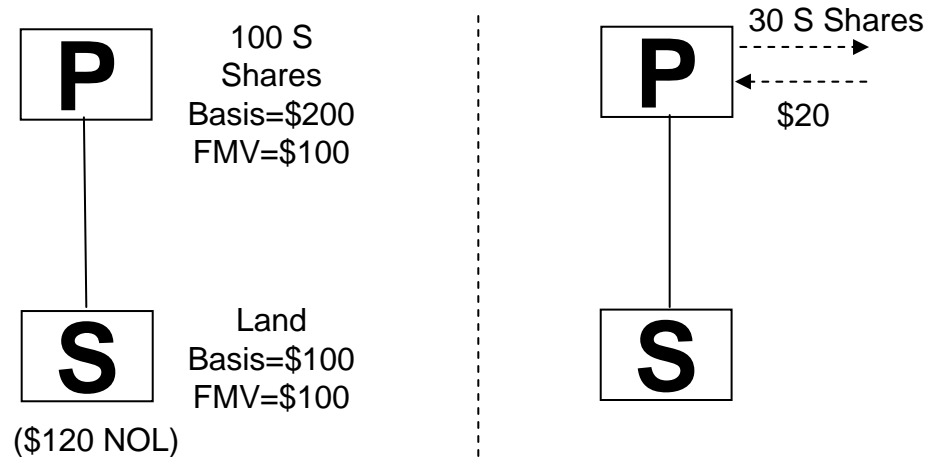
- The attribute reduction rule contains an elective provision under which groups can reduce the potential for loss duplication and thereby reduce or completely avoid attribute reduction. See Treas. Reg. § 1.1502-36(d)(6).
- Under this election, the common parent of a group can elect to reduce stock basis, reattribute attributes, or do some combination of basis reduction and attribute reattribution in order to prevent the reduction of attributes otherwise required under the proposed rules.
- The election is given effect immediately before the application of the attribute reduction rule.
- To the extent loss duplication has not been eliminated by the election, the attribute reduction rules apply in their general manner.
- Protective Election – Although the election is irrevocable, it has no effect if there is ultimately no attribute reduction amount, or the attribute reduction amount is less than the amount specified in the election.
- Reattribution of Attributes
  - The election to reattribute attributes can only be made if S ceases to be a member of the P group as a result of the transfer.
  - Similar to the reduction of attributes, P may specify the attributes in Categories A, B, & C to be reattributed.
  - P may only reattribute attributes of lower-tier subsidiaries that would otherwise be reduced as a result of tier-down attribute reduction to the extent that the reattribution does not create an excess loss account in the stock of any lower-tier subsidiary.

# Attribute Reduction – Election

## To Prevent Attribute Reduction (cont.)

- Deemed Stock Basis Election – If there is a net stock loss after taking into account any election under –36(d)(6), and such loss would otherwise be permanently disallowed (e.g., under Section 311(a)), P will be deemed to have made a stock basis reduction election equal to such loss.
- Special Rule in case of Worthlessness or Deconsolidation – Category A, B, & C attributes not otherwise reduced or reattributed under -36(d), and any credit carryover attributable to S, are eliminated immediately before the following transfers:
  - P treats the S share as worthless under section 165, if P recognizes a loss or deduction on the share and S remains a member of the group; or
  - S ceases to be a member and does not become a nonmember, if P recognizes a loss or deduction on the share (e.g., taxable liquidation).

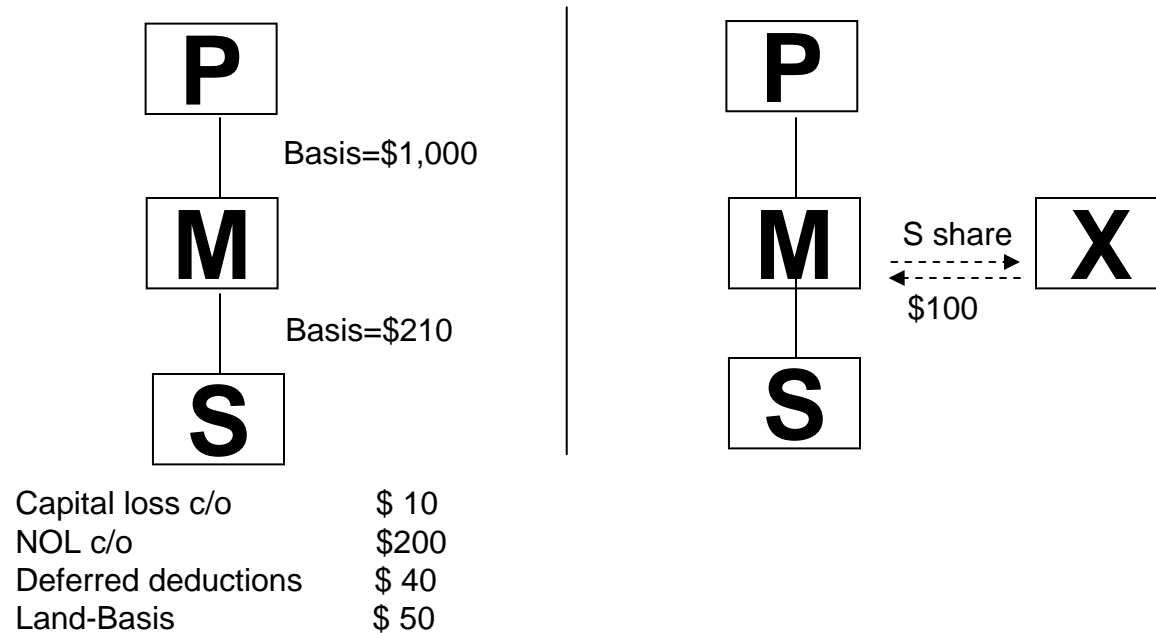
# Attribution Reduction – Example 1



**Facts:** P owns all 100 of the outstanding shares of S stock with a basis of \$2 per share. S owns land with a basis of \$100, has a \$120 NOL carryover, and has no liabilities. Each share has a value of \$1. P sells 30 of the S shares to X for \$30. As a result of the sale, P and S cease to be members of the same group, so P is treated as transferring all 100 shares. P's transfer of the S shares is a transfer of loss shares.

**Result:** The attribute reduction amount is the lesser of the net stock loss (\$100) and the aggregate inside loss (\$120), or \$100. S's \$100 attribute reduction amount is allocated and applied to reduce S's \$120 loss carryover to \$20. See Treas. Reg. § 1.1502-36(d)(7), Ex. 1(i).

## Attribution Reduction – Example 2



**Facts:** P owns the sole outstanding share of M, with a basis of \$1,000 and M owns the sole outstanding share of S, with a basis of \$210. M sells the S share for \$100. At the time of the sale, S has the attributes of \$300: \$10 capital loss carryover, \$200 NOL carryover, \$40 deferred deductions, and land with a basis of \$50.

**Result:** S's attribute reduction amount is the lesser of the net stock loss (\$110) and the aggregate inside loss (\$200, or \$300 inside attribute amount less \$100 stock value), or \$110. The attribute reduction amount is allocated and applied to reduce S's attributes as follows: \$10 to the capital loss carryovers and the remaining \$100 to the NOL carryovers. See Treas. Reg. § 1.1502-36(d)(7), Ex. 2.

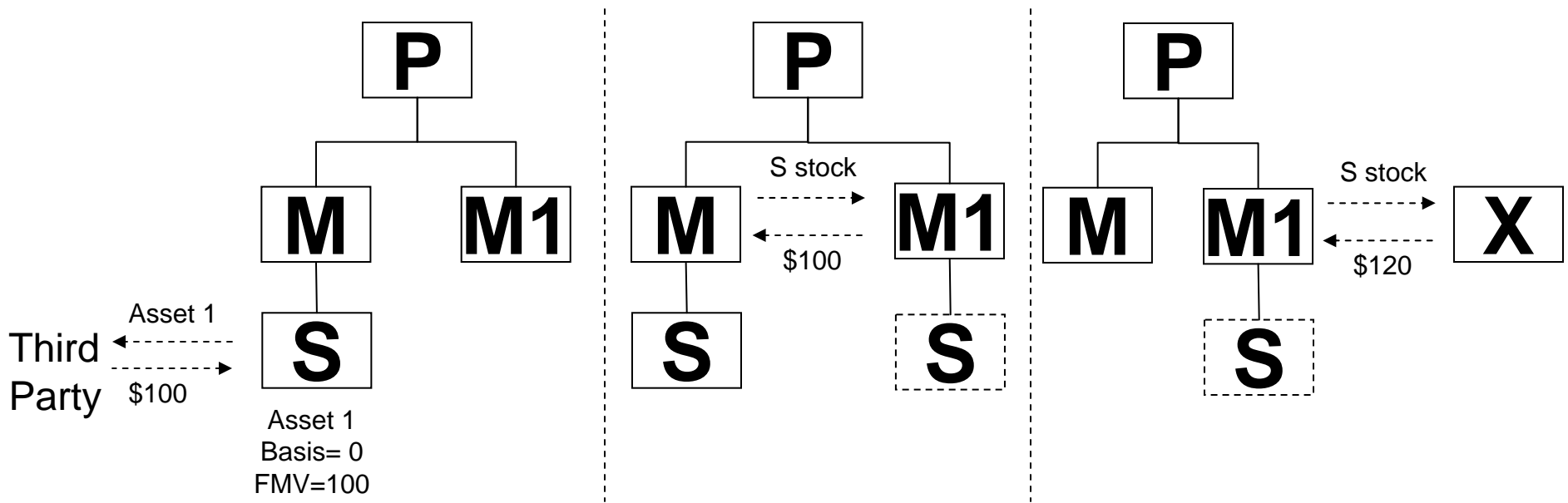
P could elect, however, to reduce the deferred deductions and NOL carryovers and preserve the capital loss carryovers. See *id.*, Ex. 2(ii).

# Intercompany Transfers

# Intercompany Transfers

- In the case of a transfer of subsidiary stock to another member in an intercompany transaction in which gain or loss is deferred under Treas. Reg. § 1.1502-13, the unified loss rules apply at the time the intercompany item is taken into account under Treas. Reg. § 1.1502-13. Treas. Reg. § 1.1502-36(e)(3)(i).
  - This is similar to the prior loss disallowance rules, except that the prior loss disallowance rules applied when the loss was taken into account under any deferral rule (e.g., section 267(f)). See Prior Treas. Reg. § 1.337(d)-2(a)(3) (incorporating Prior Treas. Reg. § 1.1502-20(a)(3)).
- In applying the unified loss rules, all transferor-members are treated as divisions of a single corporation, and appropriate adjustments are made to the intercompany items, stock basis, or attributes to further the purposes of Treas. Reg. §§ 1.1502-36 and 1.1502-13.
- The regulations permit taxpayers to elect to apply this rule to intercompany transactions that occur before the effective date but are triggered after the effective date. Treas. Reg. § 1.1502-36(3)(3)(ii).

# Intercompany Transfers – Example 1

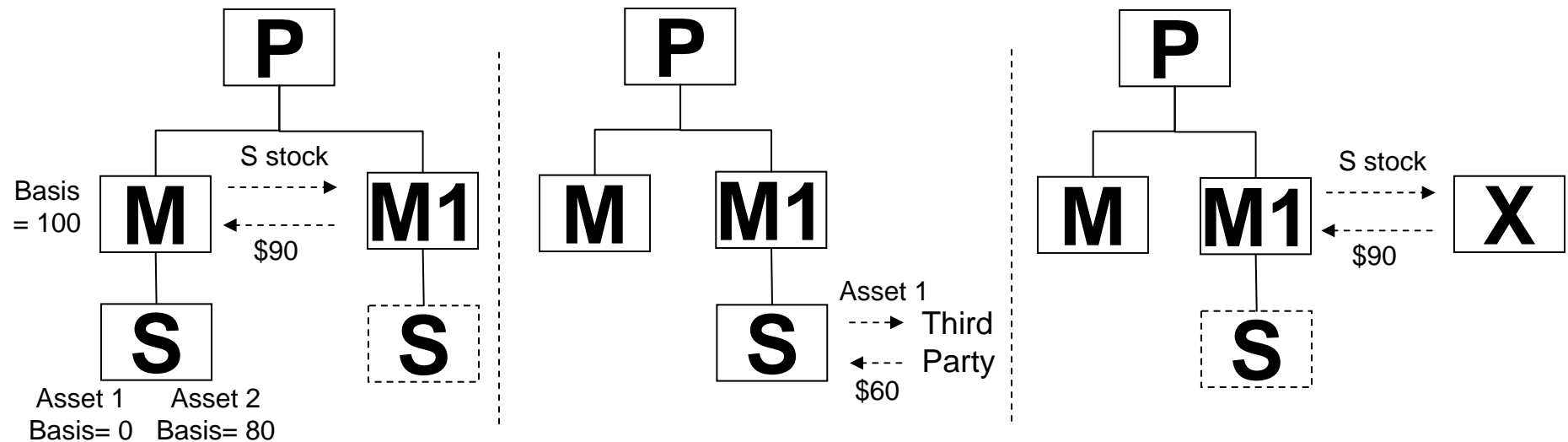


**Facts:** M owns the sole outstanding share of stock of S with a basis of \$100. S's sole asset has a basis of \$0. S sells its asset for \$100 and recognizes a \$100 gain that increases M's basis in its S share under §1.1502-32 to \$200. M sells the S share to M1 for \$100 and recognizes a \$100 intercompany loss. Later, M1 sells the S share to X, an unrelated person, for \$120.

**Result:** If M and M1 were divisions of a single corporation, the S share's basis would be \$200 (\$100 increased by \$100 for the gain recognized on the sale of the asset) and the group would recognize an \$80 loss on the sale of the share. Thus, the sale is subject to the unified loss rule (to the extent of that \$80). Under the basis reduction rule, the basis in the S share would be reduced, but not below its \$120 value, by the lesser of the \$100 disconformity amount and the \$100 net positive adjustment that was applied to the share when held by M. Accordingly, the basis in the S share would be reduced by \$80, to \$120. Because the positive adjustment was applied to the share when held by M, M's intercompany item is adjusted to reflect what it would have been had M's basis in its S share been reduced by \$80 immediately before its sale to M1. Thus, M's intercompany loss is reduced to \$20 and M takes this loss into account, and M1 recognizes a gain of \$20. See Treas. Reg. § 1.1502-36(e)(3)(iii), Ex. 2.

What if X were a member of P's controlled group but not P's consolidated group?

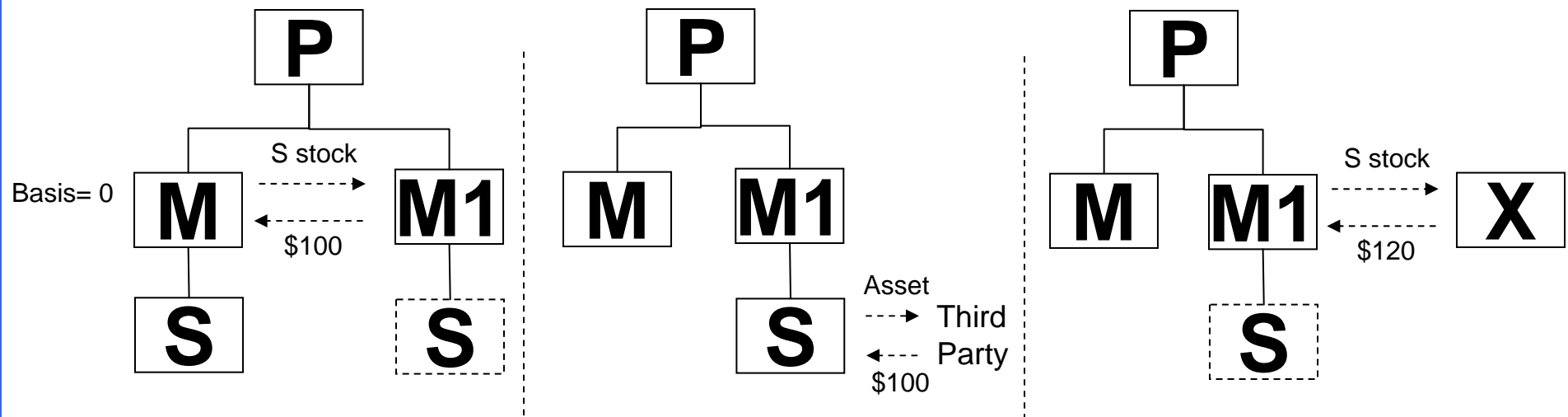
# Intercompany Transfers – Example 2



**Facts:** M owns the sole outstanding share of stock of S with a basis of \$100. S has two assets, Asset 1 with a basis of \$0 and Asset 2 with a basis of \$80. M sells the S share to M1 for \$90 and recognizes a \$10 intercompany loss. While owned by M1, S sells Asset 1 for \$60, recognizing a \$60 gain that increases M1's basis in the S share under §1.1502-32 to \$150. Later, M1 sells the S share to X for \$90.

**Result:** If M and M1 were divisions of a single corporation, the S share's basis would be \$160 (\$100 increased by \$60 for the gain recognized on the sale of Asset 1) and the group would recognize a \$70 loss on the sale of the share. Thus, the sale is subject to the unified loss rule (to the extent of \$70). Under the basis reduction rule, the basis in the S share would be reduced, but not below its \$90 value, by the lesser of the \$20 disconformity amount (\$160 stock basis over \$140 net inside attribute amount) and the \$60 net positive adjustment that was applied to the share when held by M1. Accordingly, the basis in the S share would be reduced by \$20, to \$140. Because the S share would still be a loss share, the attribute reduction rule would apply. S would have an attribute reduction amount of \$50, the lesser of the \$50 net stock loss (\$140 basis over \$90 value) and S's \$50 aggregate inside loss (the excess of the sum of S's \$80 basis in Asset 2 and S's \$60 cash from the sale of Asset 1, over the \$90 value of the S share). The adjustments required are applied as follows: because the positive adjustment was applied to the share when held by M1, the \$20 basis reduction required under the basis reduction rule is applied to M1's basis in its S share immediately before its sale to X, reducing it from \$150 to \$130. Pursuant to the attribute reduction rule, S's basis in Asset 2 is reduced by \$50, from \$80 to \$30. M takes its \$10 intercompany stock loss into account and M1 recognizes a loss of \$40. See Treas. Reg. § 1.1502-36(e)(3)(iii), Ex. 5.

# Intercompany Transfers – Example 3



**Facts:** M owns the sole outstanding share of stock of S with a basis of \$0. S's sole asset has a basis of \$0. M sells the S share to M1 for \$100 and recognizes a \$100 intercompany gain. While owned by M1, S sells its asset for \$100, recognizing a \$100 gain that increases M1's basis in the S share under §1.1502-32 to \$200. Later, M1 sells the S share to X for \$120.

**Result:** If M and M1 were divisions of a single corporation, the S share's basis would be \$100 (\$0 increased by \$100 for the gain recognized on the sale of the asset) and the group would recognize a \$20 gain on the sale of the share. Thus, the sale would not be a transfer of a loss share and the unified loss rule would not apply to the transfer. Accordingly, M takes its \$100 intercompany stock gain into account, and M1 recognizes an \$80 loss. See Treas. Reg. § 1.1502-36(e)(3)(iii), Ex. 3.

# Miscellaneous Considerations Under -36

# Taxpayer Elections Under -36

- The unified loss rule allows taxpayers to make several different elections:
  - Election to allocate attribute reduction amount. Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(i).
  - Election to reduce selling member's basis in sold subsidiary. Treas. Reg. § 1.1502-36(d)(6)(i)(A).
  - Election to reattribute attributes of sold subsidiary. Treas. Reg. § 1.1502-36(d)(6)(i)(B).
  - Elections with respect to tier-down of attribution reduction amount to lower-tier subsidiaries. Treas. Reg. § 1.1502-36(d)(5)(v)(B), (d)(5)(vi)(B).
  - Election to apply the attribute reduction amount even if the de minimis rule applies. Treas. Reg. § 1.1502-36(d)(2)(ii).
  - Election to apply the basis redetermination rule even if an exception applies. Treas. Reg. § 1.1502-36(b)(1)(ii)(B).

## Taxpayer Elections Under -36

- All elections must be made in the form of a statement included with the group's timely filed return (original or amended, if filed by the due date for the return, including extensions) for the taxable year of the transfer of the subsidiary's stock to which the election relates or, in the case of an intercompany transfer, the year in which the intercompany item from the transfer is taken into account. Treas. Reg. § 1.1502-36(e)(5).
- 9100 relief for late elections may be granted only when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that (i) the taxpayer acted reasonably and in good faith, and (ii) the grant of relief will not prejudice the interests of the Government.
  - The IRS will ordinarily not grant 9100 relief if the facts have changed since the due date for the election and the election is advantageous to the taxpayer. Treas. Reg. § 301.9901-3(b)(3)(iii).

## Considerations for the Buyer

- If the subsidiary's attributes may be reduced under the attribute reduction rule, a buyer needs to consider negotiating an election on the part of the selling group to reduce basis under Treas. Reg. § 1.1502-36(d)(6)(i)(A).
- A buyer must also obtain the stock basis history of any lower-tier subsidiaries of the target subsidiary in order to apply the unified loss rule to any future sale of the lower-tier subsidiaries.

# Section 362(e)

## Section 362(e)(2)

- In general, under section 362(e)(2), a transfer of loss property pursuant to a section 351 transaction will result in a decrease of the transferee's aggregate basis in the transferred assets.
- The transferor may elect to reduce its stock basis in the transferee in lieu of the reduction in the transferee's aggregate basis in the transferred assets. Section 362(e)(2)(C).
- The proposed Unified Loss Rule included rules for suspending the application of section 362(e)(2) in the case of transactions between members of a consolidated group so long as the duplicated loss can be eliminated under the consolidated return provisions.
- The IRS and Treasury concluded that the application of section 362(e)(2) in the consolidated return context was burdensome and largely unnecessary in light of the investment adjustment and Unified Loss Rule. Therefore, the IRS and Treasury decided to eliminate the application of section 362(e)(2) to intercompany transactions.
- Accordingly, the final regulations add a new paragraph in Treas. Reg. § 1.1502-80, which makes section 362(e)(2) generally inapplicable to intercompany transactions, and they withdraw proposed Treas. Reg. § 1.1502-13(e)(4), which suspended the application of section 362(e)(2).

# Anti-Abuse Rule

# Anti-Abuse Rule

- If a taxpayer acts with a view to avoid the purposes of Treas. Reg. §1.1502-36, or to apply the rules of Treas. Reg. §1.1502-36 to avoid the purposes of any other rule of law, appropriate adjustments will be made to carry out the purposes of Treas. Reg. §1.1502-36 or such other rule of law. See Treas. Reg. §1.1502-36(g).
- Examples include:
  - Purchase of corporation with losses with a view to liquidate the corporation;
  - Contribution of asset to a partnership with a view to preventing a reduction in the basis of such asset;
  - Converting cash to an intercompany receivable with a view to preventing a reduction in the basis of another asset; or
  - Stuffing a gain asset.