

TAX EXECUTIVES INSTITUTE CINCINNATI/COLUMBUS CHAPTER

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Current Developments in Consolidated Returns

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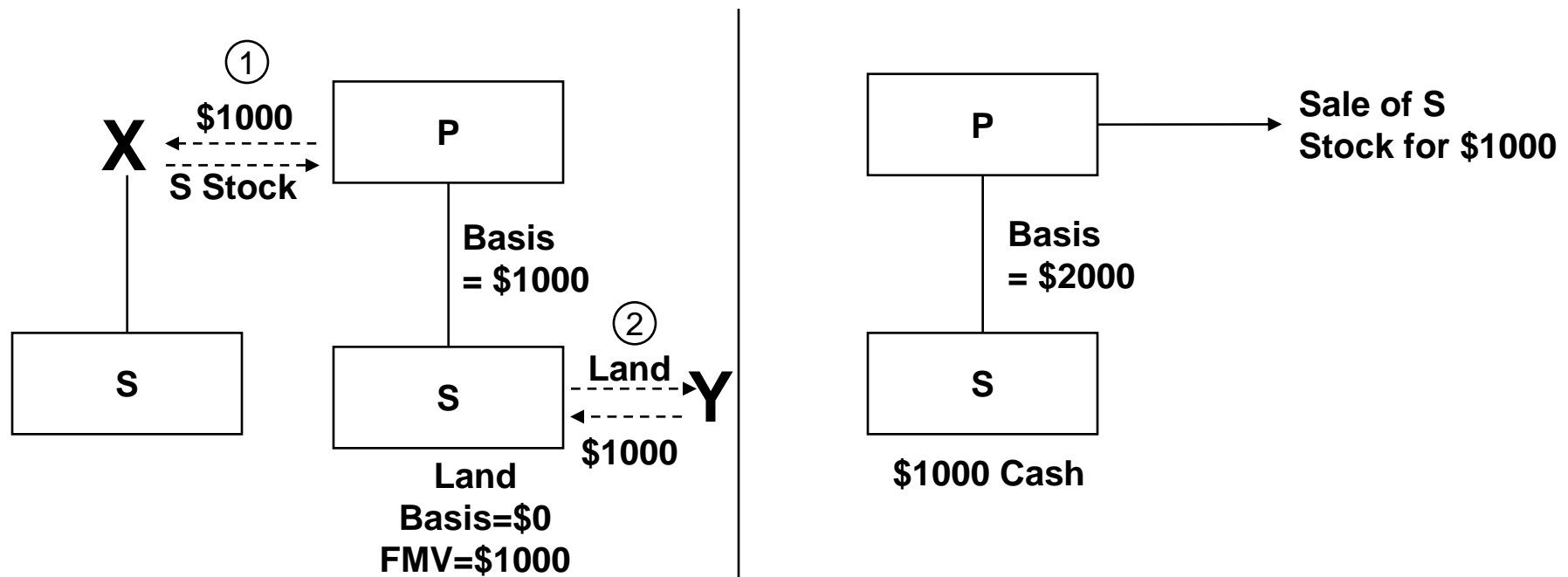
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Final Unified Loss Rule

Treas. Reg. § 1.1502-36

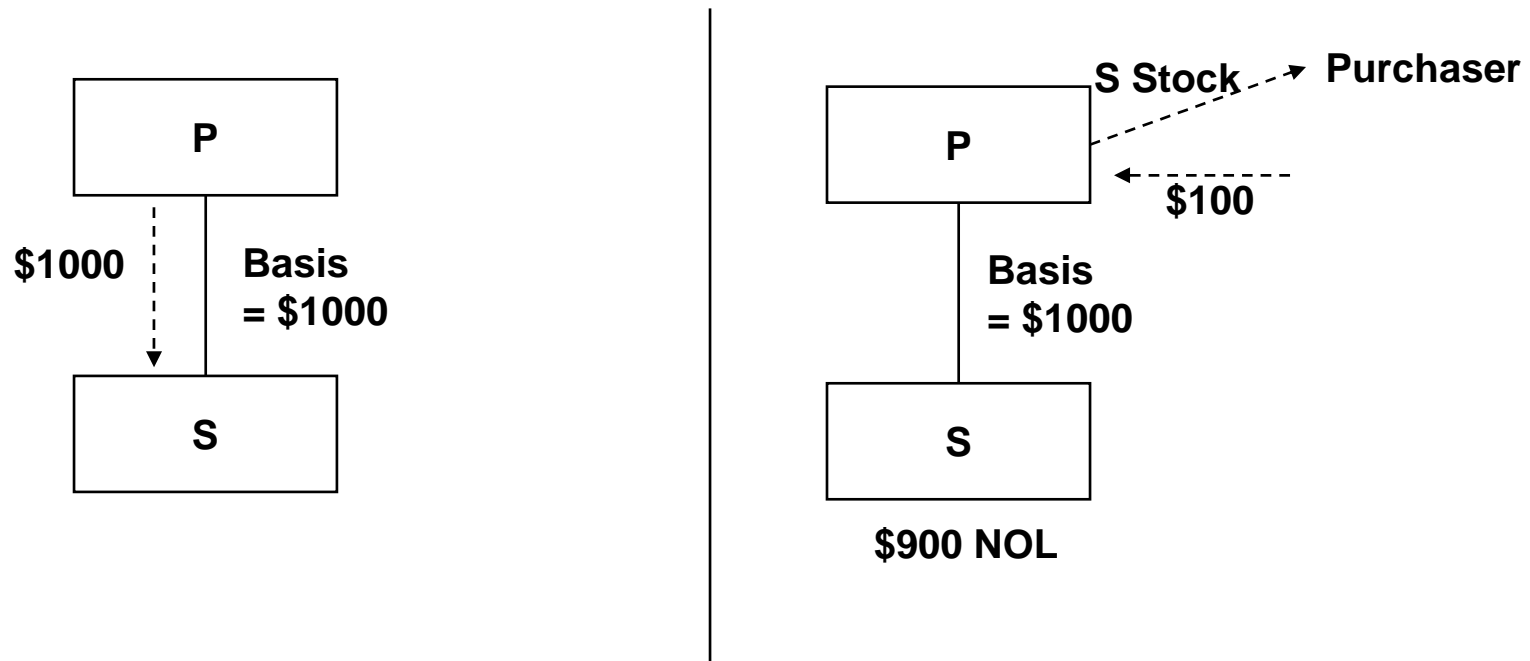
Background

“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

- 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

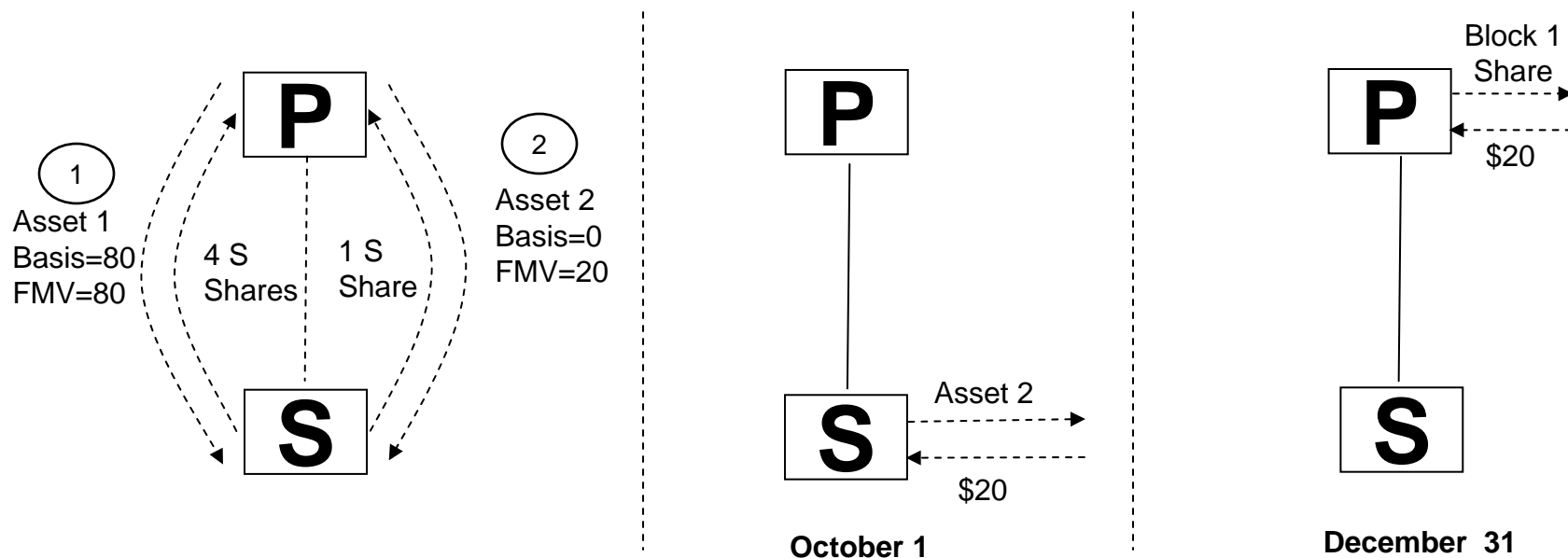
- The basis redetermination rule applies when a member transfers a share of subsidiary (S) stock and, after the application of all other provisions of the Code and regulations, the share is a loss share. It subjects all members' shares of S stock to redetermination. See Treas. Reg. §1.1502-36(b)(2).
- 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.

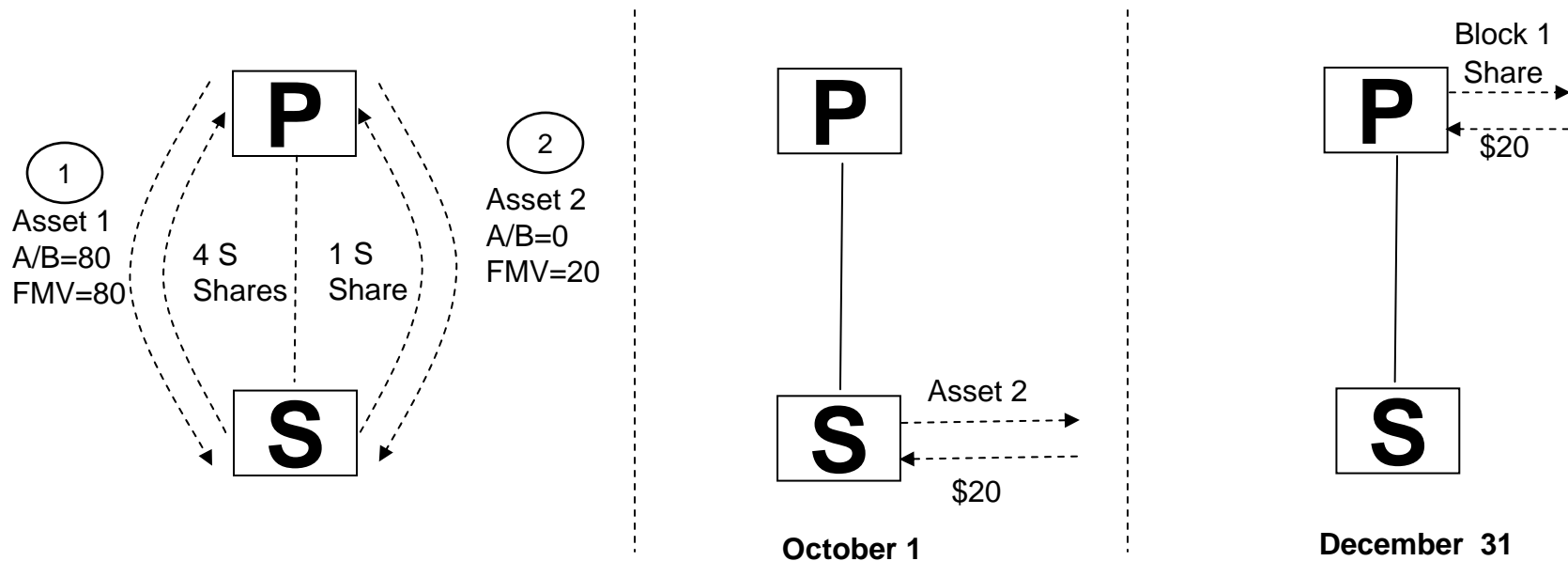
See Treas. Reg. § 1.1502-36(b)(2)(iii).
- The rule contains two safe harbors that excuse taxpayers from reallocating basis in situations in which redetermination is deemed unnecessary --
 - When members' bases in shares of S common stock are equal (that is, there is no disparity) and members' basis in 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



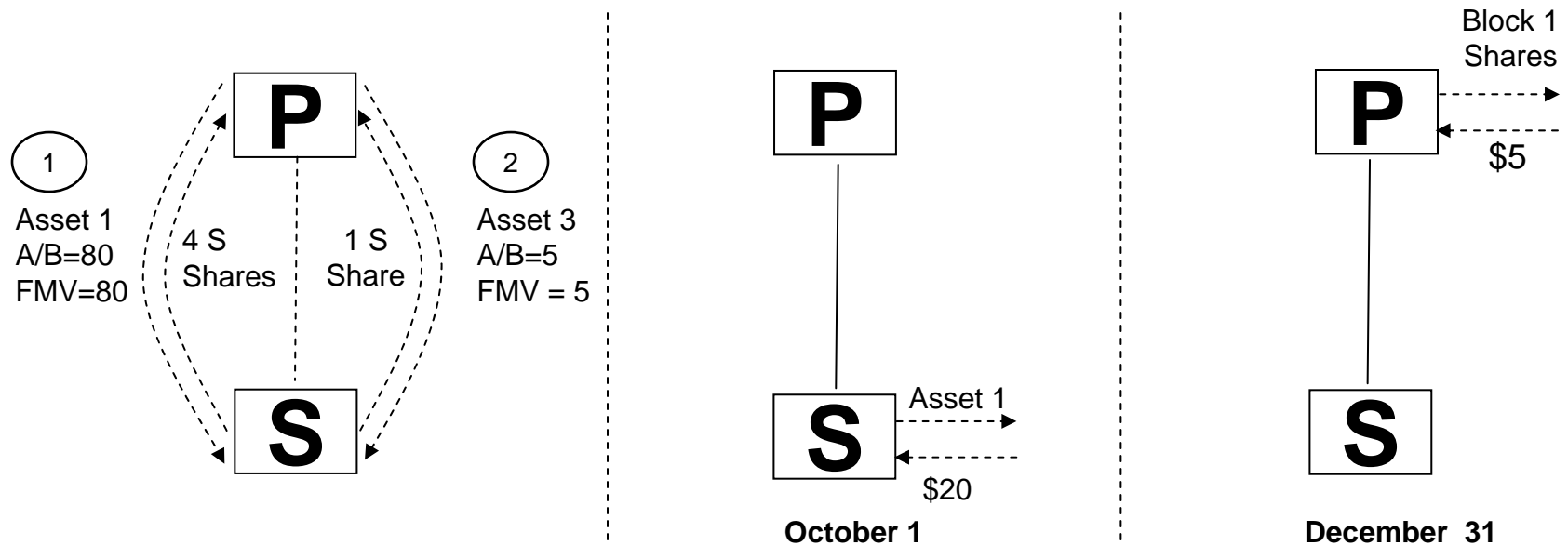
Facts: P owns two assets, Asset 1 and Asset 2. On January 1, year 1, P receives four shares of S common stock (the Block 1 shares) in exchange for Asset 1, which has a basis and value of \$80. The exchange qualifies under section 351 and, therefore, under section 358, P's aggregate basis in the Block 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.)



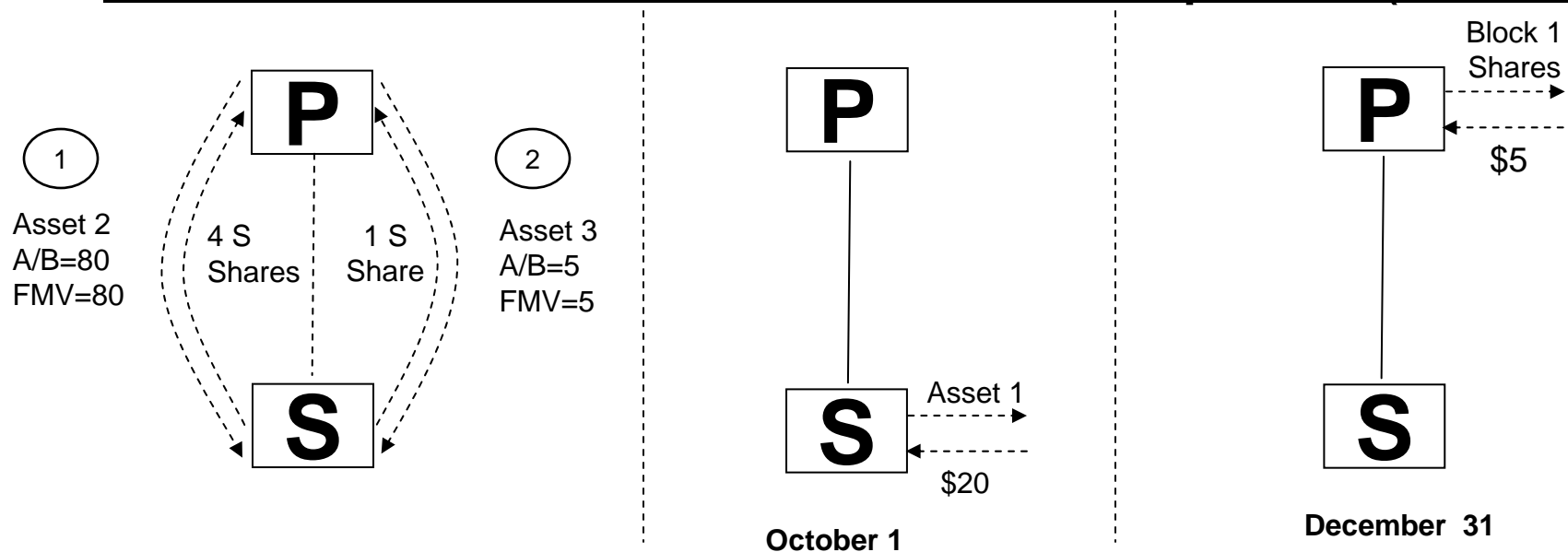
Result: P's basis in the transferred loss share is reduced, but not below value, by removing PIAs applied to the basis of the share. Accordingly, P's basis in the transferred Block 1 share is reduced by \$4 (the amount of the PIA applied to the share), from \$24 to \$20. No further reduction to the basis 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

- 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.

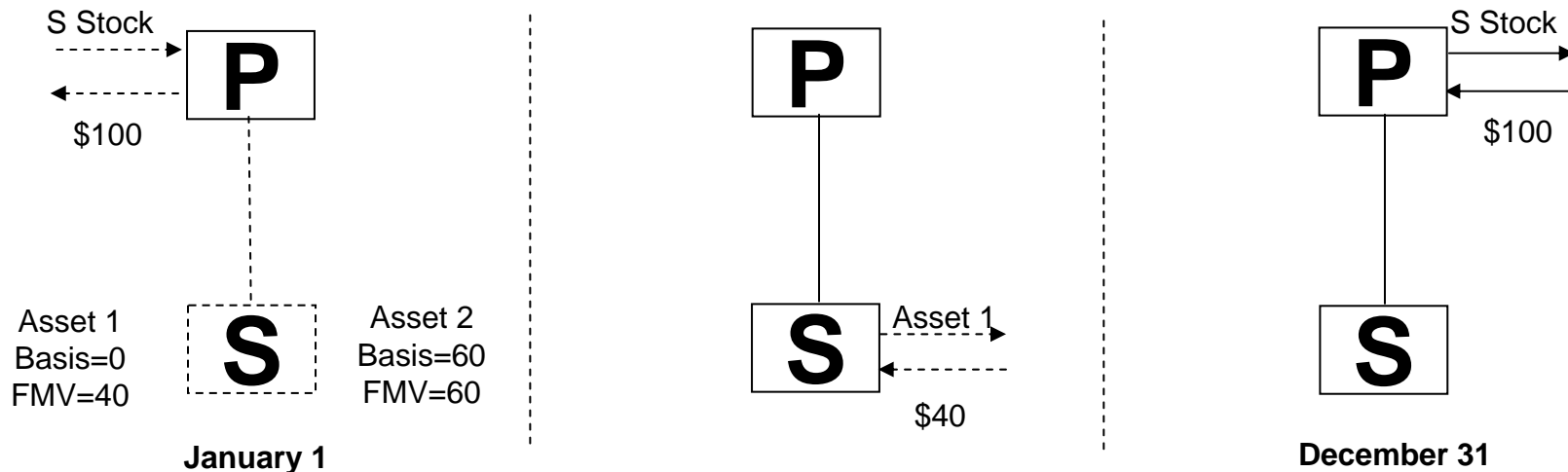
Basis Reduction

- 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).

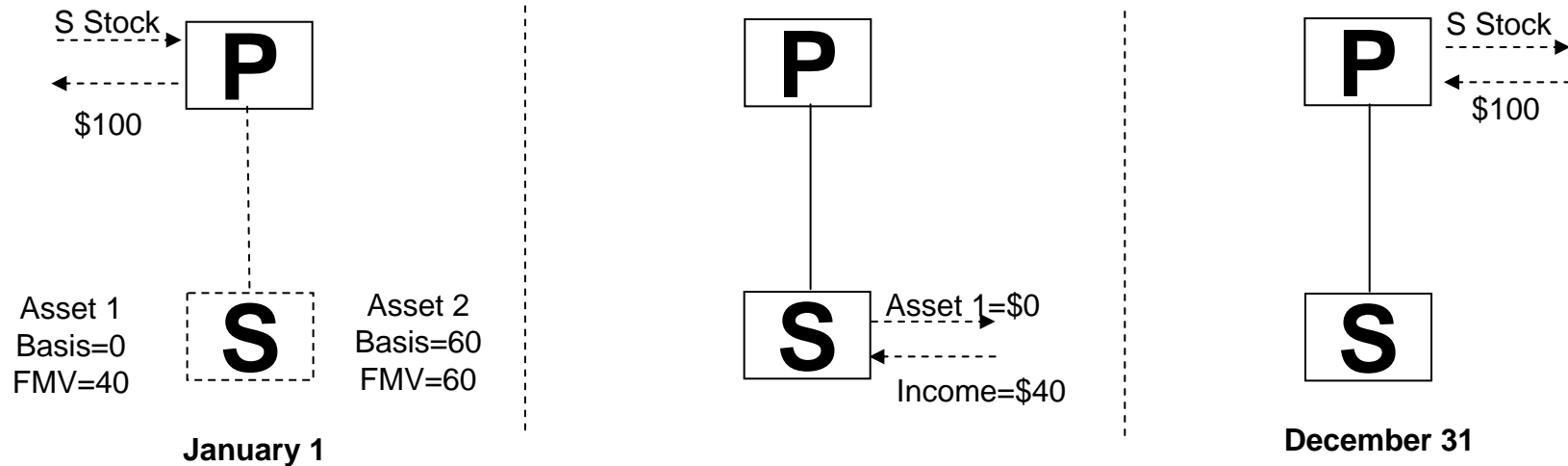
Basis Reduction – Example 1



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).

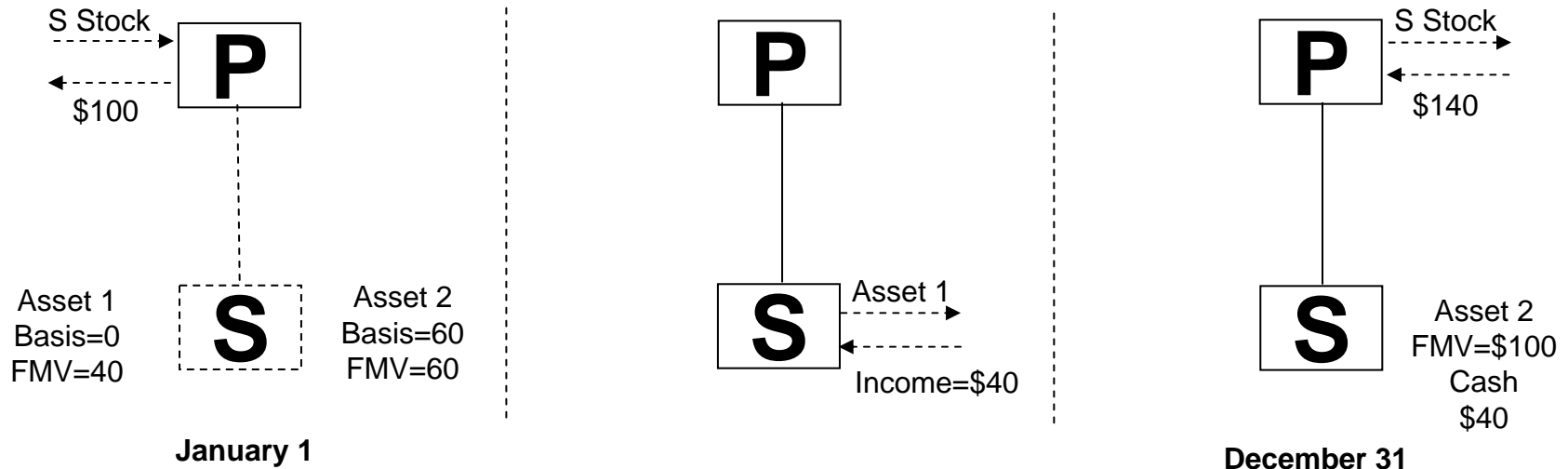
Basis Reduction – Example 2



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).

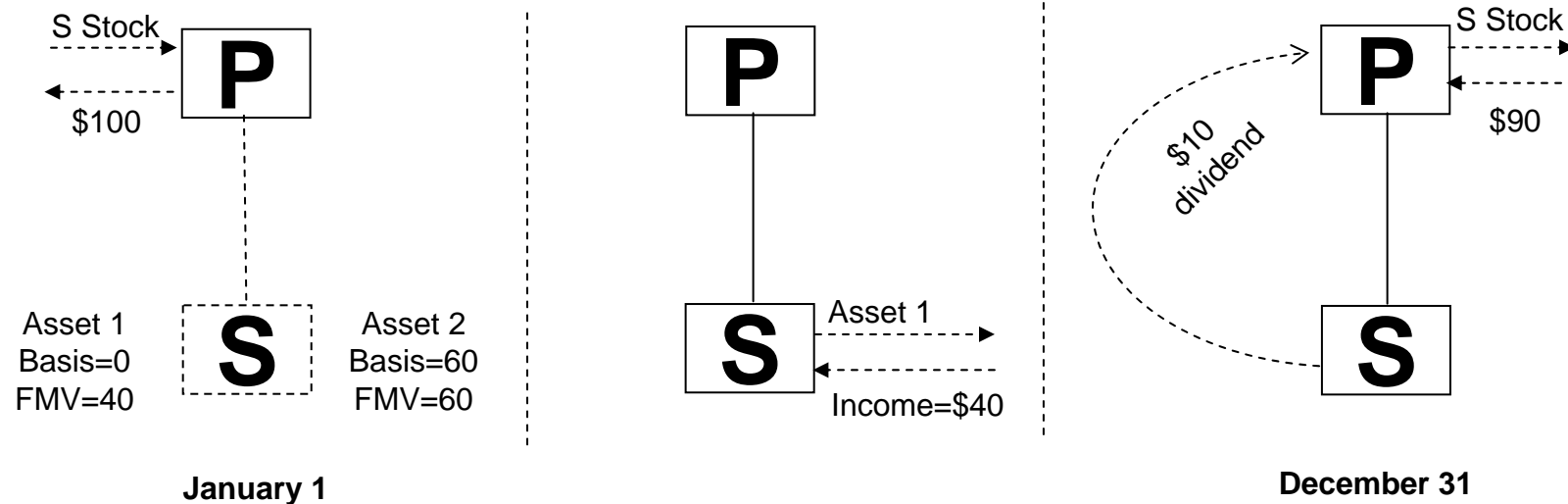
Basis Reduction – Example 3



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).

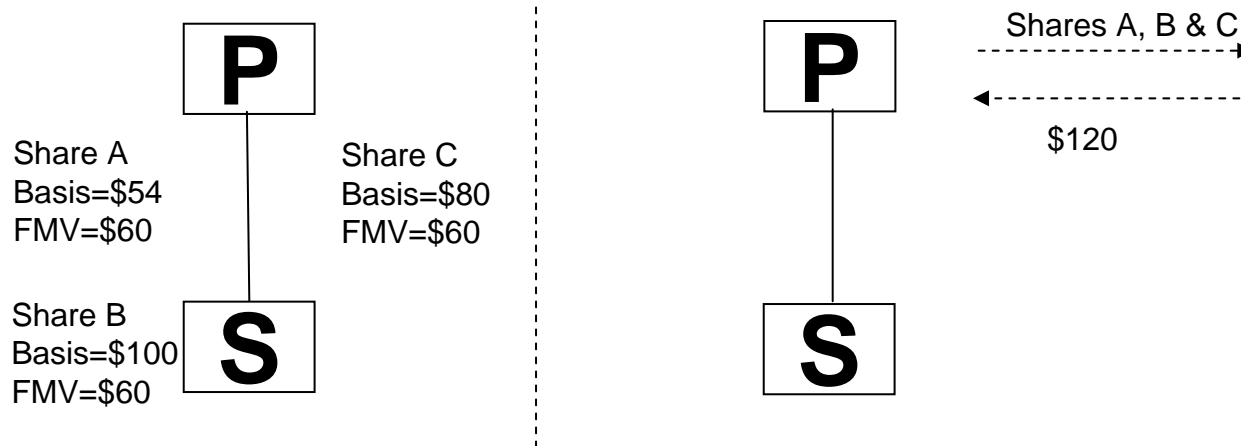
Basis Reduction – Example 4



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

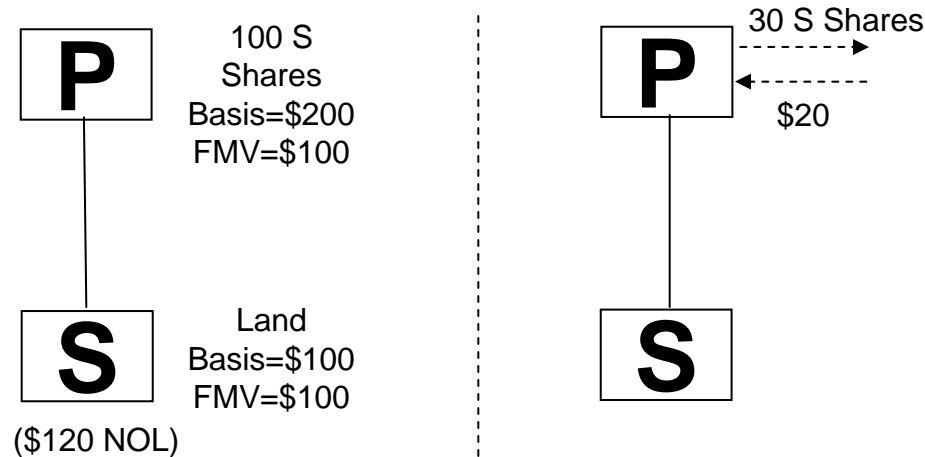
- The attribute reduction rule contains an elective provision under which groups can reduce the potential for loss duplication and thereby reduce or completely avoid attribute reduction. See Treas. Reg. § 1.1502-36(d)(6).
- Under this election, the common parent of a group can elect to reduce stock basis, 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).

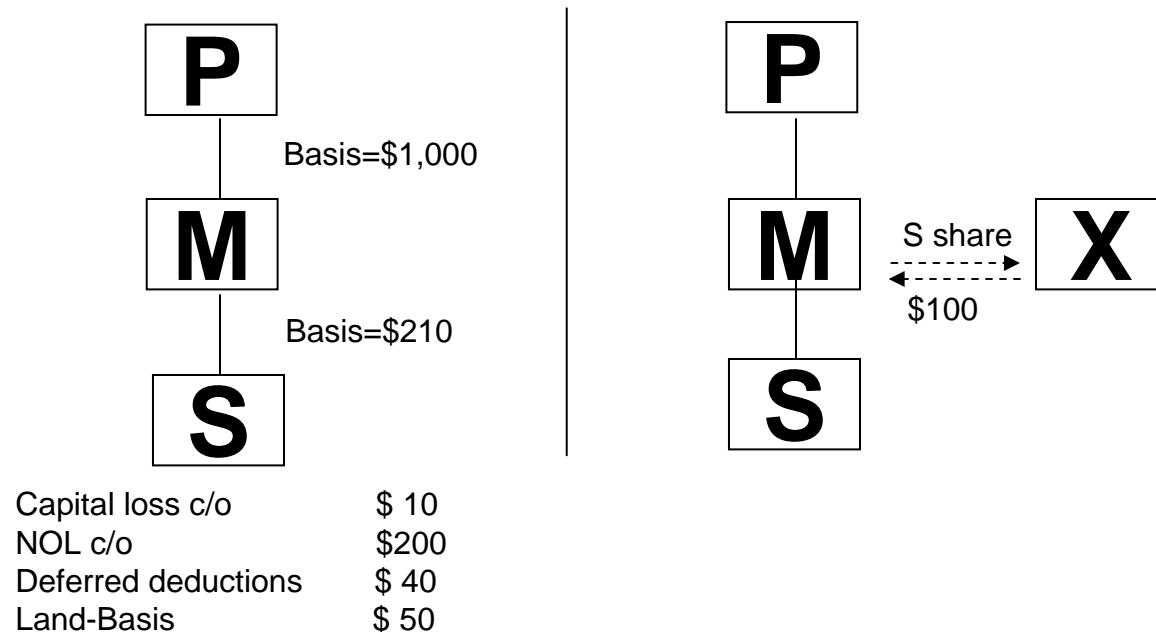
Attribution Reduction – Example 1



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).

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

- 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.

Proposed Intragroup Debt
Regulations –
§ 1.1502- 13(g)

Intercompany Debt Regulations - Overview

- On September 28, 2007, Treasury and the IRS published proposed regulations concerning intercompany obligations under Treas. Reg. § 1.1502-13(g) (the “2007 Proposed Regulations”).
- The 2007 Proposed Regulations replace proposed regulations that were issued in 1998 (the “1998 Proposed Regulations”).
- Final regulations under -13(g) were issued in 1995 (the “1995 Final Regulations”).
- The 2007 Proposed Regulations apply to transactions occurring in consolidated return years beginning on or after the regulations are finalized.
- The Preamble to the 2007 Proposed Regulations provides that taxpayers may continue to rely upon the form and timing of the recast transaction, as clarified in the 1998 Proposed Regulations.

2007 Proposed Regulations – In General

- The 2007 Proposed Regulations apply to certain transactions involving intercompany obligations:
 - Transactions in which an obligation becomes an intercompany obligation (“inbound transactions”);
 - Transactions in which an intercompany obligation ceases to be an intercompany obligation (“outbound transactions”); and
 - Transactions in which an intercompany obligation is assigned or extinguished within the group (“intragroup transactions”).
- An intercompany obligation is an obligation between members of a consolidated group, but only for the period during which both parties are members.

2007 Proposed Regulations – In General

- The 1995 Final Regulations and the 1998 Proposed Regulations
 - The 1995 Final Regulations and 1998 Proposed Regulations adopt the deemed satisfaction-reinsurance model to determine the tax consequences of inbound, outbound, and intragroup transactions.
 - The deemed satisfaction-reinsurance model furthers single entity treatment, and preserves the location of the intercompany items from an intercompany obligation, matches the timing of such items, and ensures that future items of income or loss (OID / premium) will correspond in amount and timing.
 - Under the deemed satisfaction-reinsurance model set forth in the 1995 Final Regulations and the 1998 Proposed Regulations, an obligation is treated as satisfied and, if the obligation remains outstanding, reissued as a new obligation.
- 2007 Proposed Regulations
 - The 2007 Proposed Regulations modify the deemed satisfaction-reinsurance model to simplify its mechanics in the context of outbound and intragroup transactions.
 - The 2007 Proposed Regulations retain the existing deemed satisfaction-reinsurance model with respect to inbound transactions.
 - The 2007 Proposed Regulations also introduce new exceptions to the application of the deemed satisfaction-reinsurance model.

2007 Proposed Regulations - Recast Transaction

- Outbound and Intragroup Transactions -- For outbound and intragroup transactions, the 2007 Proposed Regulations adopt a revised recast transaction that deems the following events to occur immediately before the actual transaction –
 - The debtor is deemed to satisfy the obligation for a cash amount equal to the obligation's fair market value, and
 - The debtor is deemed to immediately reissue the obligation to the original creditor for that same cash amount.
 - The parties are then treated as entering into the actual transaction with the new obligation.
- The recast model set forth in the 2007 Proposed Regulations differs from the model contained in the 1995 Final Regulations and the 1998 Proposed Regulations.
 - Simplified mechanics – Separating the deemed satisfaction and reissuance from the actual transaction.
 - Use of fair market value.

2007 Proposed Regulations - Recast Transaction

- Simplified Mechanics of Recast Transaction

- The 2007 Proposed Regulations provide that, under the recast transaction, the debtor is treated as retiring the obligation for cash and then reissuing a new note to the initial creditor prior to the parties' entering into the actual transaction.
- The Preamble to the 2007 Proposed Regulations states that, under the 1995 Final Regulations, and as revised by the 1998 Proposed Regulations, the recast transaction causes uncertainty because the recast may affect the tax consequences of the actual transaction.
 - The 1995 Final Regulations provide that the debtor is treated as retiring the obligation for cash and then reissuing a new note to the party holding the obligation.
 - In response to commentators' concerns regarding the effect of the recast transaction on common tax-free restructuring transactions, the 1998 Proposed Regulations clarified that the cash received by the initial creditor is transferred to the party holding the obligation in exchange for the actual proceeds prior to the reissuance of the new note.

2007 Proposed Regulations - Recast Transaction

- Use of Fair Market Value
 - The 2007 Proposed Regulations adopt a fair market value approach to determine the deemed satisfaction and reissuance amount.
 - The 1995 Final Regulations and the 1998 Proposed Regulations generally adopted the OID principles of sections 1273 and 1274 to determine the deemed satisfaction and reissuance amount.
 - The Preamble to the 2007 Proposed Regulations states that the IRS and Treasury acknowledge the inherent difficulty in valuing intercompany obligations, but that a fair market value approach more accurately preserves the location of items of income and gain and results in less distortion of consolidated group member's income.
 - The 2007 Proposed Regulations permit members to use the amount realized by the creditor in an outbound or intercompany transaction rather than fair market value if the triggering transaction is not an exchange (or deemed exchange) of debt of a member for newly issued debt of a member.

Application of the 2007 Proposed Regulations

- The 2007 Proposed Regulations generally apply the revised recast transaction to intragroup transactions upon a “triggering event.”
 - A triggering event is an intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation (or from a comparable transaction).
 - The 1995 Final Regulations do not apply the recast transaction to intragroup transactions where no gain or loss was realized.
 - The 1998 Proposed Regulations, however, contained language similar to that adopted by the 2007 Proposed Regulations.
- If the triggering event is a mark to fair market value under section 475, then the intercompany obligation will be deemed satisfied and reissued for its fair market value and section 475 will not otherwise apply.
- The 2007 Proposed Regulations, like the 1998 Proposed Regulations, eliminate the exception for intercompany transactions where the recast transaction would not have a significant effect on any person’s Federal income tax liability for any year.
- The 2007 Proposed Regulations otherwise retain the exceptions contained in the 1995 Final Regulations and introduce new exceptions to limit the application of the recast transaction to transactions for which its purposes are essential.

2007 Proposed Regulations – New Exceptions for Intragroup Transactions

- Intragroup Nonrecognition Transactions -- An intercompany exchange to which section 332 or section 361 applies if the debtor or creditor recognizes no amount of income, gain, deduction, or loss or an intercompany exchange to which section 351 applies if the creditor recognizes no such amount (but only if section 362(e)(2) does not apply to the exchange).
- Intragroup Taxable Assumption Transactions -- 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 money) in an intercompany transaction to which section 1001 applies.
- Intragroup Extinguishments -- 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.
- Routine Intragroup Modifications -- A modification of an intercompany obligation where the intercompany obligation is extinguished in exchange (or deemed exchange) for a newly issued obligation, and the issue price is equal to both the adjusted issue price and the creditor's basis in the extinguished obligation.
- The new exceptions contained in the 2007 Proposed Regulations for intragroup transactions do not apply, however, if it is reasonably foreseeable that the shifting of items of built-in gain, loss, income, or deduction from the intercompany obligation will secure a material tax benefit that would not otherwise be enjoyed (the "Material Tax Benefit Rule").

2007 Proposed Regulations – New Exceptions for Outbound and Inbound Transactions

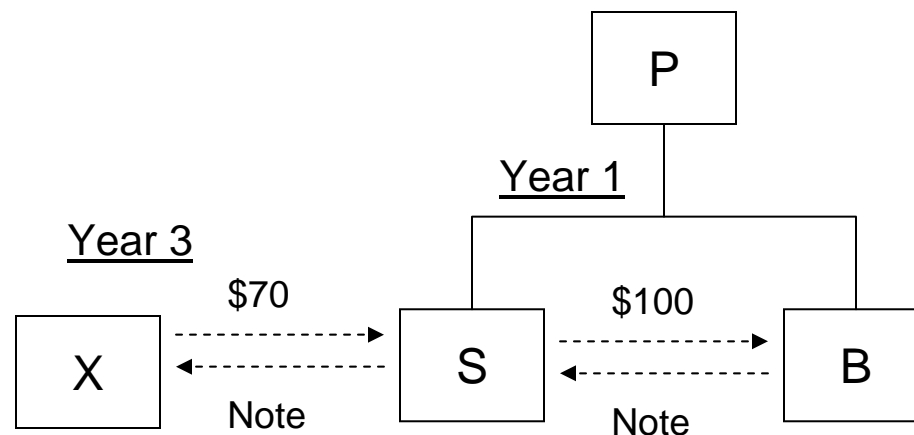
- Outbound Transactions

- Outbound Distributions 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.
- 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.

- Inbound Transactions

- The 2007 Proposed Regulations contain a “subgroup” exception similar in substance to that applicable to outbound transactions (described above).

2007 Proposed Regulations – Outbound Transaction

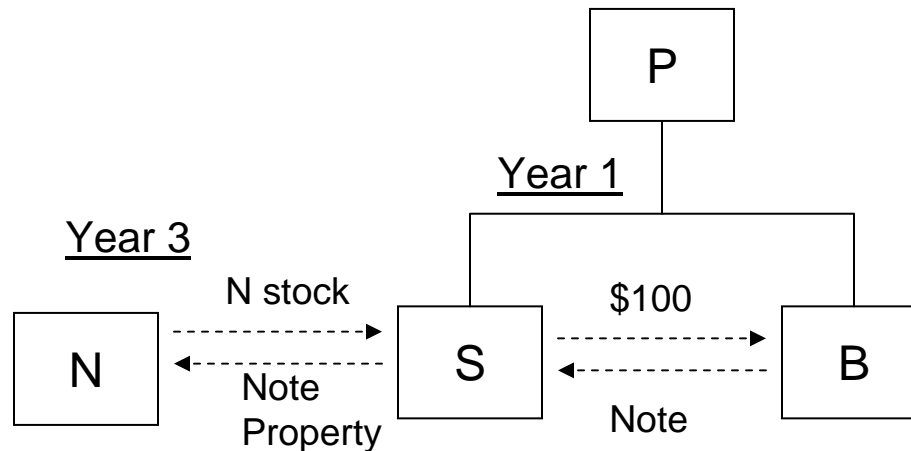


Facts: On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has paid the interest accruing under the note and S sells B's note to X for \$70, reflecting an increase in prevailing market interest rates.

Result: The transfer of the note to X in Year 3 is a triggering transaction because the obligation becomes an obligation that is not an intercompany obligation. Accordingly, B's note is treated as satisfied and reissued at a value of \$70 immediately before the sale to X. B takes into account \$30 of COD income, and S recognizes a \$30 loss. B is also treated as reissuing, immediately after the satisfaction, a new note to S with a \$70 issue price, a \$100 stated redemption price at maturity, and a \$70 basis in the hands of S. S is then treated as selling the new note to X for the \$70 received by S in the actual transaction and recognizes no further gain or loss. Prop. Treas. Reg. § 1.1502-13(g)(7), Ex. 2.

What if, instead of selling B's note, P sells the S or B stock to X?

2007 Proposed Regulations – Intragroup Transaction

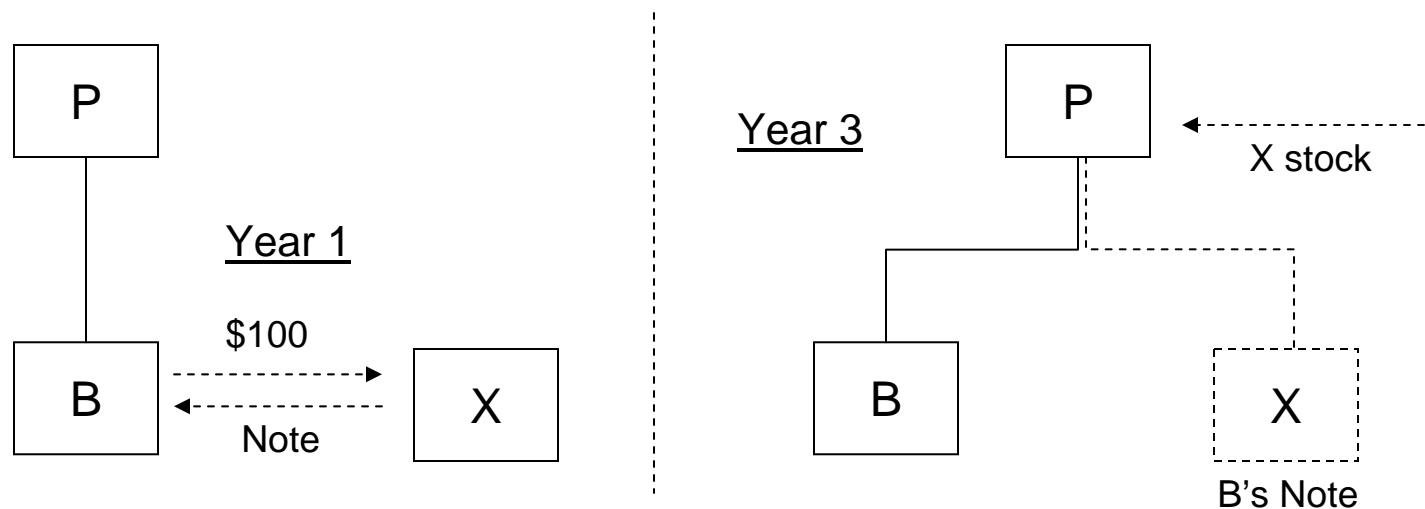


Facts: On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has paid the interest accruing under the note and transfers the note and other property to a newly formed corporation, N, in a section 351 exchange. At the time of the transfer, the note is worth \$130, reflecting a decline in prevailing interest rates. The aggregate adjusted bases of property transferred does not exceed the fair market value of such property immediately after the transfer.

Result: The transfer of the note and property to X in Year 3 is not a triggering transaction because the assignment is a section 351 exchange, S would not recognize gain or loss, and section 362(e)(2) would not apply to the exchange. Accordingly, the note is not treated as satisfied and reissued. Prop. Treas. Reg. § 1.1502-13(g)(7), Ex. 4.

If S had received boot in the section 351 exchange such that S would have recognized gain on the transfer, the transfer would be treated as a triggering transaction. As a result, the note would be treated as deemed satisfied and reissued immediately prior to the transfer.

2007 Proposed Regulations – Inbound Transaction



Facts: On January 1 of year 1, B borrows \$100 from X in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 5. As of January 1 of year 3, B has paid the interest accruing under the note, but the note's value is \$70, reflecting an increase in prevailing market interest rates. On that date, P buys all of the stock of X.

Result: B's note is treated as satisfied and reissued immediately after it becomes an intercompany obligation. The deemed satisfaction of the note will result in X recognizing a \$30 capital loss and B recognizing \$30 of COD income. These items will be taken into account in determining consolidated taxable income in Year 3. Any attributes of items resulting from the satisfaction are determined on a separate entity basis. The reissued note will be treated as an intercompany obligation with a \$70 issue price and a \$100 stated redemption price at maturity. Prop. Treas. Reg. § 1.1502-13(g)(7), Ex. 10.

Temp. Treas. Reg. § 1.1502–
13T(c)(6)(ii)(C)

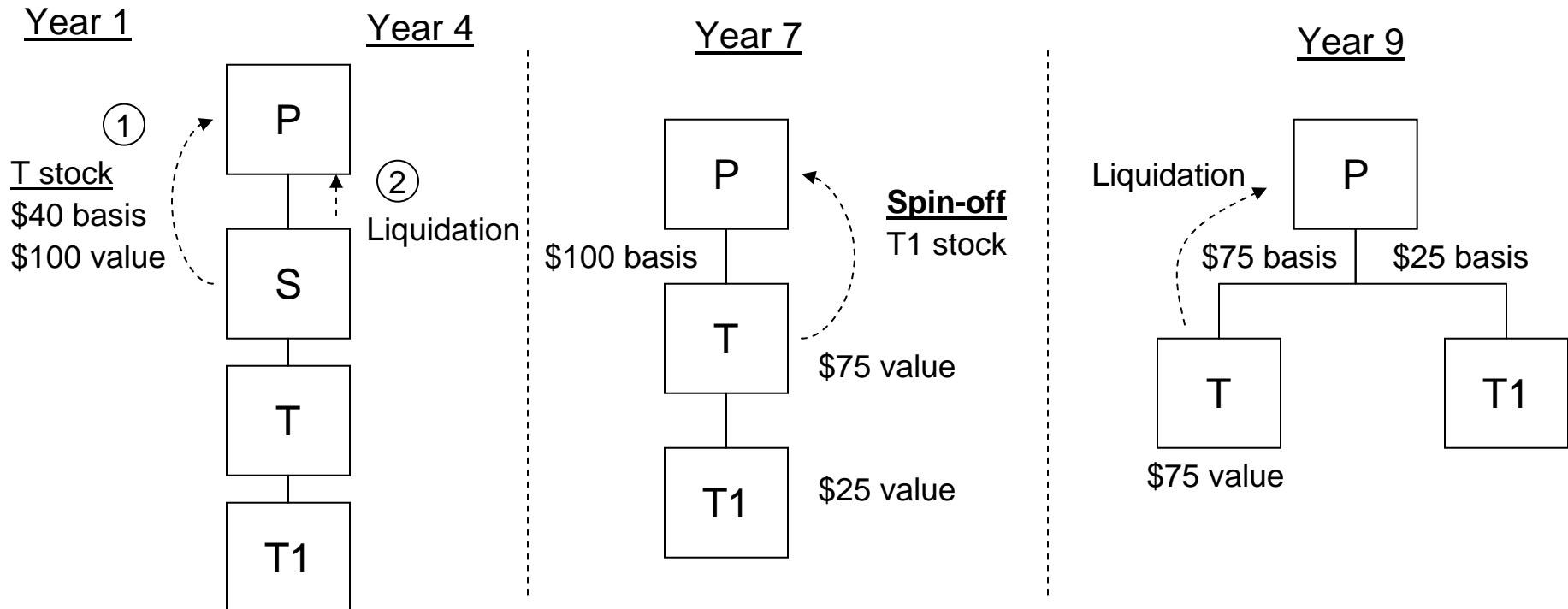
Treas. Reg. § 1.1502-13T(c)(6)(ii)(C)

- Treas. Reg. § 1.1502-13 provides rules governing the timing and characterization of items arising in connection with intercompany transactions.
- Treas. Reg. § 1.1502-13(c)(6)(i) provides generally that S's intercompany items may be redetermined to be excluded from gross income or treated as a nondeductible amount where B's corresponding item is excluded or nondeductible.
- Treas. Reg. § 1.1502-13(c)(6)(ii) limits the application of the general rule described above to one of three circumstances --
 - B's corresponding item is a deduction or loss and is permanently and explicitly disallowed in the taxable year the item is taken into account under -13;
 - B's corresponding item is a loss that is realized but not recognized under section 311(a) on a distribution to a nonmember; or
 - The IRS determines that the exclusion is consistent with the purposes of -13, other Code provisions, and other regulations.
- On March 7, 2008, the IRS published temporary regulations that added an additional exception to the rule limiting the redetermination of intercompany income or gain.
- The temporary regulations retain these exceptions, but the Preamble to the temporary regulations provides that the IRS and Treasury anticipate eliminating the exception for IRS discretion absent "compelling comments."

Treas. Reg. § 1.1502-13T(c)(6)(ii)(C)

- The exception for “permanently and explicitly” disallowed items does not include any B’s corresponding items that are realized but not recognized.
 - Thus, the exception does not apply to section 332 liquidations or section 355(c) distributions.
- Notwithstanding this rule, the temporary regulations add an exception for intercompany gain with respect to member stock to the extent the following five requirements are satisfied --
 - Such gain is the common parent’s (P’s) intercompany item;
 - P holds the member stock with respect to which the intercompany gain was realized (immediately before the intercompany gain is taken into account);
 - P’s basis in such member stock is eliminated without the recognition of gain or loss (and that basis is not further reflected in the basis of any successor asset);
 - The group has not and will not derive any Federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of such gain; and
 - The effects of the intercompany transaction have not been previously reflected on the group’s consolidated return.
- The added exception applies with respect to items taken into account on or after March 7, 2008.

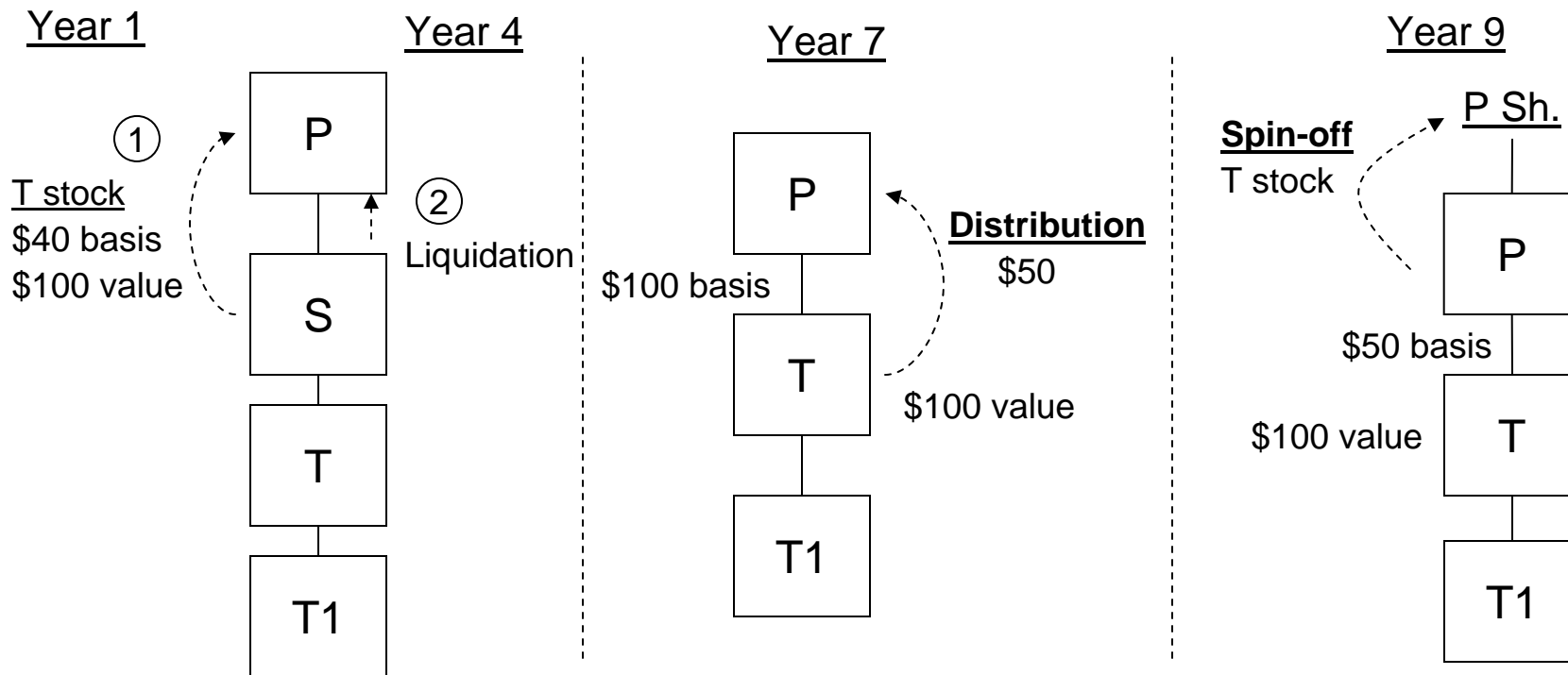
Treas. Reg. § 1.1502-13T(c)(6)(ii)(C)



Facts: In Year 1, S distributes all of its T stock to P in a section 301 transaction, recognizing a \$60 deferred intercompany gain. In Year 4, S liquidates into P in a section 332 liquidation, and P succeeds to S's intercompany gain. In Year 7, T distributes all of its T1 stock to P in a section 355 transaction. At the time of the spin-off, P has a basis in the T stock of \$100, the value of the T stock is \$75 (without taking into account the T1 stock), and the value of the T1 stock is \$25. As a result of the spin-off, P has a \$75 basis in its T stock and a \$25 basis in the T1 stock, and T1 becomes a successor asset to the T stock. In Year 9, T liquidates into P in a section 332 liquidation.

Result: P takes into account \$45 of its \$60 intercompany gain in Year 9 upon the liquidation of T (because \$15 of the \$60 intercompany gain is reflected in the T1 stock). Temp. Treas. Reg. § 1.1502-13T(c)(6)(ii)(C) redetermines the \$45 of gain to be excluded from gross income. See Treas. Reg. § 1.1502-13T(f)(7)(i), Ex. 7.

Treas. Reg. § 1.1502-13T(c)(6)(ii)(C)



Facts: In Year 1, S distributes all of its T stock to P in a section 301 transaction, recognizing a \$60 deferred intercompany gain. P receives a \$100 basis in the T stock. In Year 4, S liquidates into P in a section 332 liquidation, and P succeeds to S's intercompany gain. In Year 7, T distributes \$50 to P in a section 301 transaction, which results in a basis reduction in the T stock under Treas. Reg. § 1.1502-32. In Year 9, P distributes its T stock to its shareholders in a section 355 transaction.

Result: P takes into account \$60 of its intercompany gain in Year 9 in the spin-off transaction. Treas. Reg. § 1.1502-13T(c)(6)(ii)(C) redetermines \$50 of the \$60 intercompany gain to be excluded from gross income (as the P group received a \$10 tax benefit because the distribution of S stock in Year 1 resulted in a basis increase that prevented P from having a \$10 ELA at the time of the Year 9 spin-off). See Treas. Reg. § 1.1502-13T(f)(7)(i), Ex. 8.

Intercompany Reorganizations

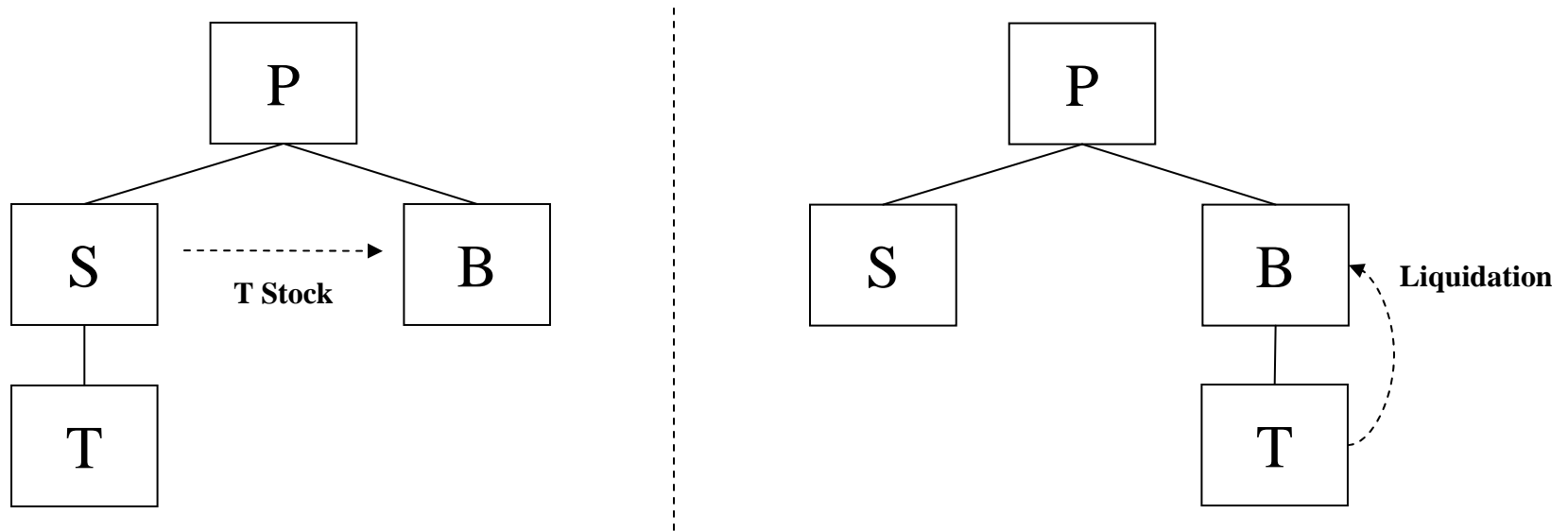
Treas. Reg. § 1.1502-13(f)(5) – In General

- In general, S's intercompany item from a transfer to B of stock of another member (T) is taken into account if B's basis in the T stock is permanently eliminated in a section 332 liquidation or other nonrecognition transaction. Treas. Reg. § 1.1502-13(f)(5)(i).
 - In such cases, Treas. Reg. § 1.1502-13(c)(6)(ii) does not apply to redetermine S's intercompany item to be excluded from income.
- If certain requirements are met, the regulations provide elective relief to prevent S from taking into account its intercompany item on the T stock. Treas. Reg. § 1.1502-13(f)(5)(ii).
 - Section 332 applies to T's liquidation, and B transfers T's assets to a new member (New T) in a transaction treated as a reorganization. Even if the transfer is not otherwise pursuant to the same plan or arrangement as the liquidation, the group can treat the transfer as part of the same plan.
 - The group must make an election pursuant to Treas. Reg. § 1.1502-13(f)(5)(ii).
 - T must be a member of the group throughout the period beginning with S's transfer and ending with the completion of the nonrecognition transaction.
- If these requirements are met, then the liquidation and contribution will be recharacterized as a reorganization and the New T stock will be treated as a "successor asset" to the T stock under Treas. Reg. § 1.1502-13(j)(1).
 - A successor asset is an asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

Treas. Reg. § 1.1502-13(f)(5) – Upstream Transactions

- Upstream Reorganizations
 - Treas. Reg. § 1.368-2(d)(4)(i), which repealed the *Bausch & Lomb* doctrine, provides that preexisting ownership will not prevent a “C” reorganization from qualifying as a tax-free reorganization.
 - As a result, upstream transactions may be characterized as either an upstream reorganization or a liquidation.
- Reincorporations
 - As a result of the anti-*Bausch & Lomb* regulations, a reincorporation of assets following an upstream transaction may qualify as either an upstream reorganization followed by a drop under section 368(a)(2)(C) or a sideways reorganization.
 - Treas. Reg. § 1.368-2(k) permits transfers or successive transfers of assets or stock acquired in a reorganization without triggering the step-transaction doctrine, provided that certain requirements are satisfied (including COBE).
 - Thus, a reincorporation of assets following an upstream transaction should be treated as an upstream reorganization followed by an asset contribution rather than a sideways reorganization.

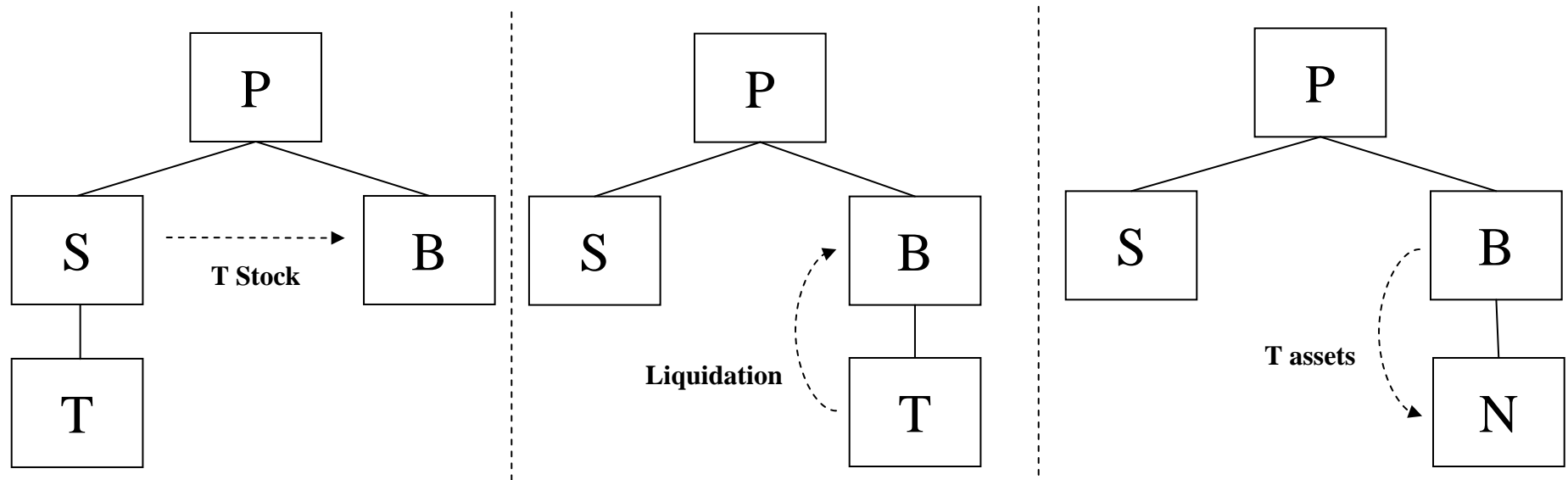
Treas. Reg. § 1.1502-13(f)(5) – No Election



Facts: S owns all of T's stock. S sells the stock of T to B at a gain. T subsequently liquidates into B in a section 332 liquidation.

Result: S's intercompany gain on the sale of the T stock is taken into account as a result of the liquidation under the matching rule. See Treas. Reg. § 1.1502-13(f)(5)(i). Treas. Reg. § 1.1502-13(c)(6)(ii) does not apply to redetermine S's intercompany item to be excluded from income.

Treas. Reg. § 1.1502-13(f)(5) - Election



Facts: S owns all the stock of T. S sells the stock of T to B at a gain. T subsequently liquidates into B in a section 332 liquidation. B then transfers the T assets into a newly formed entity, N. P files an election under Treas. Reg. § 1.1502-13(f)(5)(ii).

Result: Under Treas. Reg. § 1.1502-13(f)(5)(ii), S's intercompany gain will not be taken into account, if the liquidation and the transfer would qualify as a reorganization under section 368(a). In such case, B's stock in N should be treated as a "successor asset" to B's stock in T.

How do Treas. Reg. § 1.368-2(d)(4)(i) and -2(k) affect the result? If the reorganization is characterized as an upstream rather than a sideways reorganization, does the N stock qualify as a successor asset?

Successor Rules in Liquidations

Treas. Reg. § 1.1502-80(g)

- On February 22, 2005, the IRS published proposed regulations regarding how multiple consolidated group members succeed to and take into account items of a liquidating corporation in a section 332 liquidation.
 - The proposed regulations addressed the treatment of section 381 items (*e.g.*, NOLs, credits, E&P) and intercompany items.
- The IRS published final regulations on January 15, 2008.
- The final regulations adopt the substance of the proposed regulations but make several changes to the operation of the successor rule.
 - The final regulations withdrew the proposed rules regarding succession to intercompany items of the liquidating member.

Treas. Reg. § 1.1502-80(g)

- Treatment of Distributee Member
 - Section 381(a)(1) provides that the distributee in a section 332 liquidation will succeed to and take into account the items of the liquidating corporation.
 - Treas. Reg. § 1.381(a)-1(b)(2) provides that only a single corporation can be an acquiring corporation for purposes of section 381.
 - Section 332(b) provides, in part, that a complete liquidation includes a distribution from a liquidating corporation in which the corporation receiving such property owns stock that meets the requirements of section 1504(a)(2) (*i.e.*, 80% vote and value) and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation.
 - Treas. Reg. § 1.1502-34 provides that, for purposes of satisfying the stock ownership threshold of section 332(b)(1), a consolidated group member will be treated as holding the stock of the liquidating corporation held by all other members of the consolidated group.
 - Prior to the issuance of the proposed and final regulations, there were no rules that governed which corporation succeeds to the items of the liquidating corporation when section 332 applies to more than one distributee as may happen by reason of the application of § 1.1502-34 when the distributees are members of the same consolidated group.

Treas. Reg. § 1.1502-80(g)

- Treatment of Liquidating Corporation
 - Section 337(a) provides that the liquidating corporation does not recognize gain or loss on the distribution of property to an 80% distributee.
 - An 80% distributee refers to only the corporation that meets the 80% stock ownership requirements of section 332(b) without regard to any consolidated return regulation.
 - Section 336(a) provides that, if section 337 does not apply, then the liquidating corporation must recognize gain or loss as if the liquidating corporation sold the property distributed at its fair market value.
 - Thus, a complete liquidation may be tax free to the distributee member, but taxable to the liquidating corporation.
 - However, the gain or loss recognized by a liquidating member of a consolidated group would be deferred under the “matching rule”.
Treas. Reg. §1.1502-13.

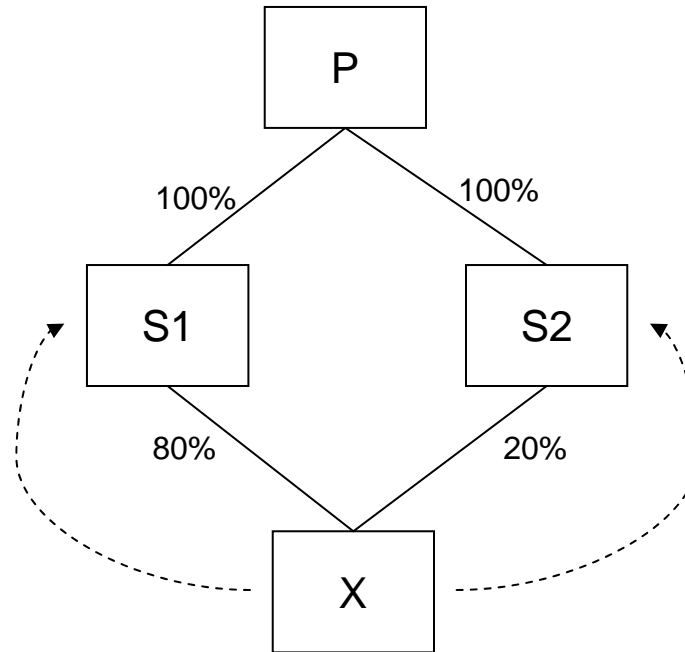
Treas. Reg. § 1.1502-80(g)

- The final regulations under -80(g), as under the proposed regulations, provide that each distributee member succeeds to and takes into account the items of the liquidating corporation under section 381 to the extent that such items would be reflected in investment adjustments to the stock of the liquidating corporation if such items were taken into account immediately prior to the liquidation.
 - For this purpose, all stock held by non-members is deemed to be redeemed immediately prior to the liquidation.
- The final regulations provide that deferred income items (e.g., Treas. Reg. § 1.451-5, section 455) of the liquidating corporation will generally be triggered to the extent property is transferred to, and the assumption of liabilities by, a distributee member that does not meeting the stock ownership requirements of section 1504(a)(2) (without application of Treas. Reg. § 1.1502-34).
- The final regulations modify the proposed regulations to provide that credits will be allocated proportionally based on the value of the stock of the liquidating corporation owned by each distributee member.
 - The proposed regulations had provided that credits be allocated based on the items of income, gain, loss, or deduction attributable to the activities that gave rise to the credits. As noted by several commentators, certain credits may not be clearly associated with particular items and, thus, difficult to allocate under the proposed regulations.

Treas. Reg. § 1.1502-13(j)(2)

- The final regulations do not adopt the proposed rules regarding the allocation of intercompany items of a liquidating member. The Preamble to the final regulations provides that the IRS and Treasury are continuing to study such rules. The Preamble provides that the rules of Treas. Reg. § 1.1502-13(j)(2)(ii) will apply.
- The existing rules under Treas. Reg. § 1.1502-13(j)(2)(ii) provide that a successor will succeed to and take into account the intercompany items of a predecessor.
 - A successor is defined by reference to section 381(a) transactions and carryover basis transactions.
 - If there are multiple successor members, then the regulations provide that the successors take into account the predecessor's intercompany items in a manner that is consistently applied and reasonably carries out the purposes of Treas. Reg. § 1.1502-13 and applicable provisions of law.
- The proposed regulations had provided for an allocation of intercompany items that was consistent with the approach adopted by the proposed rules of -80(g).
 - Under the proposed rules, distributee members succeed to intercompany items to the extent that such items would be reflected in investment adjustments to the stock of the liquidating corporation if such items were taken into account immediately prior to the liquidation under Treas. Reg. § 1.1502-13(d).

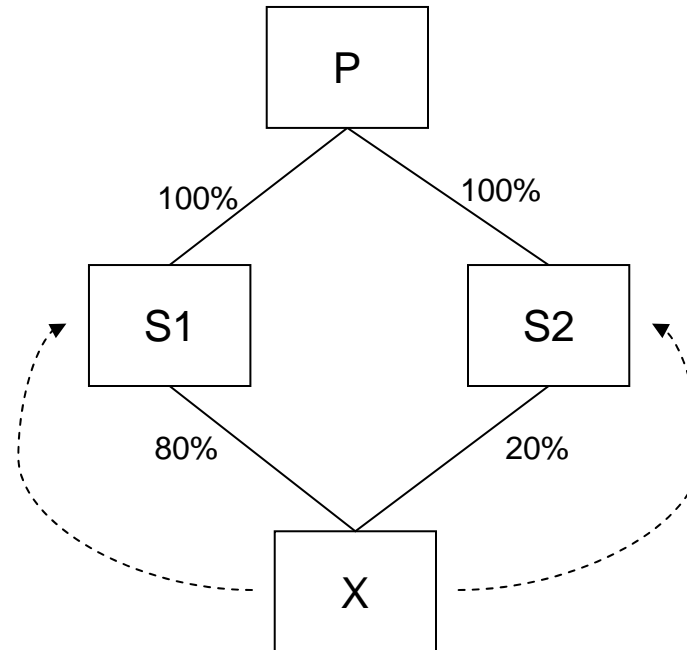
Treas. Reg. § 1.1502-80(g)



Facts: P, S1, S2, and X are members of a consolidated group. P owns 100% of the stock of S1 and S2, which own 80% and 20%, respectively, of the common stock of X. At the time of liquidation (including the effect of the tax liquidation), X has NOLs of \$100, business credits of \$40, and E&P of \$80.

Result: S1 and S2 succeed to \$80 and \$20 of X's NOLs, respectively, because the NOLs could be used offset the income of the group and, if the NOLs were taken into account immediately prior to the liquidation, S1 and S2 would have adjusted their investment basis in X stock by \$80 and \$20, respectively. Because S1 and S2 hold 80% and 20% of the value of X's stock, respectively, S1 would succeed to \$32 of X's business credits and S2 would succeed to \$8 of X's business credits. Because S1 and S2's E&P does not reflect X's E&P, S1 and S2 succeed to \$64 and \$16 of X's E&P, respectively. See Treas. Reg. § 1.1502-80(g)(4), Ex. 1.

Treas. Reg. § 1.1502-13(j)(2)(ii)



Facts: P, S1, S2, and X are members of a consolidated group. P owns 100% of the stock of S1 and S2, which own 80% and 20%, respectively, of the common stock of X. At the time of liquidation (including the effect of the tax liquidation), X owns assets with a value of \$100 and a zero basis.

Result: X has a \$20 gain on its liquidating distribution to S2 under sections 336 and 337(c). Under the matching rule, X's intercompany gain is not taken into account. S1 and S2 are both successors under Treas. Reg. § 1.1502-13(j)(2)(ii).

Which entity succeeds to X's intercompany item? An example in the current intercompany regulations provides that S1 will be treated as the successor of X's intercompany item in order to be consistent with purposes of the intercompany transaction rules. See Treas. Reg. § 1.1502-13(j)(9), Ex. 6. If S2 left the consolidated group, S1 would recognize the \$20 deferred intercompany gain as a successor to X. What would be the result if S2 were treated as the successor?

What would have been the result under the withdrawn proposed regulations?