Loss Disallowance After Rite Aid: Deconstructing "-20"

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Introduction

On September 13, 1991, the Treasury Department promulgated the final loss disallowance regulations. On July 6, 2001, just shy of the regulations' tenth anniversary, the Federal Circuit in *Rite Aid Corp.* struck a big chunk of those regulations down.[1] The Federal Circuit's decision invalidating the loss duplication factor of those regulations should have come as no surprise. When the regulations were first proposed, and after they were made final, practitioners and professional organizations commented vociferously that the regulations exceeded the authority of the Secretary and might not withstand judicial scrutiny.[2] Furthermore, prior court decisions in several circuits had invalidated other consolidated return regulations in cases in which a regulation purported to trump a statute without a precise problem created from the filing of a consolidated return.[3]

On March 7, 2002, in wake of the IRS's loss in *Rite Aid* and the decision of the Solicitor General not to petition the Supreme Court for *certiorari*, the Treasury Department and the IRS issued "interim" Temporary Reg. §1.337(d)-2T[4] for dispositions of subsidiary stock on or after that date. The regulation is a hybridization of transitional Reg. §1.337(d)-(2), which was briefly in effect before Reg. §1.1502-20 became final on February 1, 1991, and appropriate paragraphs of the latter regulation.

Also promulgated, as part of the same regulations package were Temporary Reg. §§1.1502-20T and -2T(b)(3)(v), which provide taxpayers with various elections that become necessary as a consequence of the new rules. As will be discussed in this article, the reattribution election under Reg. §1.1502-20(g) created, in some cases, a tax result that taxpayers preferred over a world of no loss disallowance. Thus, for prior years the fix was not as easy as simply repealing the regulation retroactively. To accommodate taxpayers that relied on the prior regulations, the temporary regulations provide consolidated groups with a choice to use any of three methods for computing the disallowance (or basis reduction) on a prior disposition (or deconsolidation) of a consolidated subsidiary's stock. Rather than using the rules prescribed in Reg. §1.1502-20 in its

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entirety, groups are given the option to apply that regulation without the loss duplication factor (*i.e.*, taking the *Rite Aid* opinion into account), or apply Temporary Reg. §1.337(d)-2T for all open years. The last option will generally result in less disallowance, but that regulation does not contain a reattribution election.

This article has two distinct parts. Part I discusses the temporary regulations. These include both the rules for dispositions of a subsidiary's stock after March 7, 2002, as well as steps that a group can take to obtain refunds for dispositions in prior years. Part II explores the effect that the *Rite Aid* decision could have on other consolidated return regulations. The article concludes that, contrary to the suggestions of some commentators, the decision did not alter prior law. The article analyzes specific provisions of the regulations that appear to be inconsistent with the Code. With some exceptions, most provisions of the consolidated return regulations that provide results different than the results that would be achieved if separate returns were filed, are justified by special problems that consolidated return filing creates. Legislative proposals to amend Code Sec. 1502 to strengthen the Secretary's authority to promulgate the regulations are at best unnecessary and at worst an improper delegation of legislative authority.

Part I: The Temporary Loss Disallowance Regulations

For dispositions and deconsolidations on or after March 7, 2002, and until new regulations are promulgated, the rules contained in Temporary Reg. §1.337(d)-2T are the sole governing provisions. The heart of that regulation is paragraph (c)(2), which allows the deduction of a loss on the disposition of a subsidiary's stock "to the extent that the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset ..." Some commentators have described this methodology as "tracing," but that description is not entirely accurate. As discussed below, there are many fact patterns in which the taxpayer can establish that a stock loss is not attributable to recognized built-in gain without the need to retroactively identify specific assets. On the other hand, there will be cases in which a retroactive valuation at the time a subsidiary joined a group would be necessary and "tracing" will create practical problems. For past transactions, if the acquirer used purchase accounting for financial statement purposes, the difficulty of retroactive valuations may be somewhat alleviated.

Allowing consolidated group's to claim a loss on the disposition of a subsidiary's stock to the extent that the group can establish that the loss is not attributable to recognized built-in gain is consistent with the overriding policy to ensure that the repeal of the *General Utilities* doctrine "is not circumvented through the use of any provision of law or regulations (including the consolidated return regulations...)."[5] The extent to which the temporary regulations achieve that result without either overreaching or underreaching is the subject of debate.[6]

The rule of Temporary Reg. §1.337(d)-2T, which allows for the deduction of a loss on a subsidiary's stock to the extent the taxpayer can establish that the loss is not attributable to the recognition of built-in gain, is considerably more permissive than the mechanical and frequently arbitrary rules that characterize Reg. §1.1502-20. If a loss were disallowed under Reg. §1.1502-20, those regulations provided some relief by allowing the selling group (in coordination with the buyer) to reattribute the subsidiary's net operating loss (NOL) and capital loss carryovers to the common parent of the selling group.[7] However, the amount that may be reattributed is limited to the amount of the disallowed loss. Furthermore, if the selling group would have been able to use a capital loss or capital loss carryover, and the elective methods do allow a greater deduction on the loss of the subsidiary stock while keeping the carryovers with the subsidiary after it leaves the group, then the reattribution election is not advantageous.

If the selling group elects to apply Temporary Reg. §1.337(d)-2T (which does not have any provision to reattribute loss carryovers) to a prior disposition, any losses that had originally been reattributed to the selling common parent and have not yet been absorbed, will be reallocated back to the departed subsidiary. Similarly, if the selling group elects to apply Reg. §1.1502-20 without the duplicated loss factor and that method decreases the disallowed loss, a portion of a prior reattribution election may be void, and more of the loss will stay with the departed subsidiary.

If the selling group had undergone an ownership change prior to the subsidiary's disposition, the consolidated Code Sec. 382 limitation may have been allocated in part to the departing subsidiary under Reg. §1.1502-95(c), based on assumptions that are no longer valid. The temporary regulations provide an opportunity to alter the prior allocation. Temporary Reg. §1.1502-20T(i) provides rules for reallocating a consolidated Code Sec. 382 limitation to adjust for the potential effects that a retroactive change in the amount of the previously assumed loss disallowance will have on past reattribution elections. Similarly, if a subsidiary joined a group with a loss carryover, and the subsidiary was later sold at a loss, Reg. §1.1502-96(d) contains rules for allocating the Code Sec. 382 limitation applicable to the subsidiary's separate losses that may be reattributed to the common parent under Reg. §1.1502-20(g). Temporary Reg. §1.1502-20T(i) provides rules for reallocating the limitation if the amount of the previously reattributed loss is changed as a consequence of the new regulations.[8]

Temporary Reg. §1.337(d)-2T

Temporary Reg. §1.337(d)-2T is labeled "[l]oss limitation window period (temporary)." Although descriptive matter relating to the content of a title is given no legal effect,[9] the intent of the regulation writers could not be clearer. The temporary regulations are intended to be temporary. The Assistant Secretary for Tax Policy announced on the day that the regulations were published that the Treasury is studying alternative approaches to the loss disallowance problem, and that these regulations are not the last word from the government. Of course, any new regulations would have to navigate clear of any disallowance for a true economic loss, or risk the same fate in the courts as the invalidated duplicated loss rule.

Paragraph (a)(1) contains the familiar general rule that "[n]o deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary."[10] Nearly identical language appeared in the predecessor provisions of Reg. §§1.337(d)-1, 1.337(d)-2 and 1.1502-20. As a drafting technique, the broad language of the general rule serves to require exceptions (which will be commonplace) to be construed narrowly.

Paragraph (a)(2), entitled "Definitions," replicates the language of Reg. §1.337(d)-2(a)(2)(i) that "the definitions in Reg. §1.1502-1 apply." This provision is necessary because the temporary regulation is prescribed under Code Sec. 337(d) rather than Code Sec. 1502. Regulations prescribed under the latter section would have the definitions in Reg. §1.1502-1 automatically incorporated into their rules. Note, however, that nowhere does Reg. §1.1502-1 contain language such as, "these definitions apply for purposes of the regulations under section 1502." Nevertheless, the application of those definitions can be safely assumed to apply for purposes of the regulations under Code Sec. 1502, but not as safely, without an express statement, to apply for purposes of the regulations under Code Sec. 337(d).

Paragraph (a)(2)(ii) defines "disposition" in the same manner as the predecessor provisions in Reg. §§1.337(d)-2(a)(2)(ii) and 1.1502-20(a)(2) as "any event in which gain or loss is recognized in whole or in part." Thus, an event that would trigger a worthless stock deduction under Code Sec. 165(g)(3) would fall within the potential for loss disallowance.

Paragraph (a)(3) repeats the language in Reg. §1.337(d)-2(a)(3) that coordinates the loss disallowance rule with other deferral rules and disallowance rules, for example, Code Sec. 267(f). The regulation states, "The rules of Reg. §1.1502-20(a)(3) apply with appropriate adjustments to reflect the differences between the approach of [Temporary Reg. §1.337(d)-2T] and that of Reg. §1.1502-20." In addition, Example 6 illustrates the rules in Reg. §1.1502-20(a)(5), and thus the cross-reference is sufficient.

As originally proposed, the temporary regulation did not contain a netting rule that corresponds to Reg. §1.1502-20(a)(4). However, on March 30, 2002, the temporary regulations were amended to include a netting rule. The netting rule is pro-taxpayer, but its appropriateness is debatable depending upon one's view of the purpose of the loss disallowance regulations. Under the netting rule, a loss on the disposition of a subsidiary's stock that otherwise would be disallowed, will be allowed to the extent of any gain with respect to stock with the same material terms that is taken into account as part of the same transaction. Consider the following example:

> S1 and S2 are wholly owned subsidiaries of P, the common parent of the P consolidated group. S1 buys 50 percent of T's common stock for $30. Thereafter, S2 buys the remaining 50 percent for $80. T sells an asset and recognizes $40 of gain that was built-in at the time of both stock purchases, which results in a basis increase of $20 to S1's 50-percent and $20 to S2's 50-percent interest. Thus, S1's basis in its shares of T is increased to $50 and S2's basis is increased to $100. Subsequently, S1 and S2 each sell their 50-percent interest in T to an unrelated purchaser for $75. S1 has a $25 gain, and

S2 has $25 loss. Under the netting rule, S2's loss may entirely offset S1's gain.

If the aim of the regulations is to prevent the deduction of artificial losses on subsidiary stock that arise from recognition of built-in gain, there is no more justification to allow the loss in the above example to offset gain on other stock of the same subsidiary than to allow an offset against gain from the disposition of a different capital asset. On the other hand, if the purpose of the loss disallowance regulations is less ambitious and is simply to prevent "son-of-mirror" transactions in which recognition of built-in gain on a target's assets is used to create an artificial stock loss that shelters the asset gain, then a netting rule is appropriate. By adding a netting rule to the temporary regulations, Treasury signaled its view that the temporary regulations have the more modest objectives. Whether this view will carry over to the promulgation of proposed and ultimately final regulations remains to be seen.

Whether or not a netting rule is eventually adopted, the presence or absence of the rule should not affect the ability of a group to elect the relief provisions of Reg. §1.1502-13(f)(5)(ii)(C), relating to intercompany transfers of subsidiary stock followed by a disposition to which Code Sec. 338(h)(10) applies. Consider the following example:

P owns 100 percent of S. S forms T by contributing assets with a $10 basis and a fair market value of $100 in exchange for 100 percent of T's common stock. Assuming no changes in the basis or value of T, S distributes its T stock to P in a transaction that creates $90 of intercompany gain under Code Sec. 311(b), and causes P's basis in T to be $100 under Code Sec. 301(d). In a subsequent year, P agrees to sell all of T's stock to X, and the parties agree to elect to treat the stock sale as a deemed asset sale under Code Sec. 338(h)(10).

If P does not avail itself of the elective relief provisions of Reg. §1.1502-13(f)(5)(ii)(C), the sale of T will result in a recognition of $90 of gain on the deemed sale of T's assets and will accelerate the $90 of intercompany gain that was created upon the prior distribution of T's stock by S to P. Under Reg. §1.1502-13(f)(5)(ii)(C), however, P can elect to treat the deemed liquidation of T in the Code Sec. 338(h)(10) transaction as a liquidation to which Code Sec. 331, rather than Code Sec. 332 applies. The deemed sale of T's assets under the Code Sec. 338(h)(10) election will momentarily increase P's basis to $190. If Code Sec. 331 applies to the deemed liquidation, P may claim a $90 loss on the liquidation of T's stock, which exactly offset S's $90 of intercompany gain that must be taken into account upon the deemed liquidation.

Under Reg. §1.1502-13(c)(1)(i), the separate entity attributes of the selling member (S) and the buying member (B) must be redetermined to produce the same effect on consolidated taxable income as if the transaction had been a transfer between divisions of a single corporation. For example, assume S has $130 basis in land. S sells the land to B for $100. B later sells the land to an unrelated party for $110 note. Although B has a gain on a separate entity basis, if S and B were divisions of a single corporation, B would succeed to S's basis in the land and the group would have a $20 loss upon the sale to the third party. Because installment reporting is not available in the case of property sold at a loss, B may not report its gain on a separate company basis under the installment sale rules.

Applying this rule to S's distribution of T's stock to P and P's election to treat the deemed liquidation of T as a transaction to which Code Sec. 331 applies results in no loss to S and P since they are treated as divisions of a single corporation. S's initial basis in the T stock was $10. S recognizes $90 of built-in gain, which would increase basis to $100; this increased basis equals the fair market value of T at the time of the deemed liquidation. P's separate company loss on the exchange of stock for assets in a taxable liquidation under Code Sec. 331 must be redetermined to produce the same effect as if the transaction between P and S was a transaction between divisions of a single corporation. Accordingly, there would be no loss and therefore no disallowance.[11]

Deconsolidations. Paragraph (b) of Temporary Reg. §1.337(d)-2T contains the rules for basis reduction upon deconsolidation. Consistent with the rule in Reg. §§1.337(d)-2(b)(1) and 1.1502-20(b)(1), the basis of a loss subsidiary's stock that a member continues to hold after the subsidiary's deconsolidation will be reduced by the lesser of (1) the amount that would have been disallowed if the stock was sold at fair market value, or (2) the amount that brings the basis of the stock down to fair market value. The rule is simply an anti-avoidance rule to keep a group from avoiding loss disallowance by selling off, for example, 21 percent of a subsidiary's stock, and (because the former subsidiary is no longer subject to the consolidated return regulations) then claiming a loss (that would otherwise have been disallowed) on the remaining 79 percent. As under prior law, paragraph (b)(2) artfully defines "deconsolidation" as "any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member." Thus, if P sells enough stock in S1 to deconsolidate S1 (which owns 100 percent of S2) and S1 and S2 file a consolidated return together after leaving the P group, a deconsolidation event for S2 would not have occurred.

Under Reg. §1.1502-20(b)(5), if a subsidiary became disaffiliated and any retained stock was sold at a loss within two years of the deconsolidation, the loss would have been disallowed unless the group filed a "(b)(5) statement" for the year of the disposition. That statement required the group to disclose the amount of any prior basis reduction of the subsidiary's stock on deconsolidation, the basis of the subsidiary's stock immediately before the disposition, the amount realized on the disposition, and the amount of loss recognized on the disposition. The purpose for the statement was to prevent taxpayers from overvaluing the stock at the time of the deconsolidation. A subsequent sale of the retained stock at a loss would not be subject to the loss disallowance rule, since the former subsidiary is no longer a member. Accordingly, the 1991 regulations included the provision requiring an information statement to be filed. The temporary regulations do not contain any analogous provision.

Allowable Loss. The major departure from the approach of Reg. §1.1502-20 is in Temporary Reg. §1.337(d)-2T(c), entitled, "Allowable Loss." As under prior law, a loss will be allowed (or basis will not be reduced) only if the group attaches a separate statement (commonly known as the "(c)(3) statement") to the consolidated return for the year of the subsidiary's disposition or deconsolidation. This requirement, although probably necessary to safeguard the integrity of the regulation, has been the subject of countless requests for relief under Reg. §301.9100, which the IRS routinely grants. Reg. §1.337(d)-2(c)(1)(i) contained a requirement for loss allowance only if the group:

> Disposes (in one or more transactions) of its entire equity interest in the subsidiary to persons not related to any member of the consolidated group within the meaning of section 267(b) or section 707(b) (substituting "10 percent" for "50 percent" each place that it appears); or sustains a worthless stock loss under section 165(g)(3) ...

The requirement is notably absent from the temporary regulations. Accordingly, a group may be able to sell a subsidiary's "plain vanilla" preferred stock and deduct the loss, while retaining the subsidiary as a member of the group. Such a transaction, however, would be disallowed under Proposed Reg. §1.1502-35, which will be made retroactive pursuant to Notice 2002-18.[12]

Under paragraph (c)(2) of Temporary Reg. §1.337(d)-2T, a loss will not be disallowed and stock basis will not be reduced "to the extent that the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset (including stock and securities)." This articulation of the rule attacks the classic "son-of-mirror" transaction. Consider the following example:

> P purchases 100 percent of T's stock for $100. T holds a capital asset with a value of $100 and a basis of zero. If T sells the asset for $100, P's basis in T's stock is increased to $200 under the investment adjustment rules in Reg. §1.1502-32. If P then sells T's stock for $100, the loss on the stock could offset the gain on the asset. The asset would have left corporate solution, received a basis step-up, with a corporate level tax, a result that is anathema to *General Utilities* repeal.

This approach, although sound in principle, was rejected by the drafters of Reg. §1.1502-20, because of the difficulty of applying the rule in practice. Stock and asset transactions are rarely as clear-cut as described in the above example. According to the preamble to proposed loss disallowance regulations in 1990, valuations of assets retroactive to the date a subsidiary joined a group, when those assets may have been disposed of years before the subsidiary's stock was sold at a loss, was simply unadministrable. Furthermore, in the absence of arm's-length transactions, valuations are often a matter of contention between the IRS and taxpayers, under the best of circumstances. According to the government, attempting to reconstruct valuations for transactions long past would be unworkable.

In practical application, the temporary regulations require a consolidated group that wants to claim a loss on the disposition of a subsidiary's stock to review all Schedule Ds and Forms 4797 for the period that the subsidiary was a member of the group. The maximum disallowance is the amount of gain that the subsidiary recognized on the disposition of assets as shown on those forms. The maximum disallowance, however, immediately can be reduced by examining the forms and determining the date on which the disposed assets were acquired. If the assets were acquired after the subsidiary became a member of the group, then the recognized gain could not have been "built-in" and the amount of any disallowance on the stock loss can be reduced. Similarly, if a subsidiary was purchased in a transaction in which the parties jointly elected to treat the stock purchase as a deemed asset purchase under Code Sec. 338(h)(10) and the assets were marked-to-market, the potential for the recognition of "built-in gain" on the disposition of those assets is, by definition, not possible. Furthermore, any case in which the subsidiary was a member of the group since inception is an easily demonstrable case where loss disallowance should not apply. In cases where the subsidiary was acquired by in a stock purchase, and the assets disposed of at a gain were, in fact, held by the subsidiary when the subsidiary became a member, then retroactive valuations become necessary.[13]

Also consider a situation where T, a stand alone C corporation, uses the last-in, first-out (LIFO) inventory method. If P, the parent of a consolidated group, acquires the stock of T, should the LIFO layers that T has be treated as built-in gain items? If so, the built-in gain is recognized only if T eats into a LIFO layer.

For purposes of the temporary regulation, the definition of "disposition" is not entirely clear. The Code treats a number of transactions that are not sales or exchanges as a "sale or exchange," and conversely treats actual sales or exchanges as something else. For example, assume P purchases T, which owns portfolio stock in a company with no current or accumulated earnings and profits and T's basis in the stock is zero. The company's stock, however, is publicly traded and has an ascertainable fair market value at the time that P purchases T. Subsequently, the company makes a distribution to T, which is "treated as gain from the sale or exchange of property" under Code Sec. 301(c)(3)(A). Query, is the amount included in T's income and reflected in P's basis in T stock treated as recognition of built-in gain from the "disposition" of an asset? The Tax Court has held that such gain is not eligible for installment reporting.[14]

Or, consider the application of Code Sec. 631(a), which allows a taxpayer to elect to treat the cutting of timber "as a sale or exchange of such timber cut during such year." There is no actual disposition, but the Code permits sale or exchange treatment.[15] The opposing situation arises under Code Sec. 1248(a). If a taxpayer sells stock of a foreign corporation in which it owns 10 percent or more of the voting power, "the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend." Query whether such income inclusion may be considered recognized built-in gain from the "disposition" of an asset for purposes of Temporary Reg. §1.337(d)-2T.[16] If so, the amount would not be discernable from an inspection of the group's Schedule Ds and Forms 4797.[17]

The temporary regulations, however, place the burden with the taxpayer. In the case of genuine disputes over values and the amount of recognized built-in gain, the taxpayer may be unable to establish that gain on the disposition of an asset, which increased stock basis and contributed to the loss on the sale of a subsidiary's stock, was not recognized built-in gain. By contrast, Reg. §1.1502-20 contained no exceptions even for clear cases in which built-in gain could not have been present when the subsidiary joined the group. After losing the duplicated loss factor in *Rite Aid*, the IRS understandably was unwilling to have a court review the reasonableness of the extraordinary gain disposition factor. Similarly, a court may not have accorded its usual deference to the positive investment adjustment factor with their irrebuttable and arbitrary presumptions. After some hesitation, the Treasury and the IRS admitted that their decision to abandon the other factors of the loss disallowance regulations (not addressed in *Rite Aid*) was based upon the somber assessment that the over-breath of those factors, would, in many situations, be difficult to defend.

The temporary regulation expressly states "gain recognized on the disposition of an asset is built-in to the extent attributable, directly or indirectly, in whole or in part, to an excess of value over basis that is reflected before the disposition of the asset, in the basis of the share ..." Although not expressly stated, the amount of recognized built-in gain should be taken into account and be reduced by any directly related expense, such as federal income tax attributable to the gain.[18] The "indirect" recognition of built-in gain can be illustrated by the following example:

> Assume P purchases T for $100 and T holds Blackacre with a value of $100 and a basis of $30. After the purchase, T exchanges Blackacre for Whiteacre in a transaction that qualifies for nonrecognition under Code Sec. 1031. At a later date, T sells Whiteacre for $120, which causes P's basis in T to increase to $190. If P then sells its T stock for $120, the $70 loss would be disallowed. Under these facts, the stock loss was attributable, albeit indirectly, to the excess of the value of Blackacre over its basis at the time T became a member of the group, which was reflected in the basis of T's stock upon the sale of Whiteacre.

Keeping track of recognized built-in gain could get messy where chains of subsidiaries are acquired at different times. For example, assume T1 acquires T2, and T2 recognizes built-in gain that is reflected in T1's basis in its T2 stock. P then purchases 100 percent of T1's stock. The built-in gain that T2 recognized and which is reflected in the basis of its stock in T1's hands must be taken into account for purposes of any loss that T1 sustains on a sale of T2 stock, notwithstanding that the recognized built-in gain occurred before T1 and T2 joined the P group. That recognized built-in gain, however, would not be taken into account in determining the allowable loss on a sale of T1 stock by P because P's basis in its T stock is its purchase price basis (plus post-acquisition adjustments) and does not reflect gain recognized by T2 before the acquisition of T1 by P.

Suppose, however, that T2 had not recognized the built-in gain at the time of T1's acquisition by P, and that the value had increased in the interim. For example, assume that an asset had a net unrealized built-in gain (NUBIG) of $20 a the time of T2's acquisition by T1, but a NUBIG of $30 at the time of T1's acquisition by P. After P's acquisition of T1, T2 recognizes the $30 NUBIG, and stock basis is increased at both levels. T1 subsequently sells T2 and recognized a loss, $20 of which is disallowed. Notwithstanding the disallowance, P's basis in its T1 stock is reduced. Thereafter, P sells its T1 stock and recognizes a loss in excess of $30. The disallowance on the T1 stock should be limited to $10, or P's "double counted" basis in the T1 stock (*i.e.,* the initial $30 NUBIG of the asset less the $20 basis reduction for the disallowance on the disposition of the T2 stock).[19]

Paragraph (c)(3) of Temporary Reg. §1.337(d)-2T describes the information that must be included in the statement attached to the group's return for the loss to be allowed. The regulations require only that the statement contain the name and EIN of the subsidiary, and the amount of the loss not disallowed or basis not reduced by reason of paragraph (c). The regulation does not require that the return contain any information to support the group's claim that the stock loss was not attributable to recognized built-in gain. The group, however, must of course have sufficient documentation to support that position if, upon audit, the documentation is requested. The lack of any requirement for the group to justify its position with the return may cause taxpayers to simply play the audit lottery.

Paragraph (c)(4) of Temporary Reg. §1.337(d)-2T contains cross-references to examples in Reg. §§1.337(d)-1(a)(5) and 1.1502-20(a)(5) and reproduces an example previously contained in Reg. §1.337(d)-2(c)(4). In the example, a subsidiary recognizes both built-in gain and built-in loss after its stock is purchased by the group. The example concludes that disallowed loss on the ultimate sale of the subsidiary's stock is the net recognized built-in gain. The example further provides, that the result would be the same if instead of recognizing a built-in loss, the group used a NOL carryover that was generated by the subsidiary before joining the group. This result is considerably more liberal than the result under Reg. §1.1502-20(c), which disallowed a loss on the disposition of a subsidiary to the extent the subsidiary recognized any extraordinary gain after joining the group. No offset for recognized built-in losses or absorbed pre-acquisition NOLs was permitted. Presumably, a stock basis reduction for the expiration of a pre-acquisition NOL or a capital loss carryover under Reg. §1.1502-32(b)(3)(iii)(B) should also be treated as a recognized built-in loss that can offset a stock basis increase from the recognition of built-in gain.

The IRS has ruled on the operation of Reg. §1.337(d)-2, for a transaction that occurred between November 19, 1990, and January 31, 1991, in TAM 200138005.[20] In the TAM, a subsidiary's stock basis was increased by both recognized built-in gain and post-acquisition appreciation. Thereafter, the value of the subsidiary declined, and the subsidiary's stock was sold at a loss. The technical advice allowed the group to claim the loss on the subsidiary's stock because the loss did not exceed the loss that would have resulted if the built-in gain had not been recognized. The principle applied in the TAM can be illustrated by the following example:

> P purchases T for $45 and T holds two assets. Asset 1 has a value of a $20 and a basis of zero. Asset 2 has a value of $25 and a basis of $25. T sells asset 1 for $20 and the recognized built-in gain increases P's basis in T's stock to $65. Thereafter, Asset 2 appreciates in value to $70 and T sells the asset, which creates $45 of gain (which is post-acquisition appreciation) and increases the basis of T's stock to $110 although the value of T is $90. T re-invests the $70 proceeds in an asset that declines in value by $40 to $30, and P sells the T stock for $50, resulting in a $60 loss.

Under the holding of the TAM, $40 of the $60 loss on the sale of T's stock is not disallowed under Temporary Reg. §1.337(d)-2T, and $20 is disallowed. As stated in the TAM, the loss will not be disallowed to the extent the taxpayer "is able to demonstrate that it would have had a ... loss on the sale of [the] stock whether or not it sold its built-in gain assets ..." In other words, if T had not recognized the built-in gain, but instead recognized only the $45 of post-appreciation gain, the basis of T's stock would have increased to $90 and the subsequent sale of the stock for $50 would have resulted in a $40 loss that would have been allowed. The test for the amount of allowed loss is the amount of loss that would have resulted if the built-in gain had not been recognized. The example also demonstrates that the recognized post-appreciation gain may exceed the allowed loss.[21]

Miscellaneous Rules and Effective Dates. Paragraphs (d), (e) and (f) of Temporary Reg. §1.337(d)-2T simply contain cross-references to the successor rule, the anti-avoidance rule and the investment adjustment rule of Reg. §1.1502-20(d), (e) and (f), respectively, with appropriate adjustments to reflect the differences in the approach of that section and the temporary regulations.

Notably absent is any provision in the temporary regulations analogous to the reattribution election available under Reg. §1.1502-20(g). This change alone may make some taxpayers yearn for the halcyon days when Reg. §1.1502-20 still reigned.

Paragraph (g) of Temporary Reg. §1.337(d)-2T contains effective date rules. The temporary regulations apply for stock dispositions and deconsolidations on or after March 7, 2002 (absent a binding contract). If loss is recognized because stock of a subsidiary becomes worthless, the disposition is treated as occurring on the date the stock became worthless. The regulation does not repeal Reg. §1.1502-80(c), which defers a worthless stock deduction until the subsidiary has disposed of substantially all of its assets. The rule was originally intended as a taxpayer friendly provision to prevent the deduction from being claimed when the subsidiary holds high-basis/low-value assets that would cause disallowance under the duplicated loss factor. By requiring the worthless stock claim to be deferred until the subsidiary disposes of substantially all of its assets, taxpayers would not be precluded from deducting a true economic loss.

The regulation served a laudable, pro-taxpayer purpose while the duplicated loss rules were in effect. Under the duplicated loss rule (which was invalidated by *Rite Aid*), a loss on the stock of a subsidiary was disallowed to the extent that the subsidiary held assets with a high-basis and a low-value.[22] In the case of a worthless subsidiary with debt and high-basis/low-value assets, application of that rule would invariably result in the disallowance of a true economic loss. To prevent this unfair result, the Treasury promulgated Reg. §1.1502-80(c), which prevented an owning member from even being eligible to claim the loss until substantially all of the subsidiary's assets had been disposed. Thus, at the time the worthless stock deduction became permissible, the loss disallowance regulations would not have disallowed it.

In the absence of the loss duplication factor in a post-*Rite Aid* world, the principal purpose for the promulgation of Reg. §1.1502-80(c) no longer exists. Consider the following example:

- P forms S with $70 of cash. S borrows $30 in year 1 and purchases equipment. S incurs substantial losses, discontinues operations, and becomes worthless within the meaning of Code Sec. 165(g)(3). If Reg. §1.1502-80(c) did not apply, P would be allowed to claim a worthless stock deduction in the year of worthlessness and the basis of the stock would become zero. This would trigger a deemed ownership change pursuant to Code Sec. 382(g)(4)(D). As a result, the built-in loss on the assets held by S would be subject to a limitation based on the value of S, which is zero. Thus, if S disposes of its assets, any loss would be disallowed. Accordingly, the group would end up with only one loss.
- Alternatively, if the assets were sold first. The loss on the assets would reduce P's basis in S stock. Therefore, if P later claims a worthless stock deduction, the basis in S stock would already be reduced by the loss on the assets. Again, the group would end up with only one loss.

- Given that the loss disallowance rules are no longer in effect, there does not appear to be any purpose for Reg. §1.1502-80(c). If the provision is not eliminated, its validity may be difficult for the government to defend.[23]

Temporary Reg. §1.1502-20T

As part of the same regulation package, the Treasury and the IRS promulgated Temporary Reg. §1.1502-20T, which provides an election for consolidated groups to elect out of the application of Reg. §1.1502-20 for prior open years. Paragraphs (a) through (h) are reserved and the rules are set forth in paragraph (i). As a stylistic matter, this approach is unprecedented. In the past, paragraph "(i)," which precedes paragraph "(j)," is traditionally reserved, so as to not create confusion with subdivision "(i)," which precedes subdivision "(ii)." But these are unconventional times.

An election provision was needed because some groups were better off applying Reg. §1.1502-20 than they would have been if the regulation had never been promulgated. In particular, Reg. §1.1502-20(g) contains the reattribution election, which, as discussed earlier, allows the buyer and seller of a subsidiary's stock to agree to reattribute some or all of the subsidiary's loss carryover to the common parent of the selling group. Absent an election, the subsidiary retains its allocable portion of the consolidated NOL (CNOL), as well as any unused preacquisition losses. The amount that may be reattributed is limited by the amount of the disallowed loss. In the case of a reattributed NOL, the selling group was often better off than it would have been if the capital loss on the sale of the subsidiary's stock had not been disallowed because corporate capital losses may only offset capital gains. Accordingly, the government could not simply revoke the old regulation retroactively, especially since the parties to a prior transaction may have adjusted the purchase price of the subsidiary's stock to reflect the reattribution election.

Temporary Reg. §1.1502-20T(i)(1) expressly renders Reg. §1.1502-20 inapplicable to a disposition or deconsolidation of a subsidiary on or after March 7, 2002, unless the disposition or deconsolidation was pursuant to a binding contract entered into before that date. Note that a disposition of a subsidiary pursuant to a binding contract entered into on March 7, 2002, is governed solely by Temporary Reg. §1.337(d)-2T.

Paragraph (2) of Temporary Reg. §1.1502-20T(i) contains the election for dispositions and deconsolidations before March 7, 2002 (including transactions pursuant to a binding contract entered into before that date). For any open year, a consolidated group may determine the amount of a disposing member's allowable loss (or basis reduction) by applying (1) Reg. §1.1502-20 in its entirety, (2) Reg. §1.1502-20 without the duplicated loss factor described in paragraphs (c)(1)(iii) and (c)(2)(vi) (which was invalidated by the Federal Circuit in *Rite Aid*), or (3) the provisions of Temporary Reg. §1.337(d)-2T.

Adjustment to Reattribution Election. If a group elects to use the old regulations without the duplicated loss factor, an election to reattribute the portion of the group's CNOL or consolidated capital loss carryover attributable to a sold subsidiary under Reg. §1.1502-20(g) will be respected only if the reattribution election was made on a timely filed return for the year of the disposition. The temporary regulations do not reopen the door for the reattribution election. Furthermore, the election, if properly made, is irrevocable. However, the election is permissible only to the extent that a loss on the subsidiary's disposition would be disallowed. Thus, if the old regulations are elected without the duplicated loss factor, and as a result of the elimination of that factor in the computation of the disallowance, the reattributed loss exceeds the disallowed loss, then the amount of the reattributed loss must be cut back. The amount of the originally reattributed loss will be reduced to the extent that it exceeds the greater of (1) the amount of loss disallowance recomputed without the duplicated loss factor, or (2) the amount of originally reattributed loss that the selling group absorbed in prior years that are now closed under the statute of limitations.[24]

If the group elects to apply the provisions of Temporary Reg. 1.337(d)-2T, the reattribution election is not available. Thus, any previous election to reattribute is voided, and the disposed subsidiary has its reattributed losses restored to itself. To the extent, however, that a reattributed loss was absorbed in a year that is now closed by the statute of limitations, the election is not invalidated. Accordingly, the reattributed loss is not restored to the subsidiary in the hands of the purchaser (or subsequent owner).[25]

Note that the election may give a group the benefit of some hindsight with respect to information that was not available at the time a subsidiary stock was disposed. For example, assume that a selling group did not foresee the usability of a capital loss for the year of the subsidiary's disposition or as a carryback or carryover. Accordingly, the disallowance of the loss was effectively a windfall, because the group elected to reattribute the subsidiary's NOLs. During the five-year period following the stock sale, the group, in fact, recognized capital gain. In retrospect, it is obvious that a capital loss would have been useful, and the buyer of the subsidiary's stock would now pay to be able to restore the subsidiary's NOLs, notwithstanding that the loss would be subject to a Code Sec. 382 limitation. If the seller elects to apply the rules of Temporary Reg. §1.337(d)-2T, a capital loss will result that can be absorbed as a carryover into an intervening year. By making the election, the group causes the subsidiary's reattributed NOL (assuming not absorbed in a closed year) to be restored to the subsidiary in the hands of the buyer.

Paragraph (i)(3)(iii) of Temporary Reg. §1.1502-20T addresses the problems raised as a result of a prior apportionment of a Code Sec. 382 limitation with respect to losses that were originally reattributed, but as a result of the election are restored to the subsidiary in the hands of the purchaser. Under the consolidated Code Sec. 382 regulations (Reg. §1.1502-91 *et. seq.*), the portion of a consolidated Code Sec. 382 limitation that is apportioned to a subsidiary leaving the group that is taking with it a portion of the CNOL is subject to an express election. If the effect of an election under Temporary Reg. §1.1502-20T is to alter the amount of a CNOL that was reattributed, and thus change the amount of the CNOL that leaves with the disposed member, an opportunity is available to re-designate the portion of the consolidated Code Sec. 382 limitation that the departing subsidiary was allocated. Consider the following example:

P purchases 100 percent of T for $500, at which time T has a $100 NOL carryover. Under Code Sec. 382, the annual limitation on T's $100 pre-acquisition loss is $25. Before March 7, 2002, and before any of T's pre-acquisition loss can be absorbed by the P group, P sells the T stock for $420. Under Reg. §1.1502-20(c)(2)(vi), the entire $80 loss was disallowed, and pursuant to Reg. §1.1502-20(g), P reattributed $80 of T's NOL to itself. In addition, under Reg. §1.1502-96(d)(5)(i), P attributed $20 of the $25 Code Sec. 382 loss limitation to itself.

Pursuant to Temporary Reg. §1.1502-20T(i)(2)(ii), P elects to apply the rules of Temporary Reg. §1.337(d)-2T to its loss on the sale of T. Under those rules, none of the loss is disallowed. Thus, the reattribution election is void. Accordingly, the original allocation of the Code Sec. 382 limitation to the selling group's common parent is wasted. Under Temporary Reg. §1.1502-20T(i)(3)(ii)(A), the common parent may reduce the amount of the Code Sec. 382 limitation apportioned to itself. Furthermore, if a subgroup was acquired and the subgroup's loss was subject to a Code Sec. 382 limitation, and a subsidiary of that loss subgroup has ceased to be a member of the loss subgroup, the common parent may increase the amount of the Code Sec. 382 limitation apportioned to the subsidiary under Reg. §1.1502-95(c).

Subparagraph (4) of Temporary Reg. §1.1502-20T(i) provides the time and manner for making the election to use either the provisions of Reg. §1.1502-20 *sans* the duplicated loss provisions, or to apply Temporary Reg. §1.337(d)-2T for transactions occurring before March 7, 2002. The election is made by including a statement with a timely filed original return for a tax year that includes any date on or before March 7, 2002, or on an amended return for the year of disposition, which is filed before the return that includes March 7, 2003, is due (including extensions).[26] As originally promulgated, the election could be made only on the return that included March 7, 2002. Thus, in the case of a calendar year group that extends its return, the election could be made only on the return filed on or before September 15, 2003. When the regulations were clarified on May 30, 2002, this provision was altered to allow groups to make the election on an earlier original return (*e.g.,* the 2001 calendar year return filed by September 15, 2002).

The required statement must be entitled "Allowed Loss Under [either Reg.§1.1502-20 or Temporary Reg. §1.337(d)-2T] Pursuant to Section 1.1502-20(i)." The statement must include the following:

- The name and EIN of the subsidiary and of the disposing member(s)
- A statement that the taxpayer elects to determine its allowable loss under either Temporary Reg. §1.1502-20T(i)(2)(i) (if Reg. §1.1502-20 without duplicated loss is elected), or Temporary Reg. §1.337(d)-2T (if that section is elected)
- If a reattribution election was made with the return for the year of the disposition, the amount of the loss originally reattributed, and the amount reattributed after applying Temporary Reg. §1.1502-20T(i)(3)(i) or (ii)
- If the amount of a previously apportioned Code Sec. 382 limitation is adjusted, the amount of the original and redetermined apportionment
- If the amount considered reattributed under Reg. §1.1502-20(g) was reduced, that

notification was sent to the disposed subsidiary, or, if acquired by a consolidated group, to the common parent of the acquiring group

Modification to the Waiver Rules. Finally, the regulations package included a modification to Reg. §1.1502-32(b)(4)(v), relating to the waiver of a subsidiary's loss carryover upon joining a group. Under the investment adjustment regulations, the expiration of a loss carryover results in a negative adjustment to owning member's basis in the subsidiary's stock.[27] To alleviate the harsh effect of that rule, a group that acquires a subsidiary is allowed to make an election to waive some or all of the subsidiary's loss carryovers by filing a statement with the original return for the year in which the subsidiary joins the consolidated group. If the Code Sec. 382 limitation is extremely low, or if the loss carryovers are capital losses that the acquiring group does not anticipate it will be able to use before the losses expire, an election is advisable.

If, however, loss carryovers of an acquired subsidiary's are re-established as the result of an election under Temporary Reg. §1.1502-20T by the seller of the subsidiary on a return after the year of the sale, obviously the purchaser can be harmed for its failure to waive loss carryovers that it could not have known at the time of the acquisition. Accordingly, the waiver rule was modified to allow purchasers to make an election to waive a subsidiary's loss carryovers at the time that the amount of those carryovers is re-established.

Part I Conclusion

The temporary regulations afford taxpayers an opportunity to obtain refunds attributable to the disallowance of true economic losses on the disposition of subsidiary stock in prior years. If action is not taken by September 15, 2003 (in the case of calendar year groups), the opportunity will be lost. The intricate rules require the assistance of outside professionals who are familiar with the subtleties, which may result in greater refunds.

But aside from the momentary opportunity for consolidated groups to enhance cash flow, there are greater issues here. Temporary Reg. §§1.1502-20T(i) and 1.337(d)-2T reflect the laudable efforts by the Treasury and the IRS to undo the damage created by the ill-conceived loss disallowance regulations as originally promulgated in 1991. It is not, however, as if this damage was unforeseen. Numerous commentators and professional organizations commented, at the time the regulations were promulgated, that their validity was highly questionable. The Treasury, however, chose to ignore those comments. Perhaps the lesson of this regulatory debacle will not be lost on future generations of regulation writers.

There is also a lesson here for taxpayers. In the 10 years that ensued between the promulgation of the loss disallowance regulation and their demise, countless consolidated groups were faced with disallowance of true economic loss upon the disposition of a subsidiary's stock. Tax directors may have cursed the regulation, but when confronted with the opportunity to challenge its validity, they invariably blinked. It wasn't until the Rite Aid Corp. retained counsel to challenge the validity of Reg. §1.1502-20 in the Court of Federal Claims that a consolidated group took on the challenge. In many cases now, the statute of limitations has closed and taxes that were unfairly paid will never be recovered.

Corporate America is uniquely suited to challenge Executive Branch regulations that usurp the power of Congress to write the tax law. In the words of the Federal Circuit, "Income tax liability is not imposed by the Secretary's regulations, but by the Internal Revenue Code."[28] Rite Aid is to be congratulated not simply because they won a few dollars back from the federal government, but because they took on the challenge of defending their economic rights from an overreaching bureaucracy.

Part II: Exploring the Boundaries of Consolidated Return Regulation Authority After *Rite Aid*

Following the *Rite Aid* decision, some consolidated return commentators began to speculate as to whether the *Rite Aid* opinion could be read to provide a basis for challenging the validity of other consolidated return regulations.[29] The consolidated return regulations frequently provide rules, like the duplicated loss rule, that are inconsistent with the Code. The *Rite Aid* opinion, however, blazed no new ground. The Federal Circuit simply applied the same criteria that had been previously used by the Court of Claims in *American Standard*[30] two decades earlier.

Neither *Rite Aid* nor *American Standard* concluded that the consolidated return regulations could not provide a different result than the result otherwise provided by the Code. Rather, the courts condoned the consolidated return regulations' departure from the rules applicable to separate return taxpayers when necessary "to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns ..."[31] Notwithstanding the Secretary's broad authority, Code Sec. 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed."[32] In *American Standard*, the Court of Claims invalidated a consolidated return regulation that computed the now defunct deduction for a Western Hemisphere Trade Corporation (WHTC) on a consolidated basis, rather than on a separate return basis, whereas Rite Aid invalidated the so called "duplicated loss rule" with respect to subsidiary stock.

Those who disagree with the *Rite Aid* decision have argued that the *American Standard* case was inapplicable in the loss disallowance context because it "did not involve the question of separate returns as compared to a single return approach."[33] In fact, however, that case addressed whether to compute the WHTC deduction based on consolidated taxable income or on each member's separate taxable income. Perhaps the difference in perspectives between those who applaud the *Rite Aid* decision and those who criticize it arises from the question of the breadth of the single entity approach.

Traditionally, the single entity approach has been reflected in provisions of the consolidated return regulations such as Reg. §§1.1502-24 and 1.1502-26, which compute the consolidated charitable contribution deduction or the consolidated dividends received deduction, respectively, based upon the income of the consolidated group rather than the separate taxable income of each member. Similarly, the intercompany transaction regulations in Reg. §1.1502-13 treat transactions between members of the group as if those members were divisions of a single corporation "to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, eliminating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." However, this approach should not be construed as rendering stock a nonasset.

The investment adjustment regulations[34] increase and decrease an owning member's basis in a subsidiary's stock to reflect the modified taxable income of the subsidiary each year, so as to avoid double reporting of income or deduction by the group.[35] Those regulations, however, have never been construed to render a subsidiary's stock a nonasset.

Indeed, Congress has provided an election under Code Sec. 338(h)(10) by which a buyer and a selling group can jointly elect to treat an actual stock sale as a hypothetical asset sale followed by a tax-free liquidation of the subsidiary. That provision of course is entirely elective. In a case in which the subsidiary stock was purchased at a premium above the inside basis of the subsidiary's assets, a Code Sec. 338(h)(10) election would produce greater gain to the seller and usually would not be elected. It has only been facetiously suggested that the consolidated return regulations should provide for a "gain disallowance rule," which could avoid gain on the disposition of a subsidiary's appreciated stock. Nevertheless, supporters of the loss disallowance rules viewed the loss disallowance regulations as rules that address the perennial consolidated return dilemma of treating the group as an aggregate of separate entities as opposed to a single entity.

Despite the narrow approach taken by the *Rite Aid* court, Treasury officials are concerned that the Federal Circuit's opinion would encourage widespread challenges to other consolidated return regulations. Accordingly, the Treasury convinced members of the Senate Finance Committee to have the Chairman sponsor legislation that would amend Code Sec. 1502 of the Code by adding the following sentence, "In prescribing such regulations, the Secretary may prescribe rules applicable to corporations filing consolidated returns under section 1501 that are different from other provision of this title that would apply if such corporations filed separate returns."[36]

Note that the proposed legislation does not limit the authority to prescribe rules that differ from the separate return rules of the Code to situations in which the consolidated return regulations create unique problems. Theoretically, therefore, the proposed legislation could permit the Secretary to establish a 36-percent tax rate for consolidated return filers, notwithstanding the 35-percent tax rate levied upon corporate America by Congress. Proponents of the amendment would argue that the new sentence, while strengthening the Secretary's hand, does not negate the first sentence of Code Sec. 1502, which authorizes the promulgation of regulations only "in such manner as to clearly reflect the income tax liability" of the group. The argument begs the question as to whether a consolidated return regulation would clearly reflect income tax liability if it provided a rule that was inconsistent with the Code and there was no compelling problem created from filing a consolidated return that justified a special rule. Absent such a problem, the Code must be the compass.[37]

What follows is a specific analysis of selected provisions of the consolidated return regulations that create certain tax results that differ from what would otherwise be obtained if a corporation filed a separate return. In the majority of cases, the different result to consolidated return filers is completely justified by the filing of a consolidated return. In some cases, however, the regulations may not be justified and neither Congress nor taxpayers should lament, if a court some day pronounces their demise.

Reg. §1.1502-80(b)—Inapplicability of Code Sec. 304

Reg. §1.1502-80(b) directly states, "Section 304 does not apply to any acquisition of stock of a corporation in an intercompany transaction or to an intercompany item from such transaction, occurring on or after July 24, 1991." An intercompany transaction is defined in Reg. §1.1502-13(b)(1), effectively, as any "transaction between corporations that are members of the same consolidated group immediately after the transaction." An intercompany item is defined in Reg. §1.1502-13(b)(2) as the transferor member's "income, gain, deduction, and loss from an intercompany transaction ..."

Much has been written about Code Sec. 304, one of the true gems of the Code. In its simplest form, the section prevents an individual from converting dividend income to capital gain by selling stock of a target corporation that the individual controls to another corporation that the individual also controls. If the purchasing corporation has earnings and profits, a distribution would generally be ordinary income to the individual. Absent Code Sec. 304, the individual could "sell" stock of the controlled target corporation to the controlled purchasing corporation, and treat the transaction under Code Sec. 1001. To the extent that the sales price exceeded the seller's basis in the target stock, the seller could report capital gain, and the balance would be a tax-free return of basis.

Code Sec. 304 prevents a bailout of the acquiring corporation's earnings and profits by treating the transaction as two hypothetical transactions. The common shareholder is treated as if she (he or it) first contributed the stock of target to the purchaser in exchange for the purchaser's shares in a transaction to which Code Sec. 351 applies. Then, the purchaser's shares that are deemed to have been received in the transaction are deemed to be redeemed for the property that was used in the actual sale transaction. In the simplest case, if the seller owns 100 percent of the acquiring corporation before and after the transaction, the deemed redemption will be treated as a dividend under Code Sec. 301 by reason of Code Sec. 302(d). To the extent of the acquirer's and target's earnings and profits, the sales proceeds will be taxed to the seller as a dividend under Code Sec. 301(c)(1).

Reg. §1.1502-80(b), which renders Code Sec. 304 inapplicable for a sale or exchange of a corporation's stock between two corporations that are members of the same consolidated group immediately after the transaction, arose in the aftermath of *General Utilities* repeal in the Tax Reform Act of 1986. In the mid-1980s, Congress sought to curtail the rash of hostile takeovers and "bust-up transactions" in which one corporation acquired another, and then proceeded to dispose of the unwanted businesses without tax costs. Since these techniques were not available to a target that sought to fend off the attack, Congress viewed these transactions as creating an unlevel playing field. One manner in which a bust-up transaction could have been achieved was through the application of Code Sec. 304 to the intercompany sale of stock. Consider the following example:

> P and its wholly owned subsidiary, S, file a consolidated return and wish to acquire corporation T. T is a holding company with two wholly owned subsidiaries, Wanted (W), which operates a department store, and Unwanted (U) which operates a supermarket. After an acrimonious takeover battle, P acquires T for $1 billion. W is worth $700 million, but T's basis in its W stock is zero. U is worth $300 million, and T's basis in its U stock is also zero. After P's acquisition of T, P instructs S to purchase W from T.

If Code Sec. 304 applies, the following tax consequences would result:

- T would be treated as if it contributed W to S in exchange for new S stock in a tax-free transaction to which Code Sec. 351 applied. Accordingly, T's basis in its momentary hypothetical S stock would be zero.
- S's stock would be deemed to be momentarily held by both P and T, and S would be deemed to redeem its hypothetical stock held by T.
- Both before and after the redemption by S of its stock held by T, T would be considered to own 100 percent of S under the attribution rules of Code Sec. 318.

- The redemption of the stock would be treated as a Code Sec. 301 distribution by S to T.
- The deemed Code Sec. 301 distribution would cause T's basis in its S stock to momentarily become an ELA of $700 million (effectively a negative basis).
- The elimination of that stock as part of the redemption would not cause the $700 million ELA to be triggered, but instead would shift the negative $700 million and thereby reduce P's basis in its S stock.[38]
- P's basis in its T stock would be increased by the same $700 million.[39]

T's value would remain at a $1 billion (the U stock plus $700 million in proceeds from the sale of W to S). A later sale of T to an unrelated third party for $1 billion would result in a loss to P of $700 million. The loss would be disallowed under the loss disallowance rule.[40] Notwithstanding the disallowance of the loss, P would have effectively disposed of U without gain or loss, a classic bust-up which Congress and the Treasury have, for over a decade, diligently worked to prevent.

On the other hand, if Code Sec. 304 does not apply, as provided in Reg. §1.1502-80(b), the result of a sale of W by T to S is a simple intercompany transaction to which Code Sec. 1001 applies. If T is then sold to a third party, T must accelerate the $700 million of intercompany gain on its prior sale of W stock to S,[41] a strong disincentive to attempt a bust-up transaction. Accordingly, Reg. §1.1502-80(b) is wholly justified under these circumstances due to the special problems created by the consolidated return investment adjustment regime. Any attempt to challenge the validity of the regulation under these facts should properly fail if the court employs the standard enunciated in *Rite Aid*.

Note that Reg. §1.1502-80(b) applies not only to the sale of a subsidiary's stock between members of the same consolidated group, but to "any acquisition of stock of a corporation in an intercompany transaction." Thus, if, in the above example, W were a domestic corporation where T owned at least 50 percent, but less than 80 percent of W's stock (and therefore W would not be a member of the P consolidated group), the regulation would still render Code Sec. 304 inapplicable. Code Sec. 304(a)(1) would generally apply to the sale of 79 percent of W's stock from T to S, but Reg. §1.1502-80(b) would make Code Sec. 304 inapplicable if T and S were members of the same consolidated group. The same would be true if W were a wholly owned foreign corporation or a life insurance company that was not includible in the P consolidated group. The above analysis, however, does not depend upon the status of the target company. Notably, the hypothetical transactions imposed by Code Sec. 304 are between the buyer and seller (*i.e.*, S and T in the above example). Accordingly, if those corporations are members of the same consolidated group, the nonapplication of Code Sec. 304 prevents a distortion that would otherwise result as a pure consequence of the consolidated return provisions. Thus, the regulation should be safe from challenge.[42]

Reg. §1.1502-13(f)(6)— The Parent Stock Loss Rule

Reg. §1.1502-13(f)(6)(i) disallows a subsidiary's loss on the disposition of the common parent's stock. The purpose of the regulation is to prevent consolidated groups from circumventing Code Sec. 1032 through consolidated filing. Accordingly, the regulation addresses a problem created by the filing of a consolidated return.

Regulations under the 1939 Internal Revenue Code provided that a corporation could recognize gain or loss on the sale of treasury shares to the extent of the difference between the amount received on the sale and the amount paid for such shares, as it would if the issuing corporation had sold the stock of another corporation.[43] Under this rule, a corporation could recognize a loss as well as a gain on the sale of its Treasury shares. Code Sec. 1032 of the 1954 Internal Revenue Code changed the rule to provide, as it does today, that no gain or loss is recognized on the receipt of property by a corporation in exchange for its stock, including Treasury stock. Congress noted that the old rules invited abuse because corporations were selling Treasury stock if a loss would result and were issuing new stock when there would otherwise be a gain.[44]

In a nonconsolidated context, Code Sec. 1032 does not apply to the sale of parent stock by a subsidiary. There is no statutory provision that would support a nonrecognition rule for the gain or loss on the sale by a corporation of stock of its parent.[45] On the contrary, it is the position of the IRS that a corporation which acquires stock of its parent will recognize gain or loss on the subsequent sale of that stock.[46]

By filing a consolidated return, however, absent Reg. §1.1502-13(f)(6)(i), a group could achieve precisely the result Congress, by enacting Code Sec. 1032, sought to prevent. A subsidiary could purchase common parent stock on the open market and if the stock declined in value, the subsidiary could sell the stock at a loss, which could offset the common parent's income. If the common parent stock increased in value after its acquisition, and the group wanted to raise capital, the common parent could issue new shares and Code Sec. 1032 would insulate the group from gain recognition.[47]

The consolidated return regulations, however, do not simply apply Code Sec. 1032 on a single entity basis, thereby eliminating a subsidiary's gain or loss on the disposition of P stock. Rather, the regulations disallow only the loss and retain the gain. Furthermore, the regulations make gain often difficult to avoid. In 1995, as part of the revision of the intercompany transaction regulations, the Treasury promulgated Reg. §1.1502-13(f)(4), reversing GCM 39608,[48] and requiring the trigger of any intercompany gain with respect to stock when a member acquires its own stock in an intercompany transaction. Consider the following example:

> S, a subsidiary in P's consolidated group, buys P stock on the open market on two occasions. S purchases 100 shares of P ("block 1") for $5,000 (*i.e.,* $50 per share). The value of P's shares declines dramatically and S purchases an additional 100 shares ("block 2") for $1,000 (*i.e.,* $10 per share). After P's shares recover slightly, P merges into a U.K. corporation. Under U.K. law a subsidiary may not hold stock of its parent. Accordingly, immediately prior to the transaction, S sells both block 1 and 2 at a time when the price of P stock is $30 per share.

S would realize a loss of $2,000 on the sale of block 1 and a gain of $2,000 on the sale of block 2. The loss would be disallowed pursuant to Reg. §1.1502-13(f)(6)(i) and the gain would be recognized. The gain and loss could be avoided if S were liquidated into P, but if for valid business reasons S had to be retained as a separate corporation, the problem persists.

By contrast, consider the IRS's position in Rev. Rul. 99-57,[49] where a partnership in which P is a member, sells P stock.

P contributes $100 of its own stock to AB partnership in exchange for a 50-percent interest, and A, an individual, contributes $100 cash. Under Code Sec. 723, AB's basis in the P stock is zero. After the P stock appreciates to $120, AB exchanges the P stock for property worth $120. The ruling holds that the built-in gain realized by the partnership is allocated under Code Sec. 704 to P (*i.e.,* $100) and the remaining gain (*i.e.*, $20) is allocated to A and P equally. P's gain is governed under Code Sec. 1032 and as a result, P will not recognize gain allocated to it with respect to the sale of P stock. Additionally, P was allowed an increase in the basis of its partnership interest by an amount equal to its share of gain resulting from the partnership's sale of stock. The ruling holds also that an analysis similar to that described above would apply to a transaction in which a corporate partner is allocated a loss from a transaction involving the disposition of stock of the corporate partner.

Thus, in the partnership context, the government applies Code Sec. 1032 to both gains and losses, and in the consolidated return context, the government applies Code Sec. 1032 only to losses.

Accordingly, Reg. §1.1502-13(f)(6) could be challenged as arbitrary (*i.e.,* it disallows losses but recognizes gains), however, the opportunity to use losses on the common parent's stock to offset operating income generated by the common parent itself is "created" from the filing of consolidated returns. The problem with the regulation is not that it disallows a subsidiary's losses on common parent stock, but that it disregards only loss and requires a subsidiary to take gains on such stock into account.

Reg. §1.1502 13(g)(3)(ii)(B)(2) —Override of Code Sec. 108(b) for Intercompany Obligations

Code Sec. 108(a) excludes discharge of indebtedness from gross income of a corporate taxpayer when the discharge occurs in a title 11 case, to the extent a taxpayer is insolvent, or when the indebtedness is qualified farm indebtedness. Reg. §1.1502-13(g)(3)(ii)(B)(2) renders Code Sec. 108(a) inapplicable when the indebtedness that gives rise to the discharge is an intercompany obligation.[50]

The intercompany transaction regulations under Reg. §1.1502-13, in general, were designed "to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income (or consolidated tax liability)."[51] Additionally, the intercompany obligation regulations under Reg. §1.1502-13(g) were specifically designed to prevent the origination, satisfaction or cancellation of a loan between members of a consolidated group from creating anything other than a net-zero-sum tax effect upon the group as a whole.

To the extent discharge of indebtedness income is excluded under Code Sec. 108(a), Code Sec. 108(b) requires a reduction in the taxpayer's attributes, such as net operating losses and carryovers, credits carryovers, capital loss carryovers, and basis in assets. This system is intended to provide temporary relief to financially troubled taxpayers by excluding the discharge of indebtedness from gross income and reducing attributes instead.[52]

In a consolidated return setting, however, such a system would not result in a clear reflection of income to the group as a whole. As the preamble to the final regulations states, "if S loans money to B, a cancellation of the loan subject to section 108(a) may result in: (i) excluded income to B; (ii) a noncapital, nondeductible expense to S [under the matching rule[53]]; and (iii) a reduction of B's tax attributes [*e.g.*, basis in depreciable property]." Thus, B's attributes would be reduced even though the group did not exclude any income on a net basis. To prevent this inappropriate result, Code Sec. 108(a) was made inapplicable. As a result, S and B will have offsetting ordinary income and loss, and B's tax attributes will not be reduced. Accordingly, the regulation most satisfactorily addresses a consolidated return problem and should be safe from challenge.

Reg. §1.1502-17(c)—Anti-Avoidance Rule for Methods of Accounting

Reg. §1.1502-17(c) provides an anti-avoidance rule when one member directly or indirectly acquires an activity of another member with the principal purpose to avail the group of an accounting method that would be unavailable if the members were treated as divisions of a single corporation. In such cases, the acquiring member is required to use the method of accounting that would be required if Code Sec. 381(a) applied to the transaction.[54]

A consolidated group's tax liability is computed by first calculating the separate taxable income of each member and then adding each company's separate taxable income, with certain consolidated items, in order to determine consolidated taxable income.[55] In general, each member may elect its own method of accounting.[56] Absent an anti-avoidance rule, a corporation could exploit the consolidated return rules to achieve a change in its method without obtaining the permission of the IRS. First, the corporation would contribute some or all of its assets to a new corporation ("Newco") in a transaction to which Code Sec. 351(a) applied. Newco would then elect the new/desired method of accounting and file a consolidated return with its parent. Because a Code Sec. 351 transaction is not one of the transactions listed in Code Sec. 381(a), the items which carry over would generally be limited to the basis and holding period of the contributed property.[57]

However, if a corporation transfers property to a wholly owned subsidiary with the principal purpose of adopting a new method of accounting, the anti-abuse rule in Reg. §1.1502-17(c) requires the accounting method to carry over pursuant to Code Sec. 381(c).[58] Notwithstanding that the Code does not subject a Code Sec. 351 transaction to the attribute carryover regime of Code Sec. 381, the problem addressed by Reg. §1.502-17(c) is a consolidated return problem. If accounting methods do not carry over, then a member could effectively change its method of accounting without obtaining the IRS's consent and without the requisite adjustments under Code Sec. 481(a). Query whether a method change could be achieved by a contribution of a business to a partnership owned by members of a consolidated group. If the principal purpose was to obtain a method change without seeking the IRS's permission, the partnership anti-abuse rules should apply.[59]

Reg. §1.1502-30—Stock Basis After Certain Triangular Reorganization

Reg. §1.358-6 provides rules for stock basis when a corporation is acquired in a triangular reorganization. In general, the acquiring corporation's basis in the stock of the target corporation (or its successor) will equal the target's net asset basis. Reg. §1.358-6(c)(1)(ii) states that if the amount of the target's liabilities assumed by the acquiring corporation, or to which target's assets are subject, equal or exceed the aggregate adjusted basis of target's assets, the basis of target's stock (or adjustment to the successor's stock) will be zero. Paragraph (d)(1) requires a reduction to stock basis for the fair market value of any consideration that is exchanged in the reorganization and that is not provided by P (the party whose stock is transferred) pursuant to the reorganization. Paragraph (d)(2) limits the reduction to the amount of any increase in stock basis to reflect target's net asset basis.

Reg. §1.1502-30(b)(2) declares Reg. §1.358-6(c)(1)(ii) and (d)(2) inapplicable if target (or its successor) is a subsidiary in a consolidated group as a result of a triangular merger. As a result, P will adjust its basis in target stock by taking into account the full amount of liabilities assumed and the fair market value of any consideration not provided by P pursuant to the plan of reorganization. Thus, if target's liabilities exceed basis of assets, an ELA will be created. However, nonconsolidated filers only reduce basis to zero pursuant to Reg. §1.358-6(c)(1)(ii) and (d)(2).

The preamble to the proposed regulation attempted to justify this disparate treatment as follows: "The difference in result is attributable to the fact that the consolidated return regulations provide for an ELA, a concept similar to negative basis, while the concept of a negative basis generally is not used under the Code."[60] The preamble to the final regulations indicated that there were comments for and against this treatment; however, no further justification is provided for this rule.[61] If P is a member of a consolidated group, its initial basis in the target's stock may be well below the zero basis that would result if P were not a member of a consolidated group. As of that date, no consolidated return advantages have been obtained.

The disparate treatment raises a question as to the basis results if an acquiring affiliated group does not file a consolidated return for the year of the acquisition but elects to file a consolidated return for a later year. Is there a "springing negative basis adjustment" to the target's stock? A reverse acquisition presumably can occur in a year in which the acquiring group does not file a consolidated return but later so elects.[62] Perhaps legislation would be in order to conform the separate return result to the consolidated return result. To the extent that Reg. §1.1502-30 creates a result different from the result available to nonconsolidated return filers and the problem addressed does not result from the filing of a consolidated return, the regulation may be vulnerable to judicial scrutiny.

Reg. §1.1502-31—Net Asset Basis Following a Group Structure Change

Reg. §1.1502-31 provides that the basis of stock in the former common parent of a consolidated group following a group structure change is the former common parent's net asset basis. On its face, the rule may be inconsistent with Code Sec. 362(b), which provides that the basis of property in the hands of the transferee corporation "shall be the same as it would be in hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." A group structure change is defined as a case in which the group continues under the principles of Reg. §1.1502-75(d)(2) or (3), but the common parent ceases to be the common parent.[63]

Consider a case in which the shareholders of P decide to form New Holdco to be the new common parent of the group. Since those former shareholders of P will receive all of New Holdco's stock by reason of having been shareholders of P, the formation of New Holdco is a reverse acquisition.[64] The Code provides several paths to accomplish the same end result. For example, the shareholders simply could contribute their P stock to New Holdco solely for New Holdco voting stock in a "B" reorganization.[65] Alternatively, P could form New Holdco, which could in turn form a transitory Mergerco that would merge into P in a transaction qualifying as a reverse triangular merger.[66] If the latter form is chosen, New Holdco's basis in its P stock will equal P's net asset basis, consistent with the general basis rules for triangular reorganization under Reg. §1.358-6.

Suppose, however, the shareholders pick door number 1. Absent a lack of business purpose or sham, taxpayers are generally entitled to choose the form of their transaction. Reg. §1.1502-31(a), however, does not offer a consolidated group that option because the regulation overrides the substituted basis result dictated by Code Sec. 362(b).

Particularly troublesome is Example 3 of Reg. §1.1502-31((g), entitled "Taxable stock acquisition." The example posits a case in which shareholders of T surrender their T stock to P in exchange for $70 of P stock and $30 of cash. T's assets have an aggregate basis of $60 and T has no liabilities. The transaction is described as a group structure change, implying that the value of P prior to the transaction was less than $140. The transaction is fully taxable to the former T shareholders because of the $30 cash used in the transaction. The example concludes that P's basis in its T stock is $60 (T's net asset basis) consistent with the rule described in Reg. §1.1502-31(b)(2). The example makes clear that it was the intended result of the drafters to apply a net asset basis rule notwithstanding that the transaction was fully taxable to the exchanging shareholders. If this result is sustainable, presumably a regulation could be promulgated that would give P a net asset basis in T stock where P purchases T stock entirely for cash.

In general, the consolidated return adjustment regulations reflect in stock basis all changes in a subsidiary's net asset basis required by the Code while it is a member of the group. At issue here, as under Reg. §1.1502-30, is not the adjustment to stock basis while the subsidiary is a member, but rather the initial basis of the subsidiary's stock upon becoming a subsidiary member. Code Sec. 1502 grants authority to the Secretary to prescribe regulations for corporations "both during and after the period of affiliation," but it may be questionable whether that authority extends to alter the rules of the Code as to initial stock basis upon becoming a subsidiary member. Absent a special problem created from the filing of a consolidated return, the regulation may be subject to challenge under a *Rite Aid* rationale.[67]

Reg. §1.1502-33(f)—Replication of E&P in a Group Structure Change

Reg. §1.1502-33(f) provides that in a group structure change, if P succeeds another corporation as the common parent of a consolidated group and the group continues, the earnings and profits of P are adjusted immediately after P becomes the new common parent to reflect the earnings and profits of the former common parent immediately before the former common parent ceases to be the common parent. The adjustment is made as if the transaction was described in Code Sec. 381(a). Consider the following example:

> P has $100 in earnings and profits and is the parent of a consolidated group. P's shareholders form X and contribute all of their P stock in exchange for X stock. X becomes the parent of the consolidated group and the group continues. Pursuant to Reg. §1.1502-33(f), X would be required to adjust its earnings and profits from zero to $100. P also would continue to have $100 in earnings and profits.

Code Sec. 351 transactions are not described in Code Sec. 381(a) and consequently P would not reflect the former common parent's earnings and profits absent the consolidated return regulations. However, because the group files a consolidated return, the Code Sec. 351 transaction results in a clone of the former common parent's earnings and profits to P. The apparent abuse that was being addressed was that shareholders could create holding companies with no earnings and profits, have P borrow funds that are secured by the stock of the former common parent, and make a distributions to shareholders without dividend consequences. The regulations properly prevent such a result and are consistent with treating the group as a single entity.

Reg. §1.1502-80(d)—Inapplicability of Code Sec. 357(c)

Code Sec. 357(c) provides, generally, that in the case of an exchange to which either Code Sec. 351 applies, or Code Sec. 361 applies as the result of a reorganization described in Code Sec. 368(a)(1)(D), a transferor will recognize gain to the extent that the sum of liabilities assumed exceeds the aggregate adjusted basis of the transferred assets. However, Reg. §1.1502-80(d) provides that Code Sec. 357(c) does not apply to an intercompany transaction.[68]

Prior to the promulgation of Reg. §1.1502-80(d), the preamble to the then-proposed regulations indicated that if Code Sec. 357(c) does not apply, the excess of the liabilities over basis will reduce the transferor's basis in the transferee's stock under Code Sec. 358(d). This effect is clear in the case of a transaction to which Code Sec. 351 applies. Suppose, however, that the two first-tier subsidiaries merge. The transaction would be described in both Code Sec. 368(a)(1)(A) and Code Sec. 368(a)(1)(D), and Code Sec. 357(c) will apply.[69] Under the consolidated return regulations, however, Code Sec. 357(c) will not apply. Consider the following example:

> P forms S1 for $100, and S1 invests the money in an undrilled oil well. Drillers find oil and the value of the property increases to $1000. S1 borrows $300 from the bank, secured by the property and distributes the $300 to P. Accordingly, P will have an ELA of $200 in its S1 stock and S1's liabilities will exceed its asset basis by $200. If S1 were to merge into S2, another wholly owned subsidiary of P, absent Reg. §1.1502-80(d), S1 would recognize intercompany gain under Code Sec. 357(c) (although not taken into account), and the basis of the property in the hands of S2 would be increased by $200 as well as P's basis in S2. As a result, gain would be duplicated in the basis of assets and stock of S2.

However, pursuant to Reg. §1.1502-80(d), the gain would not be recognized, the basis of the property would remain $100 and stock basis would not increase. P's basis ELA of $200 in S1 stock immediately prior to the merger would be subtracted from P's basis in S2 under Code Sec. 358, and there is no need for further adjustments.

Additionally, if the common parent merged into a first-tier subsidiary and there remained a chain of includible corporations, and the liabilities of the common parent exceeded the basis of its assets, the nonapplication of Code Sec. 357(c) will result in the assumption of liability by the subsidiary without a stock basis adjustment. In effect, the result would be the same as liquidating the subsidiary into the common parent.

The regulations indicate that Code Sec. 357(c) is inapplicable only if neither the transferor nor the transferee disaffiliates as a part of the same plan or arrangement.[70] Under the next-day rule of Reg. §1.1502-76(b)(1)(ii)(B)(2), if S joins the group as a result of the transaction, then a transaction which occurs on the day that S actually joins the group will be treated as occurring in the next day (*i.e.,* when S is a member of the group).[71]

Thus, Reg. §1.1502-80(d) makes Code Sec. 357(c) inapplicable to consolidated return filers in order to prevent gain duplication that could result by applying Code Sec. 357(c) to transactions between consolidated group members. In the same vein, the intercompany transaction regulations under Reg. §1.1502-13 were intended to prevent intercompany transactions from creating and accelerating consolidated taxable income. Given the effect on stock basis that would result if Code Sec. 357(c) applied in the consolidated return context, the regulation has a legitimate purpose and should be safe from challenge.

Reg. §1.1502-80(e)—Inapplicability of Code Sec. 163(e)(5) (AHYDOs)

Under Code Sec. 163(e)(5), the yield on applicable high yield discount obligations (AHYDOs) is bifurcated between interest and a disqualified amount, which is treated as a dividend on preferred stock. Code Sec. 163(i) defines AHYDO as an instrument with a maturity date in excess of five years, whose yield to maturity equals or exceeds the applicable federal rate by five points and which has significant original issue discount. The amount treated as a dividend is not deductible by the issuer but, solely for purposes of the Code sections governing the dividends received deduction, will be treated as a dividend to a corporate holder. If, however, the corporate holder is a member of the issuer's consolidated group, Reg. §1.1502-26(a) disallows a dividends received deduction. Accordingly, the issuer (*i.e.,* the payee member) will be disallowed a deduction but the payee member will report dividend income, which would result in a mismatch of items among group members.

To prevent such mismatch, Reg. §1.1502-80(e) provides that Code Sec. 163(e)(5) does not apply to any intercompany obligation within the meaning of Reg. §1.1502-13(g). Thus, the problem is simply and adequately solved by Reg. §1.1502-80(e).

Reg. §1.1502-80(f)—Inapplicability of Code Sec. 1031 in Intercompany Transactions

Reg. §1.1502-80(f) provides that Code Sec. 1031 does not apply to any intercompany transactions. The preamble to the proposed regulations provides:

> Code Sec. 1031 treatment for intercompany transactions is inconsistent with the general approach of the proposed regulations. If the members had been divisions of a single corporation, the basis of one property could not be substituted as the basis for another property. Although Code Sec. 1031(f) limits the planning opportunities from certain basis shifts, the limitations do not adequately address the single entity treatment of consolidated groups under the proposed regulations.
>
> To conform the treatment of like-kind exchanges more closely to the general treatment of intercompany transactions under the proposed regulations, the proposed regulations provide that Code Sec. 1031 does not apply to intercompany transactions. Any gain or loss of members will be taken into account under the matching and acceleration rules.[72]

As discussed earlier, the intercompany transaction rules are designed to provide rules to clearly reflect the taxable income of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income. Accordingly, when one group member sells an asset to another member of the group, the gain or loss related to this transaction is recognized but not taken into account until an acceleration event (*e.g.,* a disposition of the asset to a nongroup member). However, the member purchasing the asset receives a cost basis in the asset even though the gain or loss is not taken into account. When the asset is disposed of, the selling member will take into account any unrestored intercompany item and the buying member will report any gain or loss that occurred subsequent to the intercompany transaction. Both with respect to the timing and character of the transaction, the result to the group as a whole is the same as if the buying and selling members were divisions of a single corporation.

Code Sec. 1031(f) undoes the application of Code Sec. 1031(a) if within two years after a like-kind exchange between related parties, either party disposes of the property that was received in the exchange. If group members were allowed to enter into Code Sec. 1031 transactions, and could wait out the two-year period, members could swap basis among high- and low-value properties and assign the high-basis to unwanted properties. After the two years, the unwanted property could be sold with less gain than would have been the case if the intercompany exchange had not occurred. Thus, the group as a whole could achieve results that would be inconsistent with treating the exchanging members as if they were divisions of a single corporation. Accordingly, Reg. §1.1502-80(f) should be sustained under the *Rite Aid* rationale, notwithstanding that the regulation produces a result different than the result that would be achieved if the members of the affiliated group did not file a consolidated return.

Reg. §1.1502-75(d)(3)(v)(b)—Override of Code Sec. 381(b)(3)

Code Sec. 381(b)(3) provides that following a reorganization (as well as a liquidation to which Code Sec. 332 applies), NOLs or net capital losses incurred by the surviving corporation after the transaction may not be carried back to a prior tax year of the transferor (or distributor) corporation. Rather, the general rules of Code Secs. 172 and 1212(a) would apply to allow a carryback to a prior year of the surviving corporation. However, if the surviving corporation is smaller than the merged corporation, Reg. §1.1502-75(d)(3)(v)*(b)* provides that the merged corporation will be treated as the survivor.

Suppose, for example, that two stand alone companies, Bigco and Smallco, decide to merge. Despite Bigco's dominant size, it has experienced losses over the past several years and Smallco has been profitable. The parties anticipate that in the short term following the merger, the combined entity will show a loss before Bigco's operations can be turned around. From a nontax perspective, the parties are indifferent as to which entity becomes the transferor and which the transferee. After the merger, the name of the surviving entity can even be changed to the name of the merged entity. Good tax planning would suggest that Bigco should merge into Smallco, rather than the natural course of Smallco into Bigco. Post-merger losses of the surviving entity can then be carried back to offset income generated in prior years by Smallco. Also, Bigco will close its tax year and Smallco's tax year will continue. The Code generally gives taxpayers their choice of form and respects that choice.

Assume the same facts except that prior to the merger Bigco has a tiny subsidiary with which it files a consolidated return. The merger of Bigco into Smallco will constitute a reverse acquisition.[73] Under the reverse acquisition rules, Smallco, not Bigco, must close its tax year and the Bigco consolidated group will survive. Bigco's losses will not be subject to separate return limitation year restrictions.[74] Because these are purely consolidated return questions, the Secretary has authority to prescribe any reasonable rule to reflect the tax liability of the group clearly.

However, the regulations further provide that post-merger losses of the surviving common parent, Smallco, may not be carried back to prior tax years of Smallco, but are instead carried to prior tax years of Bigco, notwithstanding Code Sec. 381(b)(3). Here, the consolidated return rationale for overriding a provision of the Code that effectively gives taxpayers a choice is not apparent. Query whether *Rite Aid* casts doubt on the validity of this regulation?[75]

Reg. §1.1502-80(c)—Deferral of Worthless Stock Deduction

For a discussion of the post-*Rite Aid* applicability of Reg. §1.1502-80(c), which defers a worthless stock deduction under Code Sec. 165(g)(3), *see* Part 1 of this article.[76]

Proposed Reg. §1.1502-35—Suspension of Losses on Certain Stock Dispositions[77]

On October 18, 2002, the Treasury and the IRS issued Proposed Reg. §1.1502-35, which redetermines the basis of subsidiary stock immediately prior to dispositions and deconsolidations of loss stock. In addition, the proposed regulations suspend certain losses recognized on the disposition of subsidiary loss stock. These anti-double deduction rules are aimed solely at corporations that file consolidated returns. Furthermore, Proposed Reg. §1.1502-35(b) does not apply if all of the stock of the subsidiary is disposed in a fully taxable transaction in the same tax year as the disposition. However, Proposed Reg. §1.1502-35(f) continues to apply.

The proposed regulations (except for section (g)(3) relating to loss reimportation)[78] are retroactively applicable to stock dispositions or deconsolidations occurring on or after March 7, 2002, but only if the transaction occurs during a tax year the original return for which is due (without regard to extensions) after the proposed regulations are published as temporary or final regulations in the Federal Register.

The purpose of the proposed regulations can be found in Proposed Reg. §1.1502-35(a), which states, "The purpose of this section is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of this section shall be construed in a manner consistent with that purpose and in a manner that reasonably carries out that purpose." This purpose is consistent with the Supreme Court's holding in *Charles Ilfeld Co.* and Notice 2002-18.

The proposed regulations contain:

- a basis redetermination rule,
- a loss suspension rule,
- a basis reduction rule, and
- certain anti-avoidance rules.

Basis Redetermination Rule. Proposed Reg. §1.1502-35(b) applies when a member of a consolidated group disposes of subsidiary stock or a share of stock is deconsolidated, and the stock has a basis in excess of its value. Under Proposed Reg. §1.1502-35(b)(2), if the subsidiary remains a member of the group after the disposition, all of the basis is aggregated. The aggregated basis is first allocated to preferred stock owned by members, but not in excess of the stock's value on the date of disposition or deconsolidation ("the event"). Any remaining basis is allocated to the common shares held by the members in proportion to the stocks' relative values.

If the subsidiary does not remain a member, Proposed Reg. §1.1502-35(b)(3) requires the computation of the "reallocable basis amount." The reallocable amount is the lesser of (1) the amount by which the basis of the disposed shares exceeds the fair market value of those shares (*i.e.,* the built-in loss) immediately prior to the event, and (2) the total of the subsidiary's allocable share of items of deduction and loss that were taken into account in computing the adjustment to the basis of any share of the subsidiary's stock other than the stock disposed or deconsolidated. However, to the extent the group can establish that all or a portion of the items would not have been reflected in a computation of the duplicated loss with respect to the deconsolidated or disposed stock, the amount under (2) above is reduced. The reallocable basis amount reduces the basis in the shares of stock disposed. This amount is then allocated to any remaining preferred stock up to its value, and then among common stock in a manner that causes, to the greatest extent possible, the ratio of the basis to value of each such other share to be the same to the greatest extent possible.[79]

Notably, in situations in which the subsidiary remains a member, the regulations do not provide the taxpayer an opportunity to establish that loss on the disposition is not attributable to a built-in loss. To this extent, Proposed Reg. §1.1502-35(b)(2) may be subject to challenge.

Furthermore, Proposed Reg. §1.1502-35(b)(4) provides that the basis redetermination rules do not apply if all of the stock of the subsidiary is disposed in a fully taxable transaction in the same tax year as the event (disposition). This exception renders the regulations inapplicable to the vast majority of stock dispositions.

Loss Suspension Rule. Proposed Reg. §1.1502-35(c) contains a loss suspension rule with respect to a loss sustained on the disposition of subsidiary stock where the subsidiary remains a member of the group following the disposition. The amount suspended may not exceed the duplicated loss. The definition of duplicated loss is similar to the definition previously found in Reg. §1.1502-20(c)(2)(vi) with minor differences. The amount of suspended loss is reduced by the subsidiary's items of deduction and loss that are absorbed by the group and are allocable to the period beginning on the date of the disposition of the stock that created the suspended loss and ending on the date that the subsidiary ceases to be a member. Thus, some or all of the losses may never be claimed. If, however, the subsidiary does not remain a member of the group, the loss suspension rule is not applicable.

Basis Reduction Rule. The IRS and the Treasury were concerned that a group may obtain more than one tax benefit from a single economic loss in certain cases in which a member recognizes a loss upon the dissolution of a worthless subsidiary. In response to this concern, Proposed Reg. §1.1502-35(f) provides:

> If a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then, immediately prior to the recognition of any gain or loss with respect thereto, and immediately after all other adjustments under §1.1502-32 with respect thereto, the basis of upper-tier members in the stock of the subsidiary member shall be reduced to the extent of the consolidated net operating losses and net capital losses that would be treated as attributable to such subsidiary member (and lower-tier members) under the principles of §1.1502-21(b)(2)(iv), as though such losses were absorbed by the group. In addition, if, taking into account the provisions of §1.1502-80(c), stock of a subsidiary member is treated as worthless under section 165, then, immediately prior to the allowance of any loss or inclusion of an excess loss account

> with respect thereto, the basis of upper-tier members in the stock of the worthless member shall be reduced to the extent of the consolidated net operating losses and capital losses that would be treated as attributable to such subsidiary member (and lower-tier members) under the principles of §1.1502-21(b)(2)(iv), as though such losses were absorbed by the group.

In two sentences, Proposed Reg. §1.1502-35(f) manages to perplex any reader and provide complete confusion regarding when, if ever, a worthless stock deduction can be claimed in a consolidated context. The drafters of the proposed regulation have stated their intent to allow one deduction to a group for one economic loss. As drafted, however, Reg. §1.1502-35(f) may completely disallow a deduction for an economic loss. The first sentence in the proposed regulation applies in situations where a subsidiary is dissolved and a worthless stock deduction is claimed. The proposed regulation requires that immediately prior to the recognition of loss with respect to the stock of the subsidiary, the basis in the stock shall be reduced to the extent that consolidated NOLs and capital losses are attributable to the subsidiary as though the losses were absorbed by the group. As a result:

1. The basis in the stock would be reduced by consolidated NOLs and capital losses attributable to the subsidiary.
2. The subsidiary would dissolve.
3. Any consolidated NOL or capital loss attributable to the subsidiary would disappear.[80]

Thus, no deduction would be allowed for the group's economic loss.

Perhaps the IRS is concerned that taxpayer's may take a position that consolidated NOLs and capital losses belong to the group and not the member. Such as position is based on a misinterpretation of *dicta* in the 2001 Supreme Court decision in *United Dominion Industries, Inc.*,[81] which held that the 10-year carryback rules under Code Sec. 172(f) are determined on a consolidated rather than a separate company basis. Under this rationale, when a subsidiary dissolves, the portion of the consolidated NOL and capital loss attributable to the subsidiary would survive. There is, however, no support for such a position. The consolidated NOLs and capital losses attributable to the dissolved subsidiary are eliminated upon dissolution.[82]

The second sentence in the proposed regulation describes a situation in which the group claims a worthless stock deduction after the subsidiary disposes of substantially all of its assets. Here, the proposed regulation requires that the subsidiary's stock be reduced to the extent of any CNOLs and capital losses attributed to the subsidiary as if such losses were absorbed by the group. As a result, when a worthless stock deduction is claimed, (1) there would be a reduction in the basis of stock, and (2) a Code Sec. 382 ownership change would occur under Code Sec. 382(g)(4)(D). Proposed Reg. §1.1502-35(f) would disallow the stock loss and Code Sec. 382 would disallow the use of any NOLs and capital losses because the value of the subsidiary would be zero. Thus, no deduction would be allowed for the taxpayer's economic loss.

If Proposed Reg. §1.1502-35(f) is adopted in its current form, the provision is subject to challenge.[83] As discussed in Part 1 of this article, an amenable modification to the regulations would be to remove Reg. § 1.1502-80(c) and instead allow a worthless stock deduction in the year of worthlessness.[84] Under this scenario, only one loss would result to the group for its investment at the time of worthlessness.

Part II Conclusion

Given the special situations that consolidated return filing creates, the consolidated return regulations in most cases satisfactorily address problems that arise from the filing of consolidated returns and to that extent, the regulations should not be vulnerable to attack under a *Rite Aid* rationale. However, some consolidated return regulations may be at risk because they are inconsistent with the Code and do not address problems that arise from consolidated return filing. To that extent, taxpayers have a right to challenge the regulations and the courts have the duty to curb any abuse by the Secretary of his regulatory authority.[85]

It is unnecessary to propose legislation that gives the Secretary the power to prescribe rules under Code Sec. 1501 that are different than the Code because the majority of the consolidated return regulations do indeed address special problems created from consolidated return filing and can withstand challenge in the courts. Regulations that provide rules which are inconsistent with the Code and (1) are without justification under the single-entity approach, or (2) do not address a problem arising from consolidated filing, create distortions of income and, with or without any amendment to Code Sec. 1502, will remain subject to judicial scrutiny.

ENDNOTES

* The authors are indebted to Jared H. Gordon, Deloitte & Touche, and Michael L. Schler, Cravath, Swaine & Moore, for their assistance and thoughts.

1 *Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357.

2 *See*, for example, N.Y.S.B.A. Tax Section's *Letter to Kenneth W. Gideon, Assistant Secretary (Tax Policy)* (Apr. 17, 1990) reprinted in 90 TNT 83-16 (Aug. 22, 1990); and Irving Salem, *Judicial Deference, Consolidated Return Regulations, and Loss Disallowance: Could LDR Survive a Court Challenge?* 43 TAX EXEC. 167 (1991).

3 *American Standard, Inc.*, CtCls, 79-2 USTC ¶9417, 602 F2d 256, 220 CtCls 411; *Joseph Weidenhoff, Inc.*, 32 TC 1222, Dec. 23,761 (1959); *Kanawha Gas & Utilities Co.*, CA-5, 54-2 USTC ¶9508, 214 F2d 685; *General Machinery Corp.*, CA-6, 38-1 USTC ¶9243, 95 F2d 759; *Corner Broadway-Maiden Lane, Inc.*, CA-2, 35-1 USTC ¶9229, 76 F2d 106.

4 Hereinafter all section references are to the Internal Revenue Code of 1986, as amended ("the Code"), and to the Treasury Regulations promulgated thereunder, unless otherwise noted.

5 Code Sec. 337(d)(1).

6 For a lengthy discussion of the difficulty of this problem, *see* Michael Schler, *Consolidated Return Loss Disallowance: Conceptual Issues,* 2002 TNT 88-30 (May 3, 2002).

7 Reg. §1.1502-20(g).

8 For further analysis of the effects of the reattribution election, *see* Jared H. Gordon, Dave N. Stewart and Steven C. Thompson, *The Saga Continues: New Interim Loss Disallowance Regulations*, J. CORP. TAX'N, Jul.–Aug. 2002, at 3.

9 Code Sec. 7806(b).

10 Temporary Reg. §1.337(d)-2T.

11 *See also* Reg. §1.1502-13(f)(7), Example 2.

12 Notice 2002-18, IRB 2002-12, 644. *See* Proposed Reg. §1.1502-35.

13 Query whether the definition of a built-in gain item for purposes of the loss disallowance rules will be coordinated with the definition of a built-in gain item for purposes of Code Sec. 1374 and Code Sec. 382? *See* Reg. §1.1374-4(a)(3), Example 1, where a working interest in oil and gas property is not built-in gain property because, when the corporation converted from a C corporation to an S corporation, it held only a working interest in the oil and gas property and not the oil itself since it had not yet been extracted.

14 *R.K. Cox, Jr.*, 78 TC 1021, Dec. 39,103 (1982).

15 If such amount is not treated as a disposition and is allowed to be stepped-up to fair value due to an election under Code Sec. 631(a), the ultimate sale of the timber would not give rise to income, presenting a potential loophole. Perhaps the stepped-up amount should be taxed upon ultimate disposition/sale.

16 It should be noted that Proposed Reg. §1.302-5(b)(4) suggests that a dividend under Code Sec. 1248 is a sale or exchange of stock of the redeeming corporation for purposes of determining the accelerated loss inclusion date. 67 FR 64331–45 (Oct. 18, 2002).

17 Perhaps a dictionary definition would prove helpful; Dispose of: *to pass into the control of someone else*. BLACK'S LAW DICTIONARY (6th ed. 1990).

18 Reg. §1.1502-20(c)(2)(i).

19 *See* TAM 200138005 (May 4, 2001).

20 TAM 200138005 (Sept. 21, 2001).

21 Reg. 1.337(d)-1(a)(5), Example 3.

22 Reg. §1.1502-20(c)(2)(vi).

23 *See Aluminum Goods Manufacturing Co.*, SCt, 3 USTC ¶1024, 287 US 544, 53 SCt 227 (1933).

24 Temporary Reg. §1.1502-20T(i)(3)(i).

25 Temporary Reg. §1.1502-20T(i)(3)(ii).

26 If the date of disposition or deconsolidation is after March 7, 2002, the election should be filed on such date.

27 Reg. §1.1502-32(b)(3)(iii)(B).

28 *American Standard, Inc.*, *supra* note 3, 602 F2d, at 261.

29 *See* Irving Salem, Rite Aid: *Potentially Historic*, TAX EXEC. Mar.–Apr. 2002, at 149, 152; and Jerred G. Blanchard, Debra J. Bennett and Christopher D. Speer, *The Deductibility of Investments in Financially Troubled Subsidiaries and Related Federal Income Tax Considerations,* TAXES, Mar. 2002, at 91, 113.

30 *Supra* note 3.

31 *Supra* note 1, *citing American Standard*.

32 *Id*.

33 Report of the Senate Finance Committee on the CARE Act of 2002, at 92, note 183.

34 Reg. §1.1502-32.

35 *See Charles Ilfeld Co.*, SCt, 4 USTC ¶1261, 292 US 62, 54 SCt 596 (1934); *AMBAC Industries, Inc.*, CA-2, 73-2 USTC ¶9800, 487 F2d 463.

36 American Competitive and Corporate Accountability Act of 2002 (H.R. 5095) (introduced July 11, 2002), and Charity Aid Recovery and Empowerment Act of 2002 (H.R. 7) (reported by the Senate Finance Committee on June 18, 2002).

37 *See AICPA Letter to Leaders on CARE Act*, 2002 TNT 183-32 (Sept. 17, 2002).

38 Reg. §1.302-2(c), Example (2).

39 Reg. §1.1502-32(b)(3)(iv)(B). *See also* LTR 9815050 (Jan. 9, 1998).

40 Reg. §1.1502-20(c)(1), or Temporary Reg. 1.337(d)-2T(c), or their successor provisions. The temporary regulation may not disallow the loss given the absence of gain recognition from the disposition of an asset.

41 Reg. §1.1503-13(d).

42 It should be noted that if proposed regulations under Code Secs. 302, 304 and 1502 become final, Reg. §1.1502-80(b) will be unnecessary. *See* 67 FR 64331–45 (Oct. 18, 2002). As such, if and when the proposed regulations become final, Reg. §1.1502-80(b) should be repealed.

43 Reg. §118; Reg. §39.22(a)-15.

44 Congressional Record, 12164–66 (July 29, 1955).

45 For accounting purposes, the rule is different; stock of a corporate parent in the hands of its subsidiary is treated as Treasury stock. ANDREW A. HARIED, LEROY F. IMDIEKE AND RALPH E. SMITH, ADVANCED ACCOUNTING, at 335 (5th ed. 1991).

46 Rev. Rul. 70-305, 1970-1 CB 169; Rev. Rul. 80-189, 1980-2 CB 106.

47 *See also* Michael Schler, *Exploring the Boundaries of Section 1032*, 49 TAX LAW. 543 (1996).

48 GCM 39608 (Mar. 5, 1987).

49 Rev. Rul. 99-57, 1999-2 CB 678.

50 An intercompany obligation is defined in Reg. §1.1502-13(g)(2)(ii) as "an obligation between members, but only for the period during which both parties are members."

51 Reg. §1.1502-13(a)(1).

52 *See* Bankruptcy Tax Act of 1980 (P.L. 96-589).

53 Reg. §1.1502-13(c)(4)(i)(A), which states that to the extent B's corresponding item offsets S's intercompany item in amount, the attributes of B's corresponding item, determined based on both S's and B's activities, control the attributes of S's offsetting intercompany item.

54 Reg. §1.381(c)(4).

55 Reg. §1.1502-11(a).

56 Reg. §1.1502-17(a).

57 Code Secs. 362 and 1223.

58 Code Sec. 381(c)(4).

59 Reg. §1.701-2.

60 *See* Lawrence M. Axelrod and Kevin C. Hardman, *Axelrod And Hardman Say Proposed Rules Penalize Affiliated Groups That File Consolidated Returns,* 95 TNT 57-41 (Mar. 6, 1995), for a comment on the proposed regulations.

61 T.D. 8648, 1996-1 CB 37, at 38.

62 *See* Reg. §1.1502-75(d)(3)(v) for the inference.

63 Reg. §1.1502-33(f)(1).

64 Reg. §1.1502-75(d)(3)(i).

65 Code Sec. 368(a)(1)B).

66 Code Sec. 368(a)(2)(e)*; see also* Rev. Rul. 82-152, 1982-2 CB 205.

ENDNOTES

[67] *See also Kanawha Gas & Utilities Co.*, CA-5, 54-2 USTC ¶9508, 214 F2d 685.

[68] The IRS has ruled under pre-1995 law that if a member of a consolidated group recognizes gain under Code Sec. 357(c) by reason of a transfer to another member, the gain is deferred. LTR 9028068 (Apr. 13, 1990); LTR 9050063 (Oct. 12, 1989).

[69] *See* Rev. Rul. 76-188, 1976-1 CB 99; Rev. Rul. 75-161, 1975-1 CB 114.

[70] The regulations clarify that reference to transferor includes successor or predecessor. *But see* Reg. §1.1502-19(g), Example 3.

[71] Reg. §1.1502-76(b)(1)(ii)(D)(2).

[72] CO-11-91, 1994-1 CB 724.

[73] Reg. §1.1502-75(d)(3)(i).

[74] Reg. §1.1502-1(f)(f)(3).

[75] *See* Wessel, Davis, Vogel and Collins, *The Consolidated Group: Continuation and Termination Issues*, CONSOLIDATED TAX RETURN REGULATIONS, 1 ALI-ABA 135, 159 (2002).

[76] *See* text at note 22, *supra*.

[77] 67 FR 65060–74 (Oct. 23, 2002).

[78] Paragraph (g)(3) is applicable to transactions occurring on or after October 18, 2002, but only if the event occurs in a tax year the original return for which is due (without regard to extensions) after the proposed regulations are published as temporary or final regulations in the Federal Register.

[79] To the extent the reallocable basis amount is not allocated to preferred stock it is allocated to common stock in the same manner.

[80] The dissolution is not a Code Sec. 332 liquidation because the liabilities of the subsidiary exceed the value of its assets. Thus, any distribution would be with respect to liabilities and not stock. *See* Reg. §1.332-2(b). As a result, Code Sec. 381 does not apply and attributes (*e.g.*, NOLs) do not carry over.

[81] *United Dominion Industries, Inc.*, SCt, 2001-1 USTC ¶50,430, 532 US 822, 121 SCt 1934.

[82] Additionally, when all of the stock of a subsidiary is sold to an unrelated third party, the CNOLs and capital losses attributable to the subsidiary leave the group.

[83] *See Aluminum Goods*, *supra* note 23.

[84] *See* Part I of this article for a discussion of Reg. §1.1502-80(c).

[85] As a word of caution, it should be noted that if taxpayers take a position that is contrary to regulations, they must file Form 8275-R, *Regulation Disclosure Statement*.