Preliminary Comments on Consolidated Group Basis Redetermination and Loss Suspension (REG-131478-02)

The following preliminary comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association Section of Taxation.

These preliminary comments were prepared by individual members of the Committees on Affiliated and Related Corporations and Corporate Taxation of the Section of Taxation. Principal responsibility was exercised by Andrew Dubroff. Substantive contributions were made by John Broadbent, Jasper Cummings, Jr., Terrill Hyde, Laynie Pavio, Victor Penico, Mark Silverman, Steve Teplinsky, Gordon Warnke, and Thomas Wessel. The comments were reviewed by Wayne Strasbaugh of the Section’s Committee on Government Submissions and by Joseph M. Pari, Council Director for the Committees on Affiliated and Related Corporations and Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these preliminary comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these preliminary comments.

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We are writing to offer preliminary comments on the proposed regulations. We have been studying the regulations at great length, and have identified a number of conceptual and mechanical problems. While we plan to submit detailed comments at a later date that describe these problems in more detail, we are mindful of the government’s informally announced intention to adopt temporary or final regulations addressing loss duplication issues by March 15, 2003. We offer these preliminary comments in advance of our more detailed submission, because we believe that the approach and mechanics of the proposed regulations are unworkable. For the reasons highlighted below, we urge that the proposed regulations not be adopted in their current form.

The proposed regulations address a narrow loss duplication concern by making sweeping revisions of the basis and loss rules for stock of subsidiaries in a consolidated group. We believe that the proposed regulations will have much wider application than the government may have anticipated, and that they will greatly increase the complexity of an already complex regime. The proposed regulations rely on simplified assumptions as to relationships among stock basis, stock fair market value, and subsidiary loss items. We believe these assumptions will often be incorrect and will produce distortions that will give rise to new tax avoidance opportunities. The examples below illustrate only some of the circumstances in which distortion arises. We do not mean to imply that the problems with the proposed regulations are limited to the issues illustrated in these examples. Instead, the sweeping revisions to the consolidated return stock basis and stock loss rules present too many problems to be adequately described in these preliminary comments. Accordingly, we merely highlight a few discrete issues as illustrative of more general problems.

Examples 1 and 2 focus on the interaction between the proposed regulations and the investment adjustment rules. In Example 1, a group’s only loss is disallowed, while in Example 2, the loss duplication problem is not eliminated. We do not believe that these problems can be eliminated by simple refinements to interactions with the investment adjustment rules. Instead, comprehensive principles analogous to section 704(c) would be necessary to determine the proper allocation of the subsidiary’s items. The essential question is where S’s items should be allocated for investment adjustment purposes; anything short of comprehensive tracing will cause distortions when combined with loss disallowance concepts.

**Example 1. Group’s only loss disallowed.** P, the common parent of a consolidated group, forms S by contributing $80 for 80 shares of S common stock (representing all of S’s outstanding stock). P later contributes five assets, each with a $10 basis and $4 value, for an additional 20 shares of S common stock. P’s aggregate basis in the newer shares (“BIL Shares”) is $50 and S’s aggregate basis in the assets (“BIL Assets”) is $50. P sells the BIL Shares for $20, and because the sale does not deconsolidate S, the proposed regulations redetermine P’s basis.

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1 One particularly problematic aspect of the proposed regulations is the basis reduction required in connection with stock of worthless subsidiaries. The range of problems will be addressed in detail in our subsequent submission.
in each of its shares immediately before the sale to be $1.30. Thus, P recognizes $6 of loss on the sale of the 20 BIL Shares, and this loss is suspended. S later sells one of the BIL Assets, recognizing a $6 loss. This $6 asset loss causes P’s $6 suspended stock loss to be entirely eliminated. Moreover, S’s $6 loss offsets P’s income, and under the investment adjustment rules, P’s basis in the retained shares is reduced by 80% of that loss ($4.80), from $104 to $99.20. P later sells all of its retained shares for $80, and recognizes $19.20 of loss (for an aggregate inside and outside loss of $25.20). Thus, under the proposed regulations, the P group would be deprived of $4.80 of its original $30 loss with respect to the BIL Assets because $4.80 of S’s loss with respect to the BIL Asset reduced P’s basis in the retained S shares and had the duplicate effect of eliminating P’s suspended loss.

Example 2. Duplication not fully eliminated. P, the common parent of a consolidated group, and X, a nonmember, form S, with P contributing $80 for 80 shares of common stock and X contributing $10 for 10 shares of common stock (representing all of S’s outstanding stock). P later contributes Asset A, with a $46 basis and $10 value, for an additional 10 shares of S’s common stock (“BIL Shares”). P’s aggregate basis in the BIL Shares is $46, and S’s basis in Asset A is $46. P sells the BIL Shares for $10, and because the sale does not deconsolidate S, the proposed regulations redetermine P’s basis in each of its shares to be $1.40 immediately before the sale. Thus, P recognizes a $4 loss on the BIL Shares, and this loss is suspended. S later sells Asset A, and its $36 asset loss causes P’s $4 suspended stock loss to be eliminated. Moreover, S’s $36 loss offsets P’s income, and under the investment adjustment rules, P’s basis in its retained S shares is reduced by 80% ($28.80) of that loss, from $112 to $83.20. P later sells all of its retained shares for $80, and recognizes a $3.20 stock loss. Thus, under the proposed regulations, the P group’s $36 built-in loss with respect to Asset A generates $39.20 ($36 plus $3.20) of aggregate loss to the P group.

The negative adjustment to the retained shares does not appear to constitute a duplicate stock basis adjustment that is blocked by Reg. §1.1502-32(a)(2), in that the duplication occurs by reason of the elimination of the suspended loss and not of stock basis.

This example raises issues concerning a consolidated group’s general ability to include 100% of a subsidiary’s items in the consolidated return while reflecting only a proportionate amount of the subsidiary’s items in the group’s investment adjustments. Because the investment adjustment rules allocate 10% of S’s items to X, the proposed regulations fail to eliminate 10% of the $36 duplicated loss. The current investment adjustment approach reflects an assumption that S’s tax items parallel its economic items, and that, in order to prevent duplication, only a proportionate amount should therefore be reflected in the group’s stock basis. If S’s tax items represent built-in amounts, this basic assumption is incorrect, and distortions can arise. The proposed regulations raise new issues regarding the appropriateness of the existing investment adjustment rules, which tolerate these distortions.

The minority shareholder’s presence in this example creates the potential for preserving as much as 10% of the loss duplication. Only $3.20 of loss duplication (as opposed to the $3.60 of potential duplication) is actually achieved, because the proposed regulations stack S’s entire asset loss against the $4 suspended stock loss. However, if S’s $36 asset loss had been absorbed before P sold the BIL Shares, the full $3.60 potential loss duplication would have been achieved.

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Novel concepts introduced by the proposed regulations, such as wholesale basis redeterminations, raise a range of new issues and are likely to become a source of entirely new and unintended tax planning, because the resulting basis shifts undermine the historic efforts in other parts of the consolidated return regulations to preserve the location of gain and loss. The problem can even be multiplied by transferring a built-in loss asset multiple times within a group.

Example 3. Mirror transactions. P, the common parent of a consolidated group, owns all of the stock of S1 and S2, two subsidiaries in the P group, and S1 and S2 collectively own all of the stock of S3, another subsidiary in the P group. P’s S1 stock has a $200 basis and value (from a prior cash contribution), and its S2 stock has a $100 basis and $200 value. S1 owns 50% of the S3 common stock, with a $200 basis and value (from a prior cash contribution). S2 owns the remaining S3 common stock, with a $100 basis and $200 value, and S2 also owns 1 share of S3 preferred stock that reflects a de minimis built-in loss. P plans to sell all of the S2 stock to an unrelated buyer, but the buyer is not interested in S3. Through a recapitalization described in section 368(a)(1)(E), S2 exchanges its S3 common shares for new S3 preferred shares described under section 1504(a)(4). S2 takes a $100 basis in the new preferred shares having a $200 value. P then sells all of the S2 stock to the buyer for $200, and this sale does not deconsolidate S3 from the P group. Under the proposed regulations, the basis of the S3 stock is redetermined immediately before P’s sale of S2, because the sale does deconsolidate the preferred share of S3 stock with a de minimis built-in loss owned by S2. The approximately $300 total amount of S3 stock basis is reallocated first to the new S3 preferred stock owned by S2, and then to the S3 common stock owned by S1. Thus, the preferred stock basis increases from $100 to $200, while the common stock basis decreases from $200 to $100. Under the investment adjustment rules, the increase in S2’s net asset basis tiers up and correspondingly increases P’s basis in the S2 stock from $100 to $200. Thus, P recognizes no gain or loss on the sale of its S2 stock. Following the sale, P and the buyer negotiate for P to purchase the S3 preferred stock owned by S2 for approximately $200, and S2 recognizes little or no gain or loss from this sale.4

In addition to mechanical issues, we believe the proposed regulations present conceptual concerns. The proposed regulations deal only with consolidated returns and thus do not address similar potential for avoidance in the separate return context. For example, a parent corporation can contribute depreciated financial assets to an 80% owned profitable subsidiary in exchange for preferred stock that is not described in section 351(g)(2). The subsidiary can then sell the financial assets and recognize a loss that offsets its own operating income, and the contributing corporation can also sell the preferred stock at a loss. While the proposed regulations would require adjustments to prevent this duplication if the subsidiary happens to be a member of

4 Because there is no loss on the S2 stock, the special rules for lower-tier subsidiaries in the proposed regulations are inapplicable. The effects of this recapitalization transaction are reminiscent in many respects of the opportunities presented by the analysis in PLR 9815050 (Jan. 9, 1998), which we understand the government now finds problematic. Any approach that relies on basis shifting undermines the government’s historic efforts to prevent “mirror subsidiary” transactions. See, e.g., sections 304(b)(4), 337(c), and 355(b)(2)(D).
parent’s consolidated group, no guidance has been issued to deal with such duplication if parent and subsidiary file separate returns. Thus, the proposed regulations create a distinction between consolidated and separate returns similar to the one the Federal Circuit found fatal in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001). It is also unclear whether the pending legislation to limit the application of *Rite Aid* would resolve this issue, because it appears in its most recent form to preserve the separate return principle relied on in *Rite Aid* in the context of loss duplication.

In view of the mechanical distortions and conceptual issues described above, we are currently considering whether the loss duplication problem can be adequately addressed through alternative approaches that seek to minimize the extent to which consolidated groups are required to address loss duplication by tracing subsidiary items. We are examining the extent to which concerns with duplication should be limited to in-kind contribution (“stuffing”) transactions, and whether guidance might more appropriately be targeted at such transactions.

For example, it might be possible to address situations in which outside loss precedes inside loss by allowing the stock loss but subjecting the subsidiary’s inside items to the separate return limitation year (“SRLY”) rules if there have been stuffing transactions with respect to the subsidiary and there is any loss duplication at the subsidiary level (in the form of net built-in loss or NOL carryforwards) at the time the stock loss is recognized. This approach promotes simplification by avoiding tracing, but does not prevent the type of separate return duplication described above (i.e., where the subsidiary generates adequate income to absorb its own loss). In light of this more limited approach, consideration should be given to an anti-stuffing rule, analogous to Reg. §1.1502-20(e)(2), that addresses stuffing built-in loss assets into an otherwise built-in gain subsidiary to avoid the SRLY limitation, and perhaps additional anti-stuffing rules to limit the subsidiary’s income generation under the SRLY rules to the extent that the income depends on stuffing facilitated by the consolidated return rules.

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5 The preamble to the proposed regulations states that the rules are “based on the principle that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) (disallowing a worthless stock deduction recognized on a liquidation of a subsidiary member because the group had already obtained the tax benefit from the operating losses that gave rise to the deduction).” REG-131478-02, 2002-47 I.R.B. 892, 893. Thus, in *Ilfeld*, the stock loss was claimed after the consolidated group had already absorbed the subsidiary’s operating loss. We are not aware of any cases extending the *Ilfeld* principle to a subsidiary’s absorption of its own loss, simply because it happens to join in a consolidated return.

6 The SRLY limitation would apply without regard to the “overlap relief” that generally eliminates the SRLY limitation in favor of an equivalent section 382 limitation. See, e.g., Reg. §1.1502-21(g). Because the group is claiming loss on subsidiary stock without the subsidiary leaving the group, the government might impose the SRLY limitation on all of the subsidiary’s assets because the group is essentially treating the subsidiary as a separate return investment. If this approach is too broad, the SRLY limitation could be imposed on only a portion of the subsidiary’s assets, to more precisely correlate with the extent of the stock loss. We do not encourage rules that require particular sources of subsidiary built-in loss to be traced to particular sources of outside loss, and any narrowly applied SRLY approach should rely on irrebuttable presumptions (e.g., if $10 of stock loss is recognized, the subsidiary’s first $10 of inside loss recognition could be subject to the SRLY limitation without regard to whether it actually relates to the stock loss).

7 See, e.g., Reg. §1.1502-34 (all members are treated as owning a subsidiary’s stock owned by any member, for purposes of applying section 351(a)).
In cases where inside loss precedes outside loss, we suggest consideration be given to adopting provisions that apply section 704(c) principles to allocate negative investment adjustments arising from loss items at the subsidiary level where there have been stuffing transactions with respect to the subsidiary. While this anti-stuffing approach requires tracing, we have been unable to develop an alternative approach that adequately addresses the potential for loss duplication. Application of section 704(c) principles could be accomplished by clarifying the scope of the existing anti-avoidance rule in Reg. §1.1502-32(e), Ex. 2, and by requiring groups to disclose stuffing transactions with respect to the subsidiary within a prescribed period (e.g., within two years) of the asset sale.\(^8\)

In our experience, the March 7, 2002 suggested effective date of Notice 2002-18, 2002-12 I.R.B. 644, has adequately curtailed consolidated group loss duplication planning in the 2002 calendar year, and there is no urgency to adopt an untested new approach before fully considering its implications. Weighing the benefits of maintaining the proposed effective date by adopting temporary or final regulations by March 15, 2003, against the detriments of adopting regulatory rules that may soon thereafter require material amendments, we believe further study would be prudent before temporary or final regulations are adopted. The government has tools under current law to address any 2002 transactions involving duplicated loss tax planning, and the deadline for the adoption of new rules in order to address any new planning by calendar-year groups that might arise during 2003 is March 15, 2004. The requested postponement would also address the problem of the proposed regulations producing many results that could not have been anticipated at the time Notice 2002-18 was issued, including dramatically altering the results of transactions presenting no potential for loss duplication, and the likelihood that taxpayers will complain in these circumstances about the inappropriateness of retroactive rulemaking. Accordingly, we urge you to defer adoption of the proposed regulations until taxpayers have had a chance to study the proposed regulations more fully and offer alternative, less distortive and more conceptually sound, solutions.

\(^8\) While stuffing can be achieved with common stock as well as preferred stock, the most egregious forms of stuffing are likely to focus on preferred stock, and administrability concerns might justify limiting a mechanical application of section 704(c) principles to circumstances in which assets are stuffed in exchange for preferred stock. Where multiple classes of common stock are used, Reg. §1.1502-32(c)(2)(ii) already requires investment adjustments to take into account “the terms of each class and all other circumstances relating to the overall economic arrangement,” and this (or an amended version) might be adequate to address common stock. The only remaining concern would be circumstances involving only a single class of common stock, and the general anti-avoidance rule of Reg. §1.1502-32(e) might be sufficient even if more mechanical rules are adopted.