The following “Comments” are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Affiliated and Related Corporations Committee, and the Corporate Tax Committee, 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 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 Comments have clients who would be affected by the federal tax principles addressed by these Comments, or they have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 20, 2003
Comments on Consolidated Group Basis Redetermination and Loss Suspension (REG-131478-02)

These Comments respond to the government’s request for comments regarding proposed regulations published in the Federal Register on October 23, 2002, that retroactively implement the guidance described in Notice 2002-18, regarding the potential for certain types of loss duplication in the consolidated return context.¹ We understand that the government wishes to adopt temporary or final regulations implementing some version of the Proposed Regulations no later than March 15, 2003. Therefore, we submit these Comments as an indication of our preliminary views, despite our not having completed our analysis of the many complex issues presented.² These Comments first review the history of the loss duplication concerns underlying the Proposed Regulations, then address whether the Proposed Regulations adequately achieve their stated policies, and finally identify technical issues in the Proposed Regulations.

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² The Proposed Regulations would generally apply retroactively, with respect to dispositions and deconsolidations occurring on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the Federal Register. This effective date conforms to the statement in Notice 2002-18, that “regulations will apply to dispositions of stock (or another asset that reflects the basis of stock) occurring on or after March 7, 2002.”

For the urgency to adopt temporary or final regulations in this context before March 15, 2003, see section 1503(a). Unless otherwise explicitly provided herein, all references to “Code” are to the Internal Revenue Code of 1986, as amended, to “section” are to provisions of the Code, to “Reg. §” and “Prop. Reg. §” are to existing and proposed Treasury regulations issued under the Code, and to “Service” are to the Internal Revenue Service.
I. Executive Summary

We urge that the Proposed Regulations not be adopted in their current form, because we believe that their approach and mechanics are unworkable. The Proposed Regulations respond to what we understand is a narrow loss duplication planning technique by making sweeping changes in the consolidated return basis and loss rules for subsidiary stock. These changes shift the location of stock basis throughout a consolidated group, and disrupt the operation of many existing rules. Basis shifting has been tried in the past, and almost universally determined by the government to be problematic. 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 the consolidated return system.

The Proposed Regulations rely on simple assumptions as to relationships among stock basis, stock fair market value, and subsidiary deduction and loss items. We believe these assumptions will produce distortions because they will often be incorrect, and will even generate new tax avoidance opportunities. Rather than the sweeping approach of the Proposed Regulations, we
recommend that more narrowly tailored rules be adopted to address the loss duplication techniques that have been identified, without disrupting the fundamental operation of the consolidated return rules.

As a result of their underlying assumptions, the Proposed Regulations (1) dramatically alter the results of transactions despite the absence of any potential for loss duplication, or any relationship to the otherwise applicable results of consolidated return filing (see, e.g., Examples 6 through 9 to these Comments); (2) eliminate a group’s only loss despite the stated goal of only eliminating duplicated loss (see, e.g., Examples 11 through 15, and 25); and (3) generate new, inappropriate tax planning opportunities (see, e.g., Examples 22 and 23). We are particularly concerned about their potential effects on insolvency restructurings, because groups are unlikely to be able to plan around distortions and, based on our experience, the assumptions regarding loss absorption are inaccurate.

The Proposed Regulations permit certain adverse presumptions to be rebutted. The rebuttal process introduces numerous technical and practical problems because it imposes valuation, tracing, and recordkeeping burdens that we believe are unadministrable in actual operation (see, e.g., Examples 28 through 32). As a result, the Proposed Regulations combine many of the most problematic aspects of inaccurate presumptions with the administrability problems associated with tracing regimes.

The Proposed Regulations do not address loss duplication with respect to separate return subsidiaries, in transactions that we believe are economically identical to transactions that the Proposed Regulations do address. Even within the consolidated return context, the Proposed Regulations draw distinctions between economically identical forms of basis recovery, depending on whether the recovery generates an actual item of deduction or loss or merely reduces an item of income or gain. As a result of these discontinuities, we anticipate that the Proposed Regulations preserve significant opportunities for taxpayers to engage in loss duplication strategies, while at the same time imposing complexity and administrability problems within the consolidated return setting. For example, if a subsidiary is deconsolidated before loss on its stock is recognized, and it is later reimported into the group, should this effort to blend separate and consolidated return elements be subject to anti-avoidance rules? See also Example 33. The many discontinuities cause us to question whether the practical results of the Proposed Regulations justify broad application of their burdens to even ordinary course transactions.

The Proposed Regulations show a substantial preference for a subsidiary’s inside deductions and losses over corresponding outside losses in the subsidiary’s stock. We do not know whether the preference reflects unstated concerns with loss acceleration, or is simply an unintended effect of modifying fundamental consolidated return regimes based on simple assumptions. In either case, we believe the results are inappropriate based on the existing decision to abandon the loss duplication feature of Reg. §1.1502-20(c)(1)(iii). We also believe that acceleration concerns should be distinguished from loss duplication concerns, that the Service should promptly initiate a separate regulatory (or perhaps legislative) project to address acceleration concerns, and that any guidance should be evenhanded in its application to both consolidated and separate returns.
The only justification cited by the Proposed Regulations for the new rules is *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), where a common parent claimed stock loss under the Code after it had already absorbed its subsidiary’s operating loss under the consolidated return rules. We are unaware of any case extending *Ilfeld* to disallow a stock loss after the subsidiary absorbed its own loss, simply because the circumstances happen to arise in a consolidated return. To the extent that the Proposed Regulations treat a consolidated group more harshly than its separate return counterpart, we believe that the disparity creates distinctions that are similar to the disparity found by the Federal Circuit to be fatal in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001). It is also unclear whether pending legislation would resolve this issue, because it could be interpreted to preserve the separate return principle relied on in *Rite Aid* in the context of loss duplication. Consequently, we anticipate that taxpayers will challenge the validity of any new rules that create similar disparities.

The Proposed Regulations arose from a particular tax planning strategy involving the in-kind contribution (“stuffing”) of built-in loss property and isolating high basis in particular shares of subsidiary stock. We believe the Proposed Regulations would adequately address this strategy, without creating undue distortions or administrative burdens, by limiting the necessarily complex new anti-duplication rules to circumstances involving stuffing transactions. The consolidated return regulations have historically blended single and separate entity treatment, and tolerated some amount of ordinary course duplication of both gain and loss. We do not believe that ordinary course forms of duplication warrant the complexity necessary to eliminate them, or that efforts to eliminate them should focus exclusively on the duplication of loss.

We recommend that the government consider adjusting existing systems, rather than pursuing novel approaches that are likely to produce unintended consequences. If the rules are restricted to stuffing transactions occurring within a specified period of a subsequent stock transaction, we believe that valuation and tracing burdens can be imposed in a manner that does not present undue administrative burdens. For example, if the subsidiary has been a party to stuffing transactions within the preceding two years, there is loss duplication (in the form of the subsidiary’s net built-in loss and NOLs), and stock loss is recognized before the subsidiary’s inside loss is recognized, the stock loss can be allowed but some or all of the subsidiary’s inside items would thereafter be subjected to the separate return limitation year (“SRLY”) rules. This promotes simplification by avoiding tracing between stock and assets, although it does not prevent separate return forms of loss duplication (e.g., where the subsidiary generates adequate income to absorb its own loss through either historic or stuffed assets).

In cases where the subsidiary’s inside loss precedes the stock loss, section 704(c) principles can be applied to allocation of the resulting negative investment adjustments in order to prevent the isolation of outside basis in particular shares of subsidiary stock. While this approach requires tracing, applying tracing solely in the context of contemporaneous stuffing transactions might make the burdens manageable. The government might also add examples to existing consolidated return anti-avoidance rules (e.g., Reg. §1.1502-13(h)) to clarify their continuing role beyond any bright-line anti-stuffing rules.

To address the peculiar problems of stock loss from worthless subsidiaries, the existing consolidated return rules can be clarified or amended. For example, the consolidated return loss
carryover rules can eliminate duplicate inside loss following a subsidiary’s dissolution, the investment adjustment rules can confirm that this elimination does not cause a negative investment adjustment, and the consolidated section 382 regulations can provide that treating subsidiary stock as worthless results in the inside loss becoming subject to limitation under section 382(g)(4)(D). Alternatively, the general loss duplication rules might apply to the stock loss and subsequently eliminate or allow it as appropriate (e.g., allow it to the extent that duplication becomes impossible), or an election might be provided at the time of the stock loss to either permit the stock loss or eliminate it in favor of the inside loss surviving.

We would be happy to develop our analysis of our alternative suggestions further, if the government confirms that the alternatives are likely to be considered. Our experience indicates that 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 a 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 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. 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 solutions.

II. Background

1. Origins

In response to concerns regarding potential circumvention of Congress’ 1986 repeal of the General Utilities doctrine, as well as more general concerns regarding the clear reflection of a consolidated group’s income and tax liability, Reg. §1.1502-20 (referred to as the “loss disallowance rule” or simply “LDR”) was adopted in 1991 and had the effect of disallowing many forms of loss associated with a consolidated group’s disposition or deconsolidation of subsidiary stock. More than 10 years later, LDR was invalidated by Rite Aid Corp. v. United

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3 See, e.g., FSA 200128014 (July 13, 2001) (potential assertion of Reg. §1.1502-19(e) anti-avoidance principles if an excess loss account eliminated through a section 332 liquidation). The government could also develop its existing authority under Ilfeld, which disallows loss duplication that depends on consolidated return principles. For example, the scope of the existing anti-avoidance rule illustrated in Reg. §1.1502-32(e)(2), Ex. 2, could be clarified.

4 Upcoming comments on Reg. §1.337(d)-2T, by individual members of the Affiliated & Related Corporations Committee and the Corporate Tax Committee, will provide more complete background on Reg. §1.1502-20.
States, at least as it applied to loss on subsidiary stock that duplicated the subsidiary’s own loss with respect to its assets and tax attributes.\(^5\)

On January 31, 2002, the government issued Notice 2002-11, announcing that it would no longer litigate the validity of LDR’s duplicated loss factor.\(^6\) Moreover, because the government perceived that all of the LDR rules were inextricably linked, LDR would be replaced in its entirety with interim regulations modeled on Reg. §1.337(d)-2 (adopted in 1990, but applicable to only a brief interim period). The government anticipated that, once the new regulations were issued, valuation, tracing, and record keeping principles would be used to identify the extent to which subsidiary stock loss would be disallowed as attributable to recognized built-in gain. But in no event would subsidiary stock loss be disallowed simply because it duplicates the subsidiary’s own loss with respect to assets and tax attributes.

On January 24, 2002, *The Wall Street Journal* reported that a large financial institution had substantially reduced its effective tax rate by implementing a section 351 transaction.\(^7\) While the government appears to have been aware of the underlying planning strategy before that date, as illustrated by the following example, this publicity appears to have intensified the government’s focus.\(^8\)

### Example 1. Generic consolidated group loss duplication

P, the common parent of a consolidated group, owns Asset A, with a $50 basis and $20 value. P contributes Asset A to S, an existing subsidiary, for a separate block of preferred stock.\(^9\) P’s basis in the preferred stock is $50, and S’s basis in Asset A is $50. P sells the preferred stock to an unrelated party for $20, and recognizes a $30 loss.

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\(^5\) *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).

\(^6\) See Notice 2002-11, 2002-7 I.R.B 526. For commentary, see Sheppard, *Let ‘Em Eat Duplicated Losses*, 94 Tax Notes 684 (Feb. 12, 2002). The Notice reversed the previously announced position of the Service regarding LDR in the aftermath of *Rite Aid*. See CC-2001-042 (Aug. 21, 2001), reprinted in 2001 TNT 172-5 (LEXIS, Fedtax Library, TNT File) (“The Service’s position continues to be that LDR is a valid regulation . . . the *Rite Aid* decision is not to be taken into account in developing or resolving any other issues”).


\(^8\) For the government’s historic approach to comparable transactions, see, e.g., FSA 200238045 (Aug. 16, 2002); FSA 200205003 (Oct. 5, 2001), supplementing FSA 200043007 (July 22, 2000), supplementing FSA 200023016 (March 1, 2000). The government also might have been considering some changes to the investment adjustment regulations, perhaps in connection with this transaction. See Office of Tax Policy and Internal Revenue Service 2001 Priority Guidance Plan (April 26, 2001), reprinted in 2001 TNT 84-36 (LEXIS, Fedtax Library, TNT File) (one project, which did not reappear in the following year’s business plan, was entitled “[g]uidance regarding stock basis adjustments”).

\(^9\) For purposes of these Comments, unless otherwise stated, all preferred stock is not described in section 351(g), all transfers in exchange for the transferee’s stock are subject to section 351, and all intercompany transactions are not subject to adjustment under any Code provision (e.g., section 269, or section 482), regulation (e.g., Reg. §1.1502-13(h)), or common law principle (e.g., business purpose, or substance over form).
The preferred stock is described in section 1504(a)(4), and S remains in the P group even if the stock represents more than 20% of S’s total stock value. S later sells Asset A for $20, and the group recognizes a duplicate $30 loss. While this loss may result in a negative adjustment to P’s basis in S’s common stock under the investment adjustment rules, the group may be able to delay or avoid the effect of this basis reduction through planning.

P’s $30 loss generally would have been disallowed by LDR’s loss duplication factor (unless S had other appreciated assets or securities of another member), but *Rite Aid* invalidated this feature of LDR. The government decided to withdraw LDR only a few days after *The Wall Street Journal* article appeared, and no other specific rule applies to disallow stock loss simply because it duplicates the subsidiary’s own loss with respect to assets and tax attributes. In effect, the government’s response to *Rite Aid* eliminated the principal technical argument for challenging this type of tax planning in prior periods.\(^{10}\)

On March 7, 2002, the government implemented the LDR approach announced in Notice 2002-11 by adopting Reg. §1.337(d)-2T (2002) for dispositions and deconsolidations on and after that date.\(^{11}\) Simultaneously, the government issued Notice 2002-18, in which it announced for the first time that additional regulations would be issued, effective for stock dispositions on or after that date, to prevent a consolidated group from obtaining a tax benefit from both a loss on the disposition of stock (or another asset that reflects the basis of stock) and a loss or deduction on another asset that reflects the same loss.\(^{12}\) Although Notice 2002-18 might appear to resurrect the loss duplication concern abandoned in Notice 2002-11, the new concern focuses on a different category of transactions. LDR disallowed stock loss within a consolidated group even though the second, inside loss might have been recognized by a taxpayer other than the group. The new concern focuses on stock loss where the second, inside loss is, or possibly might be, allowed within the same group.

Following the issuance of Notice 2002-18, the government apparently continued studying the range of transactions by which a consolidated group might duplicate loss, and government speakers suggested that Notice 2002-18 might apply even where P transfers built-in loss assets to a nonconsolidated subsidiary (e.g., a REIT controlled by the group, and with respect to which there is no diversification for purposes of section 351).\(^{13}\) The government’s theory seemed to be that the consolidated group received a direct benefit from P’s stock loss, and an indirect, second benefit from owning stock of the nonmember generating its own direct asset loss. But this application was difficult to reconcile with the Notice’s actual language, and was difficult to

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10 For the government’s use of LDR to combat various loss duplication techniques, see, e.g., Chief Counsel Notice CC-2001-033a (June 28, 2001), reprinted in 2001 TNT 130-13 (LEXIS, Fedtax Library, TNT File).


justify conceptually because this form of duplication has nothing to do with P’s filing a consolidated return.\footnote{The Notice applies to duplicate “utilization of a loss” to achieve a double “tax benefit,” while P’s indirect economic benefit from owning nonmember stock that lowers its effective tax rate would not appear to constitute the described abuse. Moreover, discriminating against P would appear to violate the \textit{Rite Aid} concern of regulations addressing an issue that “is not a problem resulting from the filing of consolidated income tax returns.” \textit{Rite Aid}, 255 F.3d at 1360.}

2. Proposed Regulations

On October 18, 2002, the government issued the Proposed Regulations, which are the focus of these Comments. The preamble to the Proposed Regulations describes the guidance (and prior Notice 2002-18) as enforcing the principle that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. The preamble cites \textit{Charles Ilfeld Co. v. Hernandez},\footnote{\textit{Charles Ilfeld Co. v. Hernandez}, 292 U.S. 62 (1934).} in which a consolidated group subsidiary generated losses that were used to offset its parent’s income in their consolidated return, but because the consolidated return regulations did not then require negative investment adjustments, the parent argued that it was entitled to a second, duplicate stock loss deduction for the same economic loss when it dissolved the subsidiary in a taxable transaction. The Supreme Court disallowed the stock loss deduction because the parent had already obtained a tax benefit from the subsidiary’s operating loss under the consolidated return regulations. Importantly, the parent would have benefited from both the subsidiary’s operating loss (through the consolidated return regulations) and the subsequent stock loss (through the basic rules of the Code), and the potential for duplication was unique to the consolidated return context.\footnote{A later case confirmed that the principles of \textit{Iffield} apply equally if the consolidated return regulations permit a sister of the subsidiary (rather than its parent) to benefit from the subsidiary’s losses. \textit{See, e.g., Greif Cooperage Corp. v. Commissioner}, 85 F.2d 365 (3d Cir. 1936).}

The preamble to the Proposed Regulations does not distinguish between cases in which duplication arises only as a result of filing consolidated returns and cases in which duplication would also have occurred if the parent and subsidiary corporations filed separate returns. Courts have tended to accept duplication in the latter case. For example, in \textit{Remington Rand}, the court held that a consolidated group was not permitted to increase basis to reflect gain recognized by a subsidiary and was therefore required to recognize double gain on the sale of the subsidiary’s stock because double taxation is the ordinary incident of a profitable stock sale.\footnote{\textit{Remington Rand}, Inc. v. Commissioner, 33 F.2d 77 (2d Cir. 1929).} In \textit{United Publishers’ Corporation}, the court held that a consolidated group was not required to reduce basis to reflect losses recognized by a subsidiary, and that double deductions were therefore available when the stock was sold at a loss.\footnote{\textit{United Publishers’ Corporation v. Anderson}, 42 F.2d 781 (S.D.N.Y 1930).} The \textit{Ifeld} court agreed with \textit{Remington Rand}, noting that double gain in consolidation is the same as double gain in separate return filing, but rejected \textit{United Publishers’} on the ground that the double loss was possible only because the consolidated return allowed the subsidiary’s loss to be offset against parent’s income.\footnote{Compare \textit{Textron, Inc. v. U.S.}, 561 F.2d 1023 (1st Cir. 1977) (P and S filed separate returns; P deducted its S stock as worthless; and later P stuffed a profitable business into S that used S’s net operating losses (“NOLs”). The}
Court did not suggest that, where loss duplication does not arise as a result of filing a consolidated return, a consolidated group should be treated differently from an equivalent separate return affiliated group. Thus, if a subsidiary absorbs its own losses, *Ilfeld* does not provide authority for disallowing the subsidiary’s deductions or the loss on its stock simply because both items appear on a single consolidated return. Accordingly, to the extent the Proposed Regulations apply in situations where a subsidiary absorbs its own losses, it would appear that the Proposed Regulations are subject to challenge under the principles of *Rite Aid*.

The preamble states that the Proposed Regulations are intended to address at least two types of transactions that may allow a group to obtain more than one tax benefit from a single economic loss. The first type of case involves S selling its assets, followed by P selling S’s stock:

*Example 2. Inside loss first, with common stock.* 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 Asset A with a $70 basis and $20 value, for an additional 20 shares of S common stock (“BIL Shares”). P’s basis in the BIL Shares is $70, and S’s basis in Asset A is $70. S sells Asset A to an unrelated party for $20, and recognizes a $50 loss that offsets P’s income on the group’s return. Under the investment adjustment rules, P’s basis in each share of S stock is reduced by a pro rata share of the $50 loss, with the result that the original 80 shares have a $40 basis, and the BIL Shares have a $60 basis. P later sells the BIL Shares for $20, recognizing a $40 loss that offsets P’s income on the group’s return.

As in *Ilfeld*, the P group has inappropriately claimed $90 of tax benefit from a single $50 economic loss, and this benefit is directly related to consolidated return filing. A variant, using preferred stock, can exaggerate the basic case through further imprecision under the investment adjustment rules:

*Example 3. Inside loss first, with preferred stock.* 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 Asset A with a $70 basis and $20 value, in exchange for 20 shares of S preferred stock. P’s basis in the preferred stock is $70, and S’s basis in Asset A is $70. S sells Asset A to an unrelated party for $20, and recognizes a $50 loss that offsets P’s income on the group’s return. Under the investment adjustment rules, P’s basis in each share of

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20 We are aware of no case suggesting that *Ilfeld* also applies when the subsidiary absorbs its own losses under the general principles of the Code, without any benefit from the consolidated return regulations.

21 An anti-avoidance rule inhibits the ability of taxpayers to plan into these structures, by modifying the general allocation rules to require negative adjustments to the basis of the preferred stock. See, e.g., Reg. §1.1502-32(e)(2), Ex. 1 (temporary capitalization with preferred stock) and Ex. 2 (application of section 704(c) principles).
S common stock is reduced by a pro rata share of the $50 loss, with the result that the original 80 S shares have a $30 basis. But P’s basis in the preferred shares is not reduced, and if P sells the preferred stock for $20, it will recognize a $50 loss that can offset P’s income on the group’s return. In this transaction, the group has obtained a $100 tax benefit from the single $50 economic loss.

The second type of case addressed by the Proposed Regulations involves P selling S stock, followed by S selling its asset:

*Example 4. Outside loss first. Same as Example 1, “Generic consolidated group loss duplication.”*

Again, as in *Ilfeld*, the P group has inappropriately claimed $60 of tax benefits from a single $30 economic loss. While P’s subsequent taxable disposition of the remaining S shares would generally cause the P group to recapture the duplicate tax benefit, the group might have an alternative, non-taxable exit strategy that preserves the duplication.22 For example, P might simply retain the remaining S shares, or liquidate S under section 332.23

The preamble and all of the examples in the Proposed Regulations address cases in which the loss duplication resulted from a “stuffing” transaction. This context implies an obvious atmosphere of front-end tax planning, but the principles of the Proposed Regulations apply equally in routine contexts that do not involve any front-end tax planning. For example, if the S stock is acquired for $100 in a qualified stock purchase, with an election under section 338(h)(10), there will be general conformity between P’s $100 basis in the S stock and S’s inside net asset basis. If S subsequently declines in value, and P later sells a 20% interest in S’s stock, P’s loss from the sale can duplicate subsequent consolidated group absorption of loss from S’s assets. The same discontinuity can arise even if P forms S and initially has conforming inside and outside basis, where P sells a portion of the S stock but remains consolidated with S. In fact, any time that a subsidiary’s net asset basis equals or exceeds its outside stock basis, the potential for duplication arises.24

### 3. Acceleration v. Duplication

Neither Notice 2002-18 nor the Proposed Regulations identifies issues beyond loss duplication, but it is possible that a second, unstated concern of the government relates to the potential for a consolidated group to accelerate its one economic loss by recognizing its loss on S stock before S recognizes the corresponding inside asset loss. Notice 2002-18 provides that “[i]t is expected that the regulations will defer or otherwise limit utilization of the loss on the stock in such

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22 Moreover, there will not always be recapture in taxable transactions. For example, S might also recognize built-in gain from asset dispositions that results in positive investment adjustments, and these adjustments can shelter S stock gain, but not S stock loss. See Reg. §1.337(d)-2T (loss disallowance rules).

23 But see FSA 200128014 (July 13, 2001) (potential assertion of Reg. §1.1502-19(e) anti-avoidance principles if an excess loss account eliminated through a section 332 liquidation).

24 In fact, loss duplication can arise in a fact pattern that begins with gain duplication. For example, S’s fair market value can start at $110, where its outside basis is $100 and its inside basis is $90, but S’s fair market value subsequently declines from $110 to $60.
transactions.” This statement evidences a preference for the inside loss over the outside loss. The policy concern underlying any such rule is presumably that a tax loss should not be recognized until the group severs its interest with the asset to which the stock loss relates. Once again, any such rule and its underlying policies may be subject to challenge under the principles of *Rite Aid*.

It is unclear whether an unstated deferral policy exists, because the preamble to the proposed regulations accompanying Reg. §1.337(d)-2T (2002) (issued at the same time as Notice 2002-18) does not indicate that there is a concern with acceleration. The preamble states that “the IRS and Treasury are considering allowing selling groups to deduct subsidiary stock losses that would otherwise reflect duplicated loss, if the subsidiary reduces its attributes (including net operating loss carryovers and asset basis) immediately prior to the disposition.”

By allowing the S stock loss, but adjusting S’s inside asset basis to prevent duplication, P is free to accelerate a single economic loss through the disposition of S’s stock. This approach reflects the hybrid nature of consolidated groups blending single and separate entity principles, and the decision in abandoning LDR not to mandate more general single entity treatment for stock transactions. Moreover, it is consistent with the government’s decision to abandon the loss duplication feature of Reg. §1.1502-20(c)(1)(iii), one of the goals of which was to reflect the general shift under the consolidated return regulations of “the taxation of investment in a subsidiary significantly toward single entity treatment.” By conceding the result in *Rite Aid*, the government retreated from the single entity goal and acknowledged the ability of groups to achieve separate entity results.

4. **Specific Identification of Share Basis**

Under current law, each lot of a parent’s shares in a subsidiary is generally treated as a separate investment. If the parent sells less than all of the shares, the basis of the sold shares is determined by identifying the lot from which the shares were drawn. In effect, the regulations create a taxpayer election to choose the basis to be recovered in a sale, provided that the taxpayer satisfies the requirements of Reg. §1.1012-1(c) for an “adequate identification.” If this requirement is not satisfied, the default rule is that shares are treated as sold on a FIFO basis.

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26 CO-93-90, 1990-2 C.B. 696. The proposed LDR regulations also acknowledge that, “[a]lthough eliminating loss duplication deprives consolidated groups of a benefit they would enjoy had they filed separate returns, filing consolidated returns provides many benefits that are not available to corporations filing separate returns. Corporations electing to file consolidated returns are not entitled to retain all of the benefits of separate returns while availing themselves of the benefits of consolidated returns.” *Id.*
27 *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).
28 Holding period also follows this determination process.
29 This regulation finds support in the case law. *See, e.g., Helvering v. Rankin*, 295 U.S. 123 (1934); GCM 39418 (Oct. 10, 1985): Under the predecessors of these provisions and section 1012, it was held with respect to stock and security exchanges in connection with nontaxable corporate reorganizations that, if one group of shares with its cost known is traceable by specific identification of certificates into another group of shares, the cost of the former group is treated as the cost of latter group. *Bloch v. Commissioner*, 148 F.2d 452 (9th Cir. 1945); see *Kraus v. Commissioner*, 88 F.2d 616 (2d Cir. 1937); *Fuller v. Commissioner*, 81 F.2d 176 (1st Cir. 1936); *cf. Cobb v. Callan Court Co.*, 274 F.2d 532 (5th Cir. 1960) (tracing of pre-reorganization claims and stock into new preferred and
The Clinton administration proposed in 1996 that, if a stockholder sells less than all of its shares, the basis of sold shares would be determined as the average basis of all substantially identical shares. Nevertheless, for purposes of determining the character of gain or loss (e.g., short- or long-term), the stockholder would be treated as selling shares on a FIFO basis. Treasury would retain authority to provide, by regulation, that the average basis rule would not apply to certain substantially identical securities if they have a special status under the Code (e.g., regulations could provide that the basis of shares of stock contributed to a partnership subject to section 704(c) would not be averaged with the basis of substantially identical shares purchased by the partnership).

The Clinton proposal presented several problems, including (i) conflicts between the average basis rule for determining gain or loss, and the FIFO rule for determining character, (ii) record keeping burdens resulting from having to redetermine average basis each time shares were purchased or sold, (iii) the difficulty of defining “substantially identical” securities that would be subject to the average basis rule, and (iv) the need for related-party rules to prevent circumvention of the averaging by splitting share ownership (and an unwillingness to shift basis among these related holders). This proposal has not resurfaced as a legislative matter, but the basis redetermination features of the Proposed Regulations would resurrect it despite the lack of any legislative acceptance.

5. Gain Duplication

Just as the government is concerned with the possibility of loss duplication, taxpayers are concerned with the possibility of gain duplication. The preamble to the Proposed Regulations acknowledges this issue by observing:

The IRS and Treasury Department, however, are considering the appropriateness and feasibility of a rule that applies the principles of the basis redetermination and loss suspension rules to certain events involving stock that has a value in excess of basis.

common stock ignored where new common had no value). On the other hand, where a number of lots of stock or securities were acquired at different times and prices, and it was not possible to identify specific blocks of new stock or securities as received in exchange for particular lots of pre-reorganization stock or securities, then the total cost of all the items surrendered was prorated among the items received in proportion to their relative fair market values. Arrott v. Commissioner, 136 F.2d 449, 451-452 (3d Cir. 1943); Commissioner v. Bolender, 82 F.2d 591 (7th Cir. 1936); Commissioner v. Oliver, 78 F.2d 561 (3d Cir. 1935); Commissioner v. Von Gunten, 76 F.2d 670 (6th Cir. 1935); Helvering v. Stifel, 75 F.2d 583 (4th Cir. 1935); cf. Kraus v. Commissioner, 88 F.2d 616 (2d Cir. 1937) (where taxpayer made no attempt to identify lots or certificates of stock received with lots or certificates of stock surrendered, average cost rule of foregoing cases not extended to an exchange of old stock for new stock in the same corporation; instead first in, first out rule of regulations applied).

30 For a description, see Department of the Treasury, General Explanations of the Administration’s Revenue Proposals 46 (March 19, 1996); Department of the Treasury, General Explanations of the Administration’s Revenue Proposals 46 (February 6, 1997); Joint Committee on Taxation, Description and Analysis of Certain Revenue-Raising Provisions Contained in the President’s Fiscal Year 1998 Budget Proposal, 105th Cong., 1st Sess. (JCS-10-97 April 16, 1997); Feld, Average Cost Basis and Compliance Complexity, 73 Tax Notes 1237 (Dec. 9, 1996); Stratton, Average Cost Basis: An Idea Whose Time Has Come?, 71 Tax Notes 21 (April 1, 1996).
With respect to the application of the principles of the loss suspension rule to
dispositions of stock that has a value in excess of basis and that reflects duplicated gain,
a rule might require taking into account the stock gain upon the disposition of the stock
but would eliminate gain recognized on the disposition of assets that had a built-in gain
at the time of the stock transaction. The IRS and Treasury Department request
comments on appropriate and administrable applications of the principles of the basis
redetermination and loss suspension rules to dispositions and deconsolidations of stock
that has a built-in gain. 31

Despite the bias toward single entity treatment, members are generally treated as separate entities
for purposes of stock transactions because, in the absence of mandatory conforming inside and
outside basis, single entity treatment is complex and has not been considered administratively
feasible. 32 Limited exceptions have been made. For example, section 338 provides an election
to treat a qualified stock purchase as the essential equivalent of an underlying asset purchase and
the consolidated return regulations provide limited exceptions to reduce gain duplication. 33
Section 336(e) authorizes the Service to issue regulations to permit a corporation that sells,
exchanges, or distributes all the stock of an affiliated corporation described in section 1504(a)(2)
to be treated as having disposed of all the assets of the affiliated corporation without recognizing
gain or loss on the affiliated corporation’s stock. But the statute was enacted in 1986 and,
apparently as a result of the complexity entailed, the Service has never issued implementing
regulations. 34

Nothing inherent in the loss duplication concerns the government identified in the Proposed
Regulations indicates that the corresponding gain duplication issues will be easier to resolve as a
result of the proposed changes. But the Proposed Regulations do attempt to integrate the issues

31 See also REG-102740-02, 2002-13 I.R.B. 701 (suggesting that duplicate stock loss be allowed, by reducing the
subsidiary’s own tax attributes).

32 For example, in the context of developing single entity rules for intercompany transactions, the government
acknowledged that “[t]he stock basis adjustment rules under §1.1502-32 provide a significant degree of single entity
treatment for member stock. However, the complexities of single entity treatment for member stock under the Code
prevent more generally disregarding the separate existence of stock for purposes of intercompany transactions. . . .
The proposed regulations do not adopt expanded single entity treatment for stock of members. That approach would
greatly increase the complexity of the proposed regulations and would have significant consequences for the tax
liability of a group. Although complexity could be reduced (e.g., by limiting single entity treatment to a higher-tier
member’s ownership of a lower-tier member’s stock or to common parent stock owned by a wholly-owned, first-tier
subsidiary), numerous problems would remain.” Notice 94-49, 1994-1 C.B. 358. This treatment is generally
reflected throughout the approach of Reg. §1.1502-13(f).

33 See, e.g., Reg. §1.1502-13(f)(5) and (f)(6).

34 The legislative history warns that the regulations might require special liquidation-reincorporation and other rules
(e.g., to prevent a subsidiary’s own net operating loss from offsetting liquidation gains, if the stock is transferred to
persons related to the transferred corporation under section 368(c)). See H.R. Conf. Rep. No. 841, 99th Cong., 2d
Sess. II-204 (1986). See also New York State Bar Association, Tax Section, Committee on Reorganizations, Report
on Section 336(e), 55 Tax Notes 539 (Apr. 27, 1992) (analysis of the issues presented in implementing section
336(e)); American Bar Association, Section of Taxation, Section of Taxation, individual members of the Affiliated & Related
Corporations Committee, Comments on Proposed Intercompany Transaction Regulations (Apr. 27, 1995), reprinted
in 95 TNT 93-22 (LEXIS, Fedtax Library, TNT File) (recommending implementation of section 336(e) for
intercompany stock sales). Cf. sections 743 and 755 (the sale of a partnership interest may be treated as the sale of
the partnership’s assets, but solely with respect to the transferee partner).
to a limited degree. P’s loss on S stock is defined as duplicating S’s own items of deduction and loss by comparing S’s (i) aggregate sources of basis and equivalents (e.g., NOLs, deferred deductions, etc.), to (ii) aggregate sources of gross asset value (e.g., stock value plus liabilities). This approach defines S’s loss duplication as problematic only to the extent that it exceeds S’s aggregate gain duplication, and thereby effectively nets the two forms of duplication. To backstop this aggregate approach, the Proposed Regulations also limit a group’s ability to recognize gross stock loss before gross stock gain by shifting basis among S’s common stock shares in a manner that tends to unify each share’s basis/value relationship. But there is no equivalent rule where the stock gain is recognized first. Unlike the related LDR rules, the Proposed Regulations do not include an anti-stuffing rule, perhaps reflecting the fact that the effects of gain duplication ameliorate the concerns with loss duplication.\textsuperscript{35}

6. \textbf{Separate Return Subsidiaries}

Loss duplication also arises in the separate return context, where it presents issues comparable to those within a consolidated group.\textsuperscript{36}

\textit{Example 5. Separate return controlled subsidiary.} P, the common parent of a consolidated group, forms S, a REIT, by contributing $99 for 99% of S’s stock, and 99 individuals contribute an aggregate of $1 for 1% of S’s stock. Because S is a nonincludible corporation under section 1504(b)(6), S is not a member of P’s group. P later contributes Asset A, which reflects built-in loss, for additional S stock (“BIL Shares”). P’s basis in the BIL Shares continues to reflect Asset A’s built-in loss, and S’s basis in Asset A also reflects Asset A’s built-in loss. P sells the BIL Shares and recognizes the built-in loss, which offsets P’s income on the group’s return. P continues to control S. S then sells Asset A and recognizes the built-in loss, which offsets S’s income from other sources. Because S is not included in the P group, S’s income and loss do not cause any adjustments to P’s basis in the S stock under the investment adjustment rules.

P benefits from S’s recognition of the Asset A loss, because the value of P’s S stock is increased by the reduction in S’s effective tax rate attributable to S’s ability to offset the loss against its otherwise taxable income. But the consolidated group directly takes into account only a single loss, and S’s ability to directly take into account a corresponding asset loss is unrelated to the P group’s ability to file a consolidated return. Perhaps out of concern for the analysis in \textit{Rite Aid}, or simply recognizing that this form of benefit to the consolidated group does not raise issues under section 1502, the Proposed Regulations do not address separate return loss duplication. Any future attempt to apply the principles of the Proposed Regulations to nonconsolidated subsidiaries will raise issues far beyond \textit{Rite Aid} and existing consolidated return principles. Of course, these types of transactions face numerous hurdles under existing Code provisions and judicial principles, including a business purpose requirement under section 351, limits under sections 269 and 482, loss trafficking restrictions under sections 382 and 384, etc.

\textsuperscript{35} Cf. Reg. §§1.337(d)-2T(e) (2002); 1.1502-20(e).

\textsuperscript{36} Arguably, the consolidated return rules facilitate stuffing, making loss duplication easier to achieve in consolidation. \textit{See, e.g.}, Reg. §1.1502-34.
7. **Proposed Consolidated Return Legislation**

Under current section 1502, the Treasury Department is provided with the following authority to write consolidated return regulations:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

A proposed amendment would add a second sentence that provides:

In prescribing such regulations, the Secretary may prescribe rules applicable to corporations filing consolidated returns under section 1501 that are different from other provisions of this title that would apply if such corporations filed separate returns.\(^{37}\)

If enacted, this new sentence would be effective for “taxable years beginning before, on, or after the date of the enactment of this Act.”\(^{38}\) In describing the purpose for the amendment, the committee report states:

[T]he Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.\(^{39}\)

The committee report also noted that, “[i]n exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of General Utilities repeal using presumptions and other simplifying conventions.”\(^{40}\)

The proposed legislation responds to the Treasury Department’s need for clear regulatory authority in the consolidated return context in the aftermath of *Rite Aid*. The proposal is

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38 *Id.* (Emphasis added.)
40 *Id.* at 28 n.74.
retroactive in effect, and has been assigned a negligible revenue estimate.\textsuperscript{41} Presumably, this indicates that the proposal is intended to merely clarify current law, or amend it within the existing requirements of clearly reflecting the income tax liability of the group, rather than altering the clear reflection requirements. The legislative history creates ambiguity, however, by stating that “the provision nevertheless allows the result of the \textit{Rite Aid} case to stand with respect to the type of factual situation presented in that case” -- that is, where the subsidiary’s losses can be used outside the group -- but that “[r]etaining the result in \textit{Rite Aid} . . . does not in any way prevent or invalidate the various approaches Treasury has announced . . . for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.”\textsuperscript{42}

Because the Proposed Regulations fundamentally alter the historic rules for the identification of stock basis under the Code, the government presumably will be relying on the enactment of the pending legislation to overcome possible taxpayer challenges.\textsuperscript{43}

\section*{III. Proposed Regulation Mechanics}

The Proposed Regulations operate through four systems: (i) shifting basis among the shares of a subsidiary’s stock; (ii) suspending loss from subsidiary stock; (iii) reducing the basis of subsidiary stock in the case of worthlessness; and (iv) anti-avoidance rules. The systems are designed to compliment each other, but each has its own mechanics and special rules.

\textit{Basis shifting rules.} The basis of subsidiary stock held by members is redetermined immediately before a disposition or deconsolidation of a share of subsidiary stock if the basis of the share exceeds its value. The rule applies differently depending on whether the subsidiary remains a member after its stock is disposed of or is deconsolidated. If the subsidiary remains a member, all members must aggregate their bases in all shares of the subsidiary, and this aggregate amount is allocated first to the subsidiary’s preferred stock held by members (in proportion to, but not in excess of, their value), and any remaining amount is allocated among the subsidiary’s common stock held by members (in proportion to their value). The reallocated amount includes all past investment adjustments, as well as stock basis that arose on acquisition or from capital contributions. If the subsidiary is deconsolidated, the amount reallocated is limited to the lesser of: (i) the share’s unrealized loss; and (ii) the subsidiary’s gross items of deduction and loss taken into account in computing the basis of other shares, subject to reduction to the extent the taxpayer establishes that the items are attributable to amounts not included in the computation of loss duplication. There is a presumption that all items were reflected in the loss duplication computation. Once the amount is determined, it reduces the basis of the shares disposed of or

\textsuperscript{41} Staff of Joint Comm. on Taxation, 107th Cong., \textit{Description of Chairman’s Modifications to the Provisions of the “Care Act Of 2002”} 7 (Comm. Print 2002) (JCX-61-02); Staff of Joint Comm. on Taxation, 107th Cong., \textit{Estimated Revenue Effects of the “Care Act of 2002,” as Modified by the Chairman’s Modification, Scheduled for Markup by the Committee on Finance on June 13, 2002} 3 (Comm. Print 2002) (JCX-64-02).

\textsuperscript{42} Id.

\textsuperscript{43} For additional problems presented by the proposed legislation, see, e.g., Salem, \textit{A Proposal to Resolve the Rite Aid Legislative War}, 98 Tax Notes 599 (Jan. 27, 2003).
deconsolidated, and this amount is reallocated to the basis of all preferred shares held by members (but not in excess of value), and any remaining amount is reallocated to the basis of all common shares held by members in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

The basis redetermination rule is inapplicable if the group disposes of all its subsidiary stock within a single taxable year, in one or more fully taxable transactions, or is allowed a worthless stock deduction with respect to all of the subsidiary’s stock. A look-through rule applies to stock of lower-tier subsidiaries when a higher-tier subsidiary’s stock is disposed of or deconsolidated, and any basis adjustments are taken into account under Reg. §1.1502-32 in determining the investment adjustments for higher-tier subsidiaries.

**Loss suspension rules.** If, after application of the basis redetermination rule, a member still recognizes a loss on subsidiary stock, and the subsidiary remains a member, the loss is suspended to the extent of the duplicated loss with respect to the stock. A special rule applies the loss suspension rule if lower-tier members are involved. In addition, a substitute asset rule applies to suspend loss from the disposition of an asset other than subsidiary stock if the asset’s basis is determined, directly or indirectly, in whole or in part, by reference to the basis of subsidiary stock with respect to which there is duplicated loss.

The amount of a subsidiary’s duplicated loss is the excess of (i) the amount of the basis of its assets (excluding stock in other subsidiaries), its losses carried to the first taxable year after the disposition, and its deferred deductions, over (ii) the value of its stock and the amount of its liabilities. Each item (except stock value) includes the subsidiary’s allocable share of the same items of any lower-tier subsidiary. This conforms to the definition of duplicated loss in Reg. §1.1502-20(c)(2)(vi), except that securities of other members are not excluded.

The suspended loss is permanently eliminated as the group takes into account the subsidiary’s deductions and losses. This reduction prevents the group from taking these inside items into account in addition to the stock loss. All deductions and losses are generally presumed to be attributable first to the duplicated loss that gave rise to a suspended stock loss. The presumption is rebuttable to the extent the taxpayer establishes that an item was not part of the duplicated loss that gave rise to a suspended stock loss.

Any suspended stock loss remaining at the time the subsidiary leaves the group is allowed, to the extent otherwise allowable. In addition, any suspended loss is allowed at the time the group is allowed a worthless stock deduction with respect to all of the subsidiary’s stock. (There is a separate basis reduction in these circumstances, as described below.) The group must file a statement of allowable loss with the consolidated return for the year in which the loss is allowable.

**Dissolution and worthlessness rules.** For stock loss to be suspended, the subsidiary generally must remain a member immediately after a disposition of its stock. But the government has expressed concern that duplication could arise in circumstances in which S’s separate legal
existence terminates in a taxable dissolution transaction.\textsuperscript{44} If S does not become a nonmember, the government is concerned that there might be no event requiring apportionment of the attributes S has contributed to the P group’s consolidated attributes, and Code limitations (e.g., section 382(g)(4)(D)) might not apply. To address these concerns, the Proposed Regulations require the basis of the subsidiary’s stock to be reduced to the extent of the consolidated net operating loss and net capital loss carryforwards attributable to the subsidiary, as though they were absorbed immediately before the disposition, if the subsidiary does not remain a member and does not have a separate return year.\textsuperscript{45}

\textit{Anti-avoidance rules.} Certain anti-avoidance rules are provided to address potential for inappropriate taxpayer planning that avoids the purposes of the Proposed Regulations. If a share of subsidiary stock is deconsolidated with a view to avoiding application of the basis redetermination rule before the disposition of loss stock, the basis redetermination rule will apply immediately before the deconsolidation. In addition, if a member contributes a built-in loss asset to a nonmember entity (e.g., a partnership or nonmember corporation), and the entity subsequently contributes the asset to a member, all with a view to avoiding the application of the basis redetermination rule or the loss suspension rule, adjustments must be made to prevent loss duplication. Finally, disposing of a sufficient amount of a subsidiary’s stock to cause its deconsolidation, but later reimporting the subsidiary’s losses into the group, can circumvent the basic rules of the Proposed Regulations. An anti-reimportation rule applies whenever: (i) a group recognizes and is allowed stock loss with respect to which there is loss duplication; (ii) the subsidiary leaves the group; and (iii) within the following 10-year period, a loss of the subsidiary member is reimported. If a loss is reimported, its deductibility is generally denied to the group. (The Proposed Regulations do not preclude the application of other anti-abuse rules, including transactions to invoke basis redetermination and avoid the effect of any other rules.)

\textit{Effective dates.} The Proposed Regulations, other than the reimportation rule, are proposed to apply to transactions occurring on or after March 7, 2002, but only if the transaction occurs during a taxable year the original return for which is due (without regard to extensions) after the date the Proposed Regulations are published as temporary or final regulations in the Federal Register. The reimportation rule is proposed to apply to losses reimported as a result of an event that occurs on or after October 18, 2002, that triggers the application of the rule, but only if the event occurs during a taxable year the original return for which is due (without regard to extensions) after the date the Proposed Regulations are published as temporary or final regulations in the Federal Register.

\textit{Comments.} The preamble to the Proposed Regulations specifically requests the following comments:

\textsuperscript{44} Alternatively, P might be able to deduct unrealized loss with respect to S’s stock due to a deemed recognition event under section 165(g) (taking into account the delayed worthlessness rule under Reg. §§1.1502-19(c)(1)(iii) and 1.1502-80(c)).

\textsuperscript{45} Similarly, if a subsidiary becomes worthless and, under section 165 and Reg. §1.1502-80(c), the group treats the subsidiary’s stock as worthless, a similar basis reduction is required to the extent of consolidated net operating loss and net capital loss carryforward attributable to the subsidiary.
1. Alternative approaches to basis redetermination that mitigate stock basis disparities, including adjusting the bases of all shares of subsidiary stock held by the group on any acquisition of subsidiary stock.

2. Applying the principles of the basis redetermination and loss suspension rules to events involving gain stock (e.g., eliminating gain recognized on the disposition of assets which was built-in gain at the time of an earlier stock transaction).

3. Rather than reducing stock basis in certain cases in which a subsidiary ceases to exist or the group is allowed a worthless stock loss, whether it would be more appropriate to restrict the losses pursuant to the approach under section 382(g)(4)(D), and whether this approach would be appropriate, desirable, and administrable.

4. Whether the tracing, valuation, and recordkeeping requirements inherent in the Proposed Regulations (e.g., to prevent the elimination of suspended stock loss) are administrable.

IV. Policy Issues

The Proposed Regulations represent a dramatic departure from the existing rules and mechanics of the Code and the consolidated return regulations. The new rules generally would not replace or clarify the existing rules, but instead create a third regime to be layered on top of the current conflicting single and separate entity regimes.

The existing regimes are already problematic. In general, the Code’s separate entity approach favors outside loss by allowing stock loss when recognized, but then limiting subsequent inside loss. The consolidated return single entity regime favors inside loss, allowing a subsidiary’s losses to offset income of other members, but reducing the subsidiary’s outside basis to eliminate potential loss duplication. In the wake of Rite Aid, and the replacement of LDR, the consolidated return regime generally works efficiently only if inside loss precedes corresponding outside loss.

We also recognize, as the preamble to the Proposed Regulations illustrates, that well-advised taxpayers can attempt to arrange for duplicated loss under the existing rules, and that they could do so even under the now invalid form of LDR. We recommend that the approach of the Proposed Regulations be reconsidered, and that problems resulting from the uncertainties of the existing rules, such as arguments that a subsidiary’s contributions to the consolidated NOL (“CNOL”) survive its taxable dissolution, be directly addressed by clarifying the CNOL regulations, and by other guidance.

46 For example, Reg. §1.1502-20(c)(1)(iii) limited loss duplication by measuring a subsidiary’s duplication at the time its stock was sold. If a built-in loss asset was transferred to a subsidiary, the built-in loss was subsequently recognized, and the loss offset P’s income, the corresponding negative stock basis adjustment might have been diverted to only certain shares of the subsidiary’s stock, and no loss duplication would have remained, in the aggregate, at the time of a subsequent stock sale. But see Reg. §1.1502-32(e) (anti-avoidance rules).
1. Preventing Only Duplicated Loss

Under Prop. Reg. §1.1502-35(a), the sole purpose of the Proposed Regulations is described as follows: 47

(a) Purpose. 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.

We acknowledge the government’s concerns with the loss duplication described in the preamble to the Proposed Regulations. These concerns are justified based on the principles set forth in Ilfeld, and reflect inappropriate tax planning that takes advantage of the consolidated return regulations in combination with the separate return rules. As described above, however, we are not aware of any case in which the Ilfeld principle has been extended to deny a deduction where the same result would have been available if the parent and subsidiary corporation had filed separate returns. Accordingly, we believe the government should seek to address such situations with rules that apply uniformly to economically equivalent separate and consolidated return situations (e.g., through corresponding amendments to the separate return rules of the Code and regulations). 48 The following examples illustrate situations in which the Proposed Regulations would eliminate stock loss in the consolidated return context while failing to address the equivalent loss in economically identical separate return contexts:

Example 6. Subsidiary absorbs its own inside loss—inside loss unrelated. P, the common parent of a consolidated group, buys 80 shares of common stock of S (representing all of S’s outstanding stock) from S’s existing shareholder for $160. S’s historic assets have a $96 basis, and their fair market value subsequently declines to $80. P later contributes Asset A, with a $70 basis and $20 value, for an additional 20 shares of common stock (“BIL Shares”). P’s basis in the BIL Shares is $70, and S’s basis in Asset A is $70. S then develops Asset B, with a $0 basis and $50 value. Thus, P has invested $230 in the S stock, S has an inside asset basis of $166, and S’s assets have a value of $150.

(a) P sells S stock first. P sells the BIL Shares for $30 (20% of $150), and because the sale does not deconsolidate S, the Proposed Regulations redetermine P’s basis in each of the S shares to be $2.30 immediately before the sale. Thus, P recognizes a $16 loss on the BIL Shares ($46 basis minus $30 proceeds), and this loss is suspended by reason of loss duplication (S’s assets have an aggregate $166 basis, and $150 value). S then sells Asset A and Asset B to unrelated parties, for $20 and $50 respectively, and S’s $50 loss and gain offset. The Asset A loss

47 The preamble to the Proposed Regulations is consistent with Prop. Reg. §1.1502-35(a).

48 For example, perhaps the type of limitations imposed by Section 382(g)(4)(D) should apply more broadly to limit additional forms of loss duplication that are perceived to be problematic. Alternatively, perhaps the principles of section 351(g) should be modified to prevent stuffing transactions that facilitate loss duplication. Cf. section 358(h) (limiting stock basis from contributions of encumbered property). As discussed elsewhere in these Comments, we do not favor these approaches as part of a consolidated return loss duplication project.
causes P’s $16 suspended stock loss to be eliminated. Under the investment adjustment rules, there is no net investment adjustment from S’s $50 loss and gain, and P’s basis in its retained S shares remains $184. Finally, P sells all of its retained S shares for $120, recognizing a $64 loss that is unaffected by the Proposed Regulations. Cumulatively, the Proposed Regulations permit the P group, which has sustained $80 of economic loss, to take into account $114 of gross loss (P’s $64, plus S’s $50), but that loss is partially offset by $50 of gain, leaving the P group with a net tax loss of $65.

(b) S sells Asset A first. S sells Asset A and Asset B to unrelated parties, for $20 and $50 respectively, and S’s $50 loss and gain offset. Under the investment adjustment rules, there is no net investment adjustment from S’s $50 loss and gain, and P’s basis in each share of S stock is unchanged (i.e., $160 basis in the purchased shares, and $70 basis in the BIL Shares). P later sells the BIL Shares for $30, and because the sale does not deconsolidate S, the Proposed Regulations redetermine P’s basis in each of the S shares to be $2.30 immediately before the sale. Thus, P recognizes a $16 loss on the BIL Shares ($46 basis minus $30 proceeds), and this loss is suspended by reason of loss duplication (S’s assets have an aggregate $166 basis, and $150 value). Finally, P sells all of its retained S shares for $120, recognizing a $64 loss that is unaffected by the Proposed Regulations, and S’s deconsolidation results in P’s $16 suspended loss being taken into account. Cumulatively, the Proposed Regulations permit the P group to take into account $130 of gross loss (P’s $64 and $16, plus S’s $50), but that loss is partially offset by $50 of gain, leaving the P group with a net tax loss of $80, which equals its economic loss.

Example 7. Subsidiary absorbs its own inside loss—inside loss related. P, the common parent of a consolidated group, forms S by contributing $80 for 80 shares of common stock of S (representing all of S’s outstanding stock). S’s assets have an $80 basis and value. P later contributes Asset A, with a $70 basis and $20 value, for an additional 20 shares of common stock (“BIL Shares”). P’s basis in the BIL Shares is $70, and S’s basis in Asset A is $70. The value of S’s original assets subsequently appreciates to $110. Thus, P has invested $150 in the S stock, S has $150 of basis in its assets, and the S assets have a value of $130.

(a) P sells S stock first. P sells the BIL Shares for $26 (20% of $130), and because the sale does not deconsolidate S, the Proposed Regulations redetermine P’s basis in each of the S shares to be $1.50 immediately before the sale. Thus, P recognizes a $4 loss on the BIL Shares ($30 basis minus $26 proceeds), and this loss is suspended by reason of loss duplication (S’s assets have an aggregate $150 basis, and $130 value). S then recognizes the $30 of gain from its original assets, as well as $30 of the $50 of built-in loss in Asset A, and the $30 gain and loss offset. The Asset A loss causes P’s $4 suspended stock loss to be eliminated. Under the investment adjustment rules, there is no net investment adjustment from S’s $30 gain and loss, and P’s basis in its retained S shares remains $120. Finally, P sells all of its retained S shares for $104, recognizing a $16 loss that is
unaffected by the Proposed Regulations. Cumulatively, the Proposed Regulations permit the P group, which has sustained $20 of economic loss, to take into account $46 of gross loss (P’s $16, plus S’s $30), but that loss is partially offset by $30 of gain, leaving the P group with a net tax loss of $16.

(b)  
S sells Asset A first. S recognizes the $30 of gain from its original assets, as well as $30 of the built-in loss in Asset A, and the $30 gain and loss offset. Under the investment adjustment rules, there is no net investment adjustment from S’s $30 gain and loss, and P’s basis in each share of S stock is unchanged (i.e., $80 basis in the original shares, and $70 basis in the BIL Shares). P later sells the BIL Shares for $26, and because the sale does not deconsolidate S, the Proposed Regulations redetermine P’s basis in each of the S shares to be $1.50 immediately before the sale. Thus, P recognizes a $4 loss on the BIL Shares ($30 basis minus $26 proceeds), and this loss is suspended by reason of loss duplication (S’s assets have an aggregate $150 basis, and $130 value). Finally, P sells all of its retained S shares for $104, recognizing a $16 loss that is unaffected by the Proposed Regulations, and S’s deconsolidation results in P’s $4 suspended loss being taken into account. Cumulatively, the Proposed Regulations permit the P group to take into account $50 of gross loss (P’s $16 and $4, plus S’s $30), which is partially offset by $30 of gain, leaving the P group with a net tax loss of $20, which equals its economic loss.

As these examples illustrate, the Proposed Regulations achieve more appropriate results when S sells Asset A first. Under the investment adjustment rules, a negative adjustment results from P’s absorption of the inside loss of S, and a corresponding amount of outside loss is therefore eliminated by the time P sells the BIL Shares. Although S’s inside gain generates a new source of outside basis from positive investment adjustments, this stock basis does not present loss duplication concerns. When S’s inside gain and loss are considered together, any duplication is also not attributable to the P group’s filing of a consolidated return, because the results conform to those of a comparable separate return group. We believe that the Proposed Regulations

49 The government might have anticipated that broad application of the basis redetermination rules would generally address the effects of S selling Asset A first, and that the stock loss elimination rules could focus solely on P selling S stock first. In simple conforming inside/outside basis cases, where the entire inside loss is recognized, there is no remaining loss duplication, and the basis redetermination prevents disproportionate amounts of loss from being recognized on the sale of particular shares. But any such assumption does not work well in more complex fact patterns.
Example 6 demonstrates that duplicated and nonduplicated stock loss can become intertwined through a basis redetermination, making it difficult to identify the relevant relationships between loss on any particular share of S stock, and loss on S’s assets. For example, why should P’s stock loss be eliminated when S’s loss from Asset A is offset by its own income, and to what extent should S’s remaining $16 unrealized loss in its historic assets be treated as related to P’s $16 loss from the BIL Shares?
Example 7 further illustrates problems with stacking of various components of S’s loss from Asset A against P’s loss from the BIL Shares. To the extent that S’s loss is offset against S’s own income, should P’s loss on the BIL Shares be eliminated only to the extent of S’s remaining $20 unrealized loss on Asset A?

50 Even if S’s loss offsets P’s income in some years, separate return results are also simulated if S also produces taxable income in other taxable years. S generates comparable tax benefits and detriments for the P group (disregarding present value effects) that offset despite arising in different taxable years. The cumulative outside basis consequences are identical to those where all of S’s items arise in a single taxable year.
should not eliminate any of the suspended stock loss in these cases, because the analysis in *Textron* should apply to permit separate return forms of loss duplication that are permitted under the Code.\(^{51}\) We also believe that our analysis, which would disregard S’s losses and deductions to the extent they merely offset S’s own income and gain, is supported by examples in the Proposed Regulations that address the effects of appreciation in S’s assets after P has stuffed the assets into S:

*Example 8. Asset appreciation.* 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 Asset A, with a $50 basis and $20 value, for 20 additional shares of S common stock (“BIL Shares”). P takes a $50 basis in the BIL Shares, and S takes a $50 basis in Asset A. Thus, P has $130 of basis in its S stock; S has $130 of inside asset basis; and S has assets with a value of $100.

P subsequently sells the BIL Shares for $20, and under the Proposed Regulations, P’s basis in these shares is redetermined from $50 to $26 (20% of the $130 aggregate basis), and its $6 loss is suspended. Later, Asset A appreciates, and S sells it for $45, recognizing only a $5 loss that offsets P’s income in the group’s return. This loss eliminates $5 of P’s suspended loss, and under the investment adjustment system, P’s basis in its retained S shares is reduced from $104 to $100. P sells its remaining S common shares for $100, and recognizes no further gain or loss. S’s deconsolidation also results in P’s $1 of remaining suspended loss being taken into account.\(^{52}\) Thus, the P group sustains an economic loss of $5 and recognizes a net tax loss of $6 ($1 suspended stock loss and S’s $5 inside asset loss).

We agree with this treatment of Asset A’s appreciation, even though the net tax loss recognized by the P group exceeds its economic loss. The example concludes that only S’s $5 actual loss recognized from Asset A reduces the suspended loss, and the remaining $1 of suspended loss is allowed when P sells its remaining S shares. We believe this treatment of asset appreciation is correct because the proper focus of the Proposed Regulations should be on the net amount of S’s items. But we are concerned that this result is reached only because $25 of Asset A’s built-in loss was offset by appreciation in Asset A’s value after its contribution to S. If Asset A’s value had remained $20 at the time it was sold, producing a $30 loss, and S had generated income of $25 from another source to offset part of that loss, the Proposed Regulations would eliminate the entire $6 suspended loss. Yet, the economic effects of S offsetting Asset A’s built-in loss against

\(^{51}\) *Textron, Inc. v. U.S.*, supra. Although a group might attempt to combine separate and consolidated results, perhaps by employing exotic investment adjustments in an effort to isolate S’s gross positive adjustments in some S shares, and S’s gross negative adjustments in other S shares, we believe such structures are rare, and the consolidated return regulations already contain adequate safeguards against such contrivances in the form of anti-avoidance authority. See, e.g., Reg. §1.1502-32(e) (investment adjustment anti-avoidance rules). To the extent the government has any doubts, it can add additional examples illustrating their application in the context of loss duplication. Accordingly, we believe that there is no need for the Proposed Regulations to adopt broad solutions simply to ensure that these cases are addressed.

\(^{52}\) See, e.g., Prop. Reg. §1.1502-35(e), Ex. 5.
Asset A’s subsequent appreciation are identical. Thus, in our view, it should not matter whether S’s asset basis recovery offsets (i) S’s post-contribution appreciation directly in Asset A, (ii) S’s post-contribution gain from a separate source, or even (iii) S’s recognized built-in gain from a separate source. In all three cases, S’s basis in Asset A is merely combined with S’s basis in its other assets in determining S’s overall inside gain or loss, there is no net investment adjustment, and the basis recovery does not contribute to the type of loss duplication that should be the focus of the Proposed Regulations. A group’s income and tax liability are clearly reflected only if comparable tax results are achieved in economically equivalent circumstances.

We also believe that allowing S to net its own gains and losses is supported by the Proposed Regulations’ method of computing the amount of P’s loss on S stock that must be suspended. Stock loss is suspended only to the extent of duplicated loss with respect to a share. Simplifying the formula, a share’s duplicated loss equals its allocable portion of the excess of (i) S’s aggregate adjusted asset basis, over (ii) the value of S’s stock and amount of its liabilities. Thus, if S’s assets have $100 of aggregate basis, its stock has $90 of value, and it has no liabilities, S’s potential duplicated loss is $10. Even if S’s assets consist of Asset A with a $100 basis and $0 value, and Asset B with a $0 basis and $90 value, the Proposed Regulations only prevent P from recovering $10 of its aggregate basis in the S stock. The Proposed Regulations do not seek to trace P’s stock loss to the $100 built-in loss in Asset A at the time it was contributed by P. By automatically netting Asset A’s $100 unrealized loss with S’s $90 unrealized gain, and limiting loss duplication to the net $10 loss, the Proposed Regulations appear to assume that $90 of S’s unrealized asset loss will be offset by its unrealized gain, and that no duplication concerns are presented by P’s recovery of stock basis in excess of $10. Yet, P’s recovery of the balance of its S stock basis literally duplicates S’s recovery of the balance of Asset A’s basis. The loss duplication formula in the Proposed Regulations may reflect a literal view that P’s recovery of additional S stock basis does not generate a separate loss to the extent of Asset B’s unrealized gain -- distinguishing basis recovery that merely offsets gain from basis recovery that generates a separate loss. But we believe that P’s recovery of stock basis has the same economic effect regardless of whether realized or unrealized items are being netted and that a group’s income and tax liability are clearly reflected only if comparable tax results are achieved in economically equivalent circumstances.

In addition to the overbreadth of stock loss elimination under the Proposed regulations, we are concerned that, contrary to their stated purposes, the basis redetermination rules of the Proposed Regulations extend well beyond circumstances involving any potential for loss duplication. Unlike the basis shifting that applies when S leaves the P group, which is limited to some or all of S’s gross deductions and losses reflected in the basis of “other” shares of S stock, the basis of every S share is redetermined without regard to any potential for loss duplication when S remains a member:

Example 9. Only outside loss. P, the common parent of a consolidated group, purchases all 10 outstanding shares of S stock from an unrelated person for $100

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53 We believe there are additional policy and technical defects in the mechanics for basis redeterminations. For example, where S deconsolidates, every loss share of S stock, not just transferred loss shares, is deconsolidated, and it is possible that the group will not retain direct ownership of any shares, or will retain only preferred shares that already have basis equal to their fair market value. These problems are addressed elsewhere in these Comments.
without making an election under section 338. S has been developing new technologies, and its assets consist solely of $0 basis intangibles. After unanticipated changes in the marketplace, S’s intangibles decline to $10 in value, but P remains optimistic regarding their business prospects. To fund S’s remaining capital needs, P contributes $90 for another 90 shares of S stock. Thus, P has $190 of basis in its S stock; S has $90 of basis in its assets, and the value of S’s assets is $100.

P sells 5 of the original S shares for $5, anticipating that it will recognize a $45 loss. The sale of these shares does not deconsolidate S, and P’s loss neither duplicates a loss in S’s assets, nor accelerates any loss otherwise recognizable by the group (aside from the unrealized loss in P’s S shares). But the Proposed Regulations nevertheless shift P’s basis among all of the S shares, and allow P only a $4.50 loss from the sale.

In this situation, the Proposed Regulations prevent P from “cherry-picking” its loss stock even though its built-in loss in its initial shares of S stock is attributable to depreciation after the stock was acquired and there is no loss duplication with respect to the S stock. The preamble to the Proposed Regulations does not provide any rationale for departing from separate return principles in this context and, as described above, we believe a unified basis regime presents sufficient challenges that the government should reconsider such an approach in the absence of loss duplication. We note here that the Proposed Regulations would be much less problematic if the basis redetermination mechanics where S remains a member were conformed to those where S deconsolidates, and then modified to address the issues identified in these Comments. As illustrated by the following example, however, the government may be concerned that conforming the mechanics will preserve some capacity for loss duplication, and therefore regard nonduplication cases as a necessary casualty:

Example 10. Gain and loss stuffing. P, the common parent of a consolidated group, and S1, its historic subsidiary, jointly form S2. P contributes Asset A, with a $50 basis and $20 value, for 20 S2 common shares (“BIL Shares”), and S1 contributes Asset B, with a $0 basis and $80 value, for 80 S2 common shares (“BIG Shares”). P’s basis in the BIL Shares is $50, S1’s basis in the BIG Shares is $0, and S2’s basis in Asset A and Asset B is $50 and $0, respectively. P sells the BIL Shares for $20 (recognizing a $30 loss) and the sale does not deconsolidate S2.

If the Proposed Regulations redetermined stock basis under the rules applicable to deconsolidation transactions, no basis would shift because no deduction and loss were taken into account in computing investment basis adjustments for the retained BIG Shares. Moreover, the rules applicable to deconsolidation transactions would not suspend P’s $30 loss from the BIL Shares because S2 does not have net duplicated loss. S2 could later sell Asset A and recognize a $30 loss, which would offset P’s income on the group’s return, and under the investment adjustment rules, S1’s basis in each retained BIG Share would be reduced by a pro rata share of the $30 loss, with the result that the BIG Shares would have a
$30 excess loss account. But the P group might avoid triggering the excess loss account by simply retaining the BIG Shares, or liquidating S2 under section 332.

If this type of case is the rationale for the overbreadth, we believe the concerns can be addressed in other ways. Because a subsidiary initially possesses both built-in gain and loss, it is theoretically capable of absorbing its own losses and deductions, and the Proposed Regulations could preserve appropriate relationships between duplicated loss and duplicated gain, as well as between separate and consolidated return results, by either (i) treating some or all of a subsidiary’s items of deduction and loss as subject to the SRLY rules following P’s sale of the BIL Shares,\(^{54}\) (ii) or suspending the items until the subsidiary’s first separate return year.\(^{55}\) Although applying SRLY principles will preserve the P group’s ability to benefit from a subsidiary’s deductions and losses, this benefit will be offset by the detriment from the subsidiary’s income and gain.\(^{56}\)

The government may reject a SRLY approach because groups might be encouraged to pursue loss duplication through either stuffing built-in gain assets into the subsidiary, or stuffing built-in loss assets into subsidiaries already possessing built-in gain. A group might be indifferent regarding the location of its income and gains (e.g., if its members have uniform tax and non-tax profiles), and built-in gain stuffing would become the norm in order to shrink the relevance of the Proposed Regulations. But we suggest that the government consider SRLY as the base rule, with additional rules to address abusive cases in both the consolidated and separate return cases.\(^{57}\)

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\(^{54}\) Thus, to the extent that S generates income or gain, its duplicate deductions and losses would be allowed as an offset (with no net adjustment to S’s stock basis under the investment adjustment rules). Moreover, cumulative measurement of the SRLY limitation would take into account S’s generation of income and gain in consolidated return years before or after its deductions and losses are recognized. To more fully conform to separate return treatment, the government might decide that SRLY subgrouping should not be permitted. See, e.g., Reg. §§1.1502-15(c) and 1.1502-21(c)(2). In any event, the SRLY limitation should not be lifted because of any overlap with section 382. See, e.g., Reg. §§1.1502-15(g) and 1.1502-21(g).

A similar, alternative approach might suspend S’s deductions and loss to the extent of S’s net negative investment adjustments (disregarding the effects of distributions), because these reflect the extent of the group’s consolidated return benefit from inclusion of S. This approach would require additional mechanics to address timing disparities between S’s various items, while such mechanics are already incorporated into the cumulative approach of the SRLY rules.

\(^{55}\) Because the need to suspend S’s items results from consolidated return single entity principles, the concept of a limited carryover period under section 172 or section 1212 should be inapplicable. Instead, the principles of the timing provisions of the intercompany transaction acceleration rule are more analogous. See Reg. §1.1502-13(d)(1)(i). Thus, S would take the deduction or loss into account in its first separate return year, and the relevant carryover periods would be determined as if the deduction or loss arose in this separate return year.

\(^{56}\) Note that any such change in approach would require amendments throughout the Proposed Regulations. For example, the anti-loss reimportation rules would be modified to impose a similar SRLY limitation on reimported loss, without regard to overlap relief under Reg. §1.1502-21(g).

\(^{57}\) To the extent that the government believes special stuffing concerns exist in the consolidated return context, specifically targeted anti-stuffing rules should be considered. For example, anti-stuffing rules might be limited to transactions facilitated by the consolidated return rules. 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)).
Until the Proposed Regulations, the consolidated return regulations have retained many aspects of the Code’s separate return stock rules, which generally permit a parent selling less than all of its subsidiary’s stock to choose the particular shares to be sold. If P purchases S’s stock over time in a creeping acquisition, the Code permits P to have a different basis in its different shares of S stock, and the Code also generally permits P to choose which shares to subsequently sell (and associated basis to recover) if P decides to sell less than all of its S shares. Historically, these results have not been perceived as unique or abusive if they happen to arise in a consolidated return rather than a separate return. P’s decision to sell S shares without a section 338 election is inherently a separate entity transaction, and the government has not previously identified a single entity rationale for depriving P of the generally available ability to choose which share basis to recover. Until such a rationale has been more fully developed, we believe any change in the current system should be confined to the loss duplication opportunities created by consolidated return filing.

The preamble to the Proposed Regulations states that

> when a group seeks to raise capital, the common parent will typically issue stock directly or sell all of the stock of a subsidiary member. Alternatively, groups sometimes seek to raise capital by creating minority interests in a subsidiary member. In such cases, however, the group will typically cause the subsidiary member to issue shares directly to the nonmember. Thus, the IRS and Treasury Department believe that a member’s sale of less than all of the stock of a subsidiary member to a nonmember, which may trigger application of the basis redetermination and loss suspension rules, is not a common transaction in the absence of tax incentives.

We agree that P can chose between issuing new P shares, selling a portion of its S shares, or causing S to issue new shares, and that tax incentives play an important role in determining which format to adopt. For example, P’s planning for a section 355 distribution of S stock to the public will often include consideration of raising funds from the public in anticipation of the distribution, including whether this takes the form of S issuing new shares or P selling existing S shares, and the decision regarding structuring will generally be influenced by P’s pre-distribution basis in S’s stock. But we do not perceive this type of tax planning, which is equally available to similarly situated separate return groups, as distorting consolidated taxable income or tax liability.

Perhaps an additional, unstated premise of the Proposed Regulations relates to the potential for a consolidated group to accelerate economic loss through a stock transaction. We believe that acceleration policies are distinct from those relating to loss duplication, and apply equally to both consolidated and separate returns. We question whether it is appropriate to alter the Code’s basis recovery rules for consolidated return relationships simply because section 1502 authorizes legislative regulations, when loss acceleration presents the same concern in the separate return context. We believe the government should differentiate between loss duplication and loss acceleration concerns, and address loss acceleration concerns in a separate project that applies to both separate and consolidated return filers.  

58 Any acceleration concerns would also appear to be somewhat inconsistent with other recently proposed amendments to the consolidated return regulations. See, e.g., REG-137519-01, 2001-49 I.R.B. 559 (“clarifying” that
If the government proceeds with the fundamental approach of the Proposed Regulations, we believe that the basis redetermination rules should permit taxpayers to value and trace when S remains a member in a manner that is comparable to the rules applicable when S deconsolidates. The revised rules should permit tracing of both S’s actual deductions and losses before a sale of loss stock, and S’s future potential deductions and losses following such a sale, developing all of the relevant relationships and limiting basis redeterminations to the greatest extent possible. Perhaps these revisions will enable the two basis redetermination systems of the Proposed Regulations to be integrated into a single set of mechanics. But even this suggestion does not fully remedy the overbreadth of the Proposed Regulations, because the Proposed Regulations presume that S’s future potential gross items of deduction and loss will be taken into account faster than its offsetting items of income and gain.

In summary, the general assumptions underlying the basis redetermination and stock loss elimination rules are not accurate, nor are they more likely to produce accurate results than the existing consolidated return regulations that the Proposed Regulations would substantially modify or replace (e.g., the basic allocation rules under Reg. §1.1502-32(c), or even Reg. §1.1502-20(c) provided additional refinements can be adopted). Yet, unlike prior consolidated return rules that sacrifice accuracy to achieve administrability when they operate through assumptions, the Proposed Regulations embrace assumptions that sacrifice accuracy while also imposing all of the burdens associated with a tracing system.

To the extent that the Proposed Regulations treat a consolidated group more harshly than its separate return counterpart, we believe that the disparity creates distinctions that are similar to the disparity found by the Federal Circuit to be fatal in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001). It is also unclear whether pending legislation would resolve this issue, because it could be interpreted to preserve the separate return principle relied on in *Rite Aid* in the context of loss duplication. Consequently, we anticipate that taxpayers will similarly challenge the validity of any new disparities. Regulating under the authority of section 1502 should be limited to problems associated with consolidated return filing. The rate at which stock basis is recovered, and the extent to which stock loss is allowed, should be altered only to the extent that they reflect inappropriate results attributable to the operation of other consolidated return rules.

2. Disallowing (or Preserving) Both Losses

As noted above, the sole stated purpose of the Proposed Regulations is to prevent a group from obtaining more than one tax benefit from a single economic loss. The preamble to the Proposed

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59 As noted elsewhere in these Comments, this same approach should be incorporated into the basis reduction requirements for the worthlessness rules.
60 Many of our concerns with the presumptions underlying the Proposed Regulations are described elsewhere in these Comments.
Regulations does not suggest that circumstances may exist in which a consolidated group should be disallowed the only available loss. The preamble even provides:

While the basis redetermination rule may prevent the recognition of a current loss on a particular share of subsidiary member stock, it does not prevent a group from obtaining a benefit from its investment in the subsidiary member. The basis redetermination rule affects only the timing of the group’s loss and, in so doing, prevents the group from inappropriately duplicating a single economic loss.

Thus, it appears that applications of the Proposed Regulations that completely eliminate a group’s only loss, or fail to eliminate the duplication of loss, are inappropriate and unintended.

The Proposed Regulations operate based on certain embedded, but unstated, assumptions regarding the relationship between a subsidiary’s inside items of deductions and loss (e.g., duplicate inside loss will not tier up to the block of stock that reflects the duplicate outside loss), and the effect of these items on the subsidiary’s stock basis through Reg. §1.1502-32. When these assumptions are incorrect, the adjustments required by the Proposed Regulations do not clearly reflect consolidated taxable income and tax liability:

**Example 11. 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 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 also eliminating P’s suspended loss.

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61 Other rules might apply to completely disallow any loss, but these are beyond the scope of the Proposed Regulations. See, e.g., Reg. §1.337(d)-2T (2002).

62 These Comments contain additional examples elsewhere, that arise in the context of more specific problems raised by the Proposed Regulations. For example, presumptions underlying the special lower-tier subsidiary rules, the worthlessness rules, and the anti-loss reimportation rules, can also have the effect of completely eliminating a group’s only loss.

63 The negative adjustment to the retained shares does not appear intended to constitute a duplicate stock basis adjustment that is blocked by Reg. §1.1502-32(a)(2).
We do not believe that the interaction between the investment adjustment rules and the stock loss suspended under the Proposed Regulations can be resolved by simply blocking the negative investment adjustments from S’s losses whenever they eliminate a corresponding amount of suspended stock loss (i.e., viewing the negative adjustment as effectively allocated to the shares sold by P, rather than the retained S shares, to avoid duplicating the elimination of suspended stock loss). Instead, valuation and tracing would be required to identify the proper allocation of investment adjustments, and negative adjustments would be allocated to the retained S shares only to the extent they bear S’s loss either economically (i.e., a “true economic loss”) or as a result of an earlier basis redetermination under the Proposed Regulations. The following example illustrates the results if S’s deductions and losses that eliminate P’s suspended stock loss do not result in a corresponding negative investment adjustment to the retained S shares.

Example 12. Coordinating with investment adjustments. The facts are the same as Example 11, “Group’s only loss disallowed,” except that P’s $6 suspended stock loss is eliminated as a result of S recognizing a $6 inside loss that is not attributable to the contributed assets (an “operating loss”). This loss offsets P’s income and, because the group does not establish that this loss was unrelated to P’s suspended loss, the suspended loss is eliminated. Under the suggested “blocking rule,” no negative investment adjustment is allocated to the retained S shares in an effort to prevent duplication of adjustments. S subsequently recognizes loss from the BIL Assets that also offsets P’s income, and 80% of the resulting negative investment adjustment is allocated to the retained S shares under the generally applicable rules. Finally, P sells the retained S shares for $75.20 (reflecting their having borne 80% of the $6 operating loss).

(a) S recognizes $0 loss from BIL Assets. None of S’s operating loss is allocated to the retained S shares, and P’s basis in the retained shares remains $104 (i.e., $80 plus $24 from the basis redetermination under the Proposed Regulations). Thus, P recognizes a $28.80 loss from the retained shares. Combined with S’s $6 operating loss, the P group recognizes an aggregate loss of $34.80. Yet, the P group incurred $36 of economic loss (assuming that P incurred the $30 loss on the BIL Assets before contributing them to S). 64

(b) S recognizes $6 loss from BIL Assets. Although none of S’s operating loss is allocated to the retained S shares, S’s $6 loss from the BIL Assets reduces P’s $104 basis in the retained shares by 80% of this loss, to $99.20. Thus, P recognizes a $24 loss from the retained shares that, when combined with S’s $6 operating loss and the $6 loss from the BIL Assets, results in an aggregate loss of $36. This corresponds to the P group’s $36 of aggregate economic loss. 65

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64 The $1.20 ($36 minus $34.80) represents the interaction of (i) erroneously eliminating P’s suspended stock loss due to S’s unrelated $6 operating loss, and (ii) erroneously blocking the $4.80 negative investment adjustment that the retained S shares economically bear. These errors offset, producing a net $1.20 detriment.

65 The absence of any shortfall/excess represents a coincidence of (i) erroneously eliminating P’s suspended stock loss due to S’s unrelated $6 operating loss, (ii) erroneously blocking the $4.80 negative investment adjustment that the retained S shares economically bear, and (iii) erroneously allocating to the retained S shares $4.80 of the
(c) *S recognizes $10 loss from BIL Assets.* Although none of S’s operating loss is allocated to the retained S shares, S’s $10 loss from the BIL Assets reduces P’s basis in the retained shares by 80% of this loss, to $96. Thus, P recognizes a $20.80 loss from the retained shares that, when combined with S’s $6 operating loss and $10 loss from the BIL Assets, results in an aggregate loss of $36.80. This exceeds the P group’s $36 of aggregate economic loss.\(^{66}\)

(d) *S recognizes $30 loss from BIL Assets.* Although none of S’s operating loss is allocated to the retained S shares, S’s $30 loss from the BIL Assets reduces P’s basis in the retained shares by 80% of this loss, to $80. Thus, P recognizes a $4.80 loss from the retained shares that, when combined with S’s $6 operating loss and $30 loss from the BIL Assets, results in an aggregate loss of $40.80. This exceeds the P group’s $36 of aggregate economic loss.\(^{67}\)

The varying yields in these cases reflect the failure of the Proposed Regulations to accurately associate S’s asset losses with the basis reflected in the S stock. The appropriate $36 aggregate loss could be achieved in each of these cases only if the investment adjustment allocations are determined through valuations and tracing in every case. But valuations and tracing would impose an administrative burden that the Proposed Regulations sought to avoid by adopting presumptive rules to redetermine stock basis. The problems of the presumptive approach of the Proposed Regulations can arise in a variety of fact patterns.

**Example 13. Special allocations.** 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 Asset A, with a $50 basis and $20 value, for S preferred stock. The preferred stock provides for a fixed return plus an additional participation in S’s earnings that exceed a specified threshold. P’s aggregate basis in the preferred stock is $50, and S’s basis in Asset A is $50. P sells the preferred stock for $20, and because the sale does not deconsolidate S, the Proposed Regulations redetermine P’s basis in every share of S stock. The preferred stock’s participation in S’s earnings prevents the stock from satisfying the definition of “preferred stock” in the Proposed Regulations. Therefore P’s negative investment adjustment for loss from the BIL Assets. The retained S shares should have been allocated $4.80 of the operating loss, but none of the $6 loss from the BIL Assets because that loss was allocated entirely to eliminate P’s suspended stock loss on the BIL Shares. It is merely a coincidence that two different $4.80 errors neutralized each other.

\(^{66}\) The $0.80 excess ($36.80 minus $36) represents the interaction of (i) erroneously eliminating P’s suspended stock loss due to S’s $6 operating loss, (ii) erroneously blocking the $4.80 negative investment adjustment that the retained S shares economically bear, and (iii) erroneously allocating to the retained S shares $8 of the negative investment adjustments for loss from the BIL Assets. The retained S shares should have been allocated $4.80 of the operating loss, and $4 of the loss from the BIL Assets (the remainder of the $10 loss from the BIL Assets, after allocating $6 to eliminate P’s suspended stock loss, to reflect the earlier redetermination of basis under the Proposed Regulations). Thus, $8.80 should have been allocated to the retained S shares, while only $8 was actually allocated.

\(^{67}\) All of the duplicated loss has been fully flushed through stock basis. Thus, the remaining $4.80 excess loss is the result of erroneously blocking the $4.80 negative investment adjustment that the retained S shares economically bear.
aggregate $130 basis in the S shares is redetermined by reference to the relative fair market value of each share. Accordingly, $26 is allocated to the preferred stock, P recognizes a $6 loss on the sale of these shares, and this loss is suspended. S later sells Asset A, and its $30 loss causes P’s suspended stock loss to be eliminated. Moreover, S’s $30 loss offsets P’s income, and under the investment adjustment rules, P’s basis in the remaining S shares is reduced from $104 to $74. 68 P later sells the remaining S shares for $80, and recognizes a $6 gain. Thus, $6 of the P group’s $30 loss with respect to Asset A has been completely eliminated.

Example 14. Intercompany transaction. P, the common parent of a consolidated group, owns all of the stock of S, and S owns all of the stock of T. S acquired all of the T stock in a single section 338(h)(10) transaction for $140, and the stock now has a $100 value. S distributes all of the T stock to P in an intercompany transaction that is not subject to section 355. Because S has uniform basis in every T share, the redetermination of basis does not alter the amount of S’s basis in any share, and S recognizes a $40 loss on the distribution. 69 S’s loss with respect to the T stock is subsequently taken into account when S (but not T) leaves the P group, and the $40 loss is suspended under the Proposed Regulations at that time. 70 T later sells its loss assets and recognizes a $40 loss that causes the suspended stock loss to be eliminated. Moreover, T’s $40 loss offsets P’s income, and under the investment adjustment rules, P’s basis in the T stock is reduced from $100 to $60. Finally, P sells the T stock for $100, and recognizes a $40 gain. Thus, the P group’s entire $40 loss with respect to T’s assets has been completely eliminated.

Example 15. Carryback to separate return year. P, the common parent of a consolidated group, acquires 80 shares of S stock (representing all of S’s outstanding stock) from the X consolidated group for $80. P later contributes to S Asset A, with a $50 basis and $20 value, in exchange for an additional 20 shares of S common stock (“BIL Shares”). P’s basis in the BIL Shares is $50, and S’s basis in Asset A is $50. P sells the BIL Shares for $20, and because the sale does not deconsolidate S, the Proposed Regulations redetermine P’s basis in every share to be $1.30. Thus, P recognizes a $6 loss on the sale of BIL Shares, and this loss is suspended. S later sells Asset A to an unrelated party for $20, and recognizes a $30 capital loss that S is required to carry back to the prior X group, generating a refund for the X group that is not shared with S under their tax sharing agreement. S’s loss causes P’s suspended stock loss to be eliminated because S’s loss is “taken into account in determining consolidated taxable

68 If a subsidiary has multiple classes of participating stock outstanding, the investment adjustments allocated to each class reflect its participation in the corresponding economic income or loss.

69 This transaction might be eligible for the exception to basis shifting for complete, taxable dispositions within a single tax year. This issue is not relevant to the example, and the same effect would be achieved if less than 100% of the stock were distributed.

70 We have questions regarding the operation of the loss suspension rule in the context of loss being deferred under other rules. These issues are discussed elsewhere in these Comments.
income (or loss),” “absorbed by the subsidiary member,” and “treated as taken into account in the year in which it arises and not the year in which it is absorbed.” Moreover, under the investment adjustment rules, P’s basis in the retained S shares is reduced from $104 to $80. Thus, $6 of the P group’s $30 loss with respect to Asset A has been completely eliminated.\(^{71}\)

We note that, just as the basis shifting rules can overstate the corrections necessary to prevent loss duplication, they can also understate the corrections:

Example 16. Minority stock—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 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 of S stock 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 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.\(^{72}\)

\(^{71}\) The extent to which inappropriate loss duplication is achieved might depend on the nature of any tax sharing arrangement between the P and X groups. If the X group retains the economic benefit of the carryback, does this case more closely resemble the type of separate return loss duplication case that the Proposed Regulations do not affect? On the other hand, if the P group retains the economic benefit, it starts to look more like the form of loss duplication that is prohibited by the Proposed Regulations. The example demonstrates that the distinctions drawn by the Proposed Regulations have created new sources of stress on the extent to which single entity treatment applies when separate return years are involved.

\(^{72}\) This example raises issues regarding the general ability of a consolidated group to include 100% of a subsidiary’s items in the consolidated return, but to only reflect a proportionate amount of the subsidiary’s items in the group’s investment adjustments. Because 10% of S’s items were allocated to X for purposes of the investment adjustment rules, the Proposed Regulations fail to eliminate 10% of the $36 duplicated loss. The current investment adjustment approach reflects an assumption that S’s items are not built-in, and therefore only a proportionate amount should be reflected in the group’s stock basis in order to prevent their duplication. If S’s items represent built-in amounts, this basic assumption is incorrect, and distortions can arise. The Proposed Regulations raise new issues regarding the appropriateness of tolerating these distortions.

The minority shareholder’s presence in this example creates the potential for preserving as much as 10% of the loss duplication. But because the Proposed Regulations stack S’s entire asset loss against the $4 suspended stock loss, rather than only the $3.60 share allocable under the investment adjustment rules, the example shows that only $3.20 of the $3.60 potential duplication was actually achieved. By contrast, if S’s $36 asset loss had been absorbed before P sold the BIL Shares, the full $3.60 potential loss duplication could be achieved.
The essential problem illustrated by these examples is that there are defects in the assumptions embedded in the Proposed Regulations regarding the interaction between outside stock loss and investment adjustments arising from inside deduction and loss. The assumptions can be incorrect in any number of circumstances, because the inside/outside relationships can change over time (factual, due to intervening changes in law, etc.), and do not necessarily bear any relationship to relative fair market values of different classes of stock. In fact, the relationships can change multiple times over the course of a transaction, and perhaps conflict in some respects. We have tried to identify principles that would enable the Proposed Regulations to avoid full-blown tracing, but we have not identified any simple relationships that address more than a very narrow set of circumstances. We believe that the only solution is to make the stock basis adjustments under the Proposed Regulations even more flexible, depending on the particular circumstances. But we do not believe that a more flexible approach would provide taxpayers with the concrete guidance that the government had hoped, and these are the very “complex rules addressing basis adjustments” that the preamble indicates the Proposed Regulations were designed to avoid. The problem of the design of the Proposed Regulations is that taxpayers will complain about cases in which too much loss is eliminated, but continue to plan into circumstances in which too little loss is eliminated.

3. Frequency of Application

The preamble to the Proposed Regulations indicates “[t]he IRS and Treasury Department do not expect that the basis redetermination and the loss suspension rules will apply frequently.” This appears to be based on expectations regarding how groups raise capital and sell interests in subsidiaries, and that the Proposed Regulations will sufficiently eliminate tax incentives so that the problematic transactions simply will not occur.

We disagree with the government’s expectations regarding the limited relevance of the Proposed Regulations. In fact, we expect that they will have common application. Virtually every transaction involving subsidiary stock will have to at least consider the Proposed Regulations in order to identify planning opportunities, and the Proposed Regulations will therefore be implicated in virtually every commonplace transaction. Taxpayers may welcome some opportunities created. For example, to avoid any risk of triggering excess loss accounts in lower-tier members when selling or distributing the stock of a higher-tier member, taxpayers may make a practice of triggering the application of the basis redetermination rules. More disconcerting, however, is the fact that the Proposed Regulations might prove to be unavoidable in many commonplace transactions, and their complexity and potential inaccuracies will have a critical impact on the ability of the consolidated return regulations to operate properly:

For example, could the subsidiary’s inside items be subjected to a SRLY limitation or suspended until it has a separate return year? Alternatively, might suspended stock loss be eliminated only to the extent that the inside deduction or loss results in negative investment adjustments that are allocated to the sold stock (i.e., the extent to which stock loss would have been eroded if the inside deduction or loss had preceded the outside stock loss), in order to address the acceleration of outside loss relative to inside items? This latter approach could be too favorable to taxpayers if less than the entire duplicate inside loss and deduction is recognized, because there might not be a recognition event with respect to the subsidiary’s stock bearing the balance of the investment adjustments. Moreover, taxpayers might manipulate the approach by recapitalizing shares (e.g., into, or out of, status as preferred stock) to manipulate investment adjustment allocations. Cf. Reg. §1.1502-32(e)(2), Ex. I (recapitalization subject to anti-avoidance adjustments).
Example 17. Intercompany transaction. P, the common parent of a consolidated group, owns all of the stock of S, and S owns all of the stock of T. P purchased the S stock in a taxable transaction without making an election under section 338. T has been an historic subsidiary of S, and both S and T are actively engaged in separate trades or businesses that are subject to separate regulatory regimes. T requires additional capital, and P makes a cash contribution to T in exchange for a 10% direct equity interest. Due to unrelated, unanticipated changes in S’s marketplace, its regulatory commission orders S to dispose of its entire interest in T, so S distributes its T stock to P. S cannot distribute the T stock under section 355(c), due to limitations under section 355(d). Accordingly, the group elects to make the distribution fully taxable under section 311 and Reg. §1.1502-13(f).

Under the Proposed Regulations, any excess of S’s basis in the T stock over value will result in shifting of basis to P, and any remaining S loss will be suspended.

Example 18. Loss reimportation. P, the common parent of a consolidated group, owns all of the stock of S. S’s business is volatile, and due to unanticipated changes in S’s marketplace, S needs capital. P sells its entire interest in S to an unrelated person, and recognizes a loss. Over the course of the following 10-year period, P remains active in its business sector, and acquires many new targets. Under the Proposed Regulations, P must monitor every acquisition, and every asset associated with every acquisition, to determine whether any future item of deduction or loss derived from these acquisitions was reflected in P’s loss from the stock sale.

Example 19. Worthlessness. P, the common parent of a consolidated group, owns all of the stock of S. S operates a technology business that had promise when P purchased the S stock in 1999. S’s technology has proved unreliable, and even became obsolete when its competitors developed a new product in 2001. Rather than continue funding S, P decides to terminate the bulk of S’s operations, and claim a loss with respect to the S stock. Under Prop. Reg. §1.1502-35(f), P must reduce its basis in the S stock based on assumptions regarding future absorption of S’s existing loss carryovers. It is factually unclear that the P group will have income to absorb S’s carryovers, and it is possible that they are subject to limitations that effectively prevent any absorption.

Example 20. Capturing the group’s only loss. Same as Example 9, “Only outside loss.”

74 See Reg. §1.1502-13(f)(5)(ii)(D). Alternatively, the distribution could be taxable under section 355(f).

75 Issues can also arise from mere intercompany sales of subsidiary stock. For reasons noted previously, we are ignoring the potential application of the exception to basis shifting for complete, taxable dispositions within a single tax year.
4. Parallel Investment Adjustment Allocation System

A principal concern underlying the basis shifting provisions of the Proposed Regulations is that the investment adjustment system is inaccurate because its assumptions fail to reflect circumstances in which S’s items of deduction and loss relate disproportionately to the basis of particular shares of S stock. The preamble to the Proposed Regulations observes:

One assumption is that the subsidiary’s losses are borne by the holders of the common stock before the holders of the preferred stock. Another assumption is that each share within a class is entitled to an equal portion of the subsidiary’s items of income and gain, and, in the case of common stock, of deduction and loss. The investment adjustment rules, therefore, generally allocate basis adjustments without regard to differences in members’ bases in their shares of the stock of the subsidiary member and without regard to whether a basis adjustment reflects an item of income, gain, deduction, or loss that was built-in with respect to contributed property. These assumptions can give rise to the results illustrated in the transactions described above.

The investment adjustment rules have two essential components: (i) computing the amount of stock basis adjustments, and (ii) allocating this amount among the different shares of subsidiary stock. The current allocation process accepts the general Code rules for establishing a distinct basis in each share of subsidiary stock (e.g., section 1012, section 358, section 263, etc.), allocates only changes in the inside net asset basis of a subsidiary, and allocates the amount of any change among the subsidiary’s shares based on assumptions regarding their relative participation in the economics associated with the amount. For example, each share of a single class of common stock is assumed to participate equally in the economics associated with a particular adjustment, and therefore the amount of any investment adjustment is equally allocated among these shares. The system was recently overhauled, and the current rules attempt to achieve a balance between accuracy and administrability. The rules require allocations among classes of common stock by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement, with the allocation generally reflecting the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the allocated items. Adjustments between common and preferred shares are even subject to a cumulative redetermination process. The current investment adjustment system also incorporates forms of basis shifting, but they are very limited, do not involve shifting between members, and focus primarily on reducing the likelihood of a member having an excess loss account with respect to only some of its shares. This limited shifting reflects concerns expressed by Congress regarding basis shifting involving member debt, as well as more general concerns about the types of tax planning issues described above. In our experience, the current

77 See Reg. §1.1502-32(c)(2)(ii).
78 See Reg. §1.1502-32(c)(4).
79 See Reg. §§1.1502-19(d) and 1.1502-32(c)(2)(i).
80 The former investment adjustment regulations permitted a single member to more readily shift basis between its debt and equity investments in a subsidiary. See former Reg. §1.1502-19(a)(6) (1994). Because of the potential to
system already challenges taxpayers to the full extent of their record keeping and economic analysis capabilities, and works well for most of the types of transactions to which the Proposed Regulations will apply.\textsuperscript{81}

The government now appears more concerned about possible relationships between the amount of a share’s basis and any inside basis, than with the share’s economic participation, and the extent to which any particular source of share basis relates to a particular source of the subsidiary’s deductions or losses. In an effort to correlate inside and outside basis relationships, but avoid the burdens associated with more precise tracing, the Proposed Regulations simply redetermine stock basis in a manner that tends to unify basis/value relationships within each class of subsidiary stock held by the group. (Preferred stock receives special treatment, which is designed to eliminate its sources of gain and loss, and might be analogized to the current treatment of intercompany debt.) As discussed elsewhere in these Comments, we do not believe that the assumptions underlying the Proposed Regulations are more accurate than those underlying the current regulations or will more readily promote clear reflection of consolidated taxable income and tax liability. They are simply different, and introduce new sources of potential inaccuracy:

\textit{Example 21. Special allocations.} P, the common parent of a consolidated group, and S, an existing subsidiary, form partnership PS, and elect to classify PS as an association taxable as a corporation, with PS becoming a member of the P group. P contributes Division P, and S contributes Division S, each with a $50 basis and value. Under the PS operating agreement, P’s allocations from PS track 90% of the performance of Division P, while S’s allocations from PS track 90% of the performance of Division S.\textsuperscript{82} P and S each have an initial $50 basis in their PS interest, and PS’s initial basis in its assets is $100. The PS operations generate no income or deductions from Division P, but a $30 net loss from Division S that offsets the income of other members in the P group. Under the investment adjustment rules, 90% of the negative adjustments from PS are allocated to S, reducing the basis of its PS interest from $50 to $23, reflecting an assumption that undermine requirements under section 453, elective shifting between stock and debt was eliminated by the enactment of section 1503(e)(4). See, e.g., H.R. Rep. No. 247, 101\textsuperscript{st} Cong., 1\textsuperscript{st} Sess. 1234 (1989). In addition, former Reg. §1.1502-19(a)(6)(ii) (1994) was adopted to prohibit elective shifting among shares to stock “to the extent the reduction has the effect of netting gain or loss in a manner that would not be permitted” under the LDR. For example, elective basis shifting could be equivalent to stuffing that was limited by Reg. §1.1502-20(e). When the investment adjustment regulations were overhauled in 1995, the shifting mechanics were simply eliminated.

\textsuperscript{81} The relative simplicity of the investment adjustment system might be analogized to a similar compromise struck under Subchapter S. By contrast, Subchapter K imposes much greater burdens of precision, including tracing requirements under section 704(c). We do not believe that consolidated groups can apply the principles inherent in section 704 as a routine matter, and suspect that there is widespread noncompliance even in typical partnership structures, which are often far simpler than affiliated group structures (i.e., corporate tiers, assembled at varying times, in both recognition and nonrecognition transactions, with distinct basis in each share of stock, different classes of shares, different rules applicable to stock gains and stock losses, etc.).

\textsuperscript{82} This example could have used a corporate entity and more traditional tracking stock, but the flexible allocations of a partnership emphasize how far the Proposed Regulations can deviate from the current investment adjustment system. Taxpayers might attempt more modest manipulations, such as issuing stock that would constitute preferred stock, but for a small participation feature, so that it is treated like common stock under the basis shifting rules.
S bears the economics associated with the Division S operations. By contrast, the Proposed Regulations tend to reallocate the entirety of the PS basis between P and S by reference to the relative value of their interests in PS, which takes into account both recognized and unrealized amounts. Thus, whether S will have more or less than the $23 basis under the investment adjustment rules will depend on the results of valuations.

We do not believe that allocating the basis effects of recognized amounts by reference to the economic effects of unrealized amounts will generally be more accurate than the approach of the investment adjustment rules. There is no reason to believe that the presumption underlying the Proposed Regulations, regarding inside PS items being noneconomic and corresponding to a particular source of outside basis in PS will be generally correct, and simply averaging all basis represents a very high price to overcome these inaccuracies. In fact, the new basis rules are even subject to manipulation. For example, P or S can influence the resulting basis allocation through the contribution of an appreciated or depreciated asset to PS, thereby changing the relative value of their PS interests and which of them bears the negative adjustment for PS deductions and losses. The preamble notes that “the basis redetermination rule equalizes members’ bases in subsidiary stock such that the loss suspension rule . . .need not include inordinately complex rules to address the method by which inside losses reduce stock basis under §1.1502-32.”

Because there is no necessary relationship between where basis is allocated, and how future investment adjustments will be allocated, we do not agree that the need for complex rules has been successfully avoided.

The Proposed Regulations do not limit their basis manipulation to the cumulative amount of investment adjustments, and there is no obvious relationship in a non-stuffing case between the basis results and the parties having joined in filing a consolidated return. Most of the problems illustrated by the Proposed Regulations involve stuffing transactions. The current investment adjustment rules authorize anti-avoidance adjustments to prevent stuffing abuses, and the Proposed Regulations do not identify the inadequacies of this approach. We believe that such a radical new system should be required to overcome a rather high threshold before it is applied to the more general non-stuffing case because of the distortions that may arise. In the absence of stuffing, the relationship between any particular source of inside basis or outside basis will generally be unclear, and the Proposed Regulations are too simplistic in seeking to overcome this problem by overriding existing basis principles through an approach that combines the worst of both worlds – overbroad assumptions and burdensome valuations and tracing.

Perhaps the Proposed Regulations can be redirected to make stuffing their sole focus. In particular, can the Proposed Regulations be limited to cases of P stuffing loss assets into S in exchange for specially designed blocks of S stock? For example, a rule analogous to section 358(h) might be devised to prevent preferred stock from ever taking basis under section 358 that exceeds fair market value. To the extent that stuffing could migrate to common stock transactions, the current anti-avoidance rules could be expanded to impose tracing requirements.

83 Interestingly, it can even make a difference when the stuffing takes place. There will be an impact if the stuffing transaction precedes the basis shift, but no impact if it follows the basis shift.

84 See Reg. §1.1502-32(e)(2), Ex. 2 (imposing section 704(c) principles in the abusive stuffing transaction context).
for these types of aggressive structures. These approaches would more precisely tailor the new rules to the persons for whom they are designed. The most realistic fact pattern in the case of a true operating subsidiary will be in connection with an anticipated distribution to the public, because it will generally be impractical in circumstances to create a minority interest in the common stock of the subsidiary due to the parent’s control and the numerous problems associated with introducing a minority shareholder. Accordingly, the regulations might limit their focus to preferred stock arrangements. If the government’s true concern is with taxpayers using special purpose subsidiaries to facilitate the sale of common stock, the structures are likely to be unusual and might be addressed through much more focused anti-avoidance rules.

Even if we accepted the principles of the Proposed Regulations as an improvement, we are concerned that the valuations on which they rely will present as many difficulties as the more complex tracing that was to be avoided. As described elsewhere in these Comments, we believe that any system predicated on valuations will be unadministerable, and inevitably will become a source of substantial controversy with the Service. These very issues were contemplated during the recent overhaul of the investment adjustment system, and the illusion of additional precision that valuations can introduce was specifically rejected due to concerns with administrability. Because we believe the effects of the Proposed Regulations extend far beyond the context of potential loss duplication, will have frequent application, and are not an improvement over current law, we do not believe that the Proposed Regulations justify the problems that they introduce.

The Proposed Regulations preserve all of the current investment adjustment rules (e.g., for transactions involving the disposition or deconsolidation of only gain shares), and require taxpayers to simultaneously apply both the current rules and the Proposed Regulations in the planning for every transaction in order to determine the tax consequences of various alternative structures. While we recommend that the Proposed Regulations be reconsidered in their entirety, we also believe that, if the government decides to retain the proposed approach, it should consider replacing Reg. §1.1502-32(c) in its entirety with the basis shifting components of the Proposed Regulations. At least there will be only a single allocation system, and this approach will eliminate inevitable conflicts between two systems that have very different goals (i.e., the Proposed Regulations shift basis by reference to the overall value of shares, while investment

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85 The preamble to the final investment adjustment regulations provides “[t]he proposed regulations do not predicate stock basis adjustments on presumptions as to whether amounts are already reflected in stock basis. Instead, they reflect the treatment under the Code of all changes in S’s net asset basis while S is a member. Substantially altering this approach to take additional information into account would require significant modifications, including appraisals and tracing.” T.D. 8560, 1994-2 C.B. 200. In addition, “[t]he absence of a negative adjustment under the current regulations [for certain distributions of affiliated E&P] appears to be based on a presumption that the distributed E&P is not reflected in stock basis. This presumption may be wrong if, for example, P purchases S’s stock after the E&P economically accrues but before it is taken into account for Federal income tax purposes. To limit the negative adjustment would be inconsistent with the general approach of the regulations because it would require appraisals and tracing of E&P to provide different stock basis reductions depending on the nature of the distributed E&P.” Id. Moreover, “Negative adjustments (other than for distributions) are not allocated to preferred stock because of its similarity to debt, which receives no negative adjustments. S’s losses should not be allocated to preferred shares until S is unable to satisfy their priority. S’s ability to satisfy their priority can only be determined with appraisals, and the use of appraisals is contrary to the general approach of the regulations.” Id.

86 If the Proposed Regulations are to apply more broadly, the basis redetermination rules must be modified. For example, they must apply to both gain and loss shares of subsidiary stock.
adjustments focus solely on assumed economics with respect to particular adjustments). For example, if a subsidiary’s common share is sold at a loss, and the Proposed Regulations shift basis to or from a retained preferred share of the subsidiary, how should the cumulative redetermination rules operate in subsequent periods? If the basis is shifted under the Proposed Regulations away from preferred stock issued by a lower-tier subsidiary, and the investment adjustment rules tier up the basis change to the stock of higher-tier subsidiaries, does the investment adjustment conflict with the purposes of subsequent cumulative redeterminations with respect to preferred stock of the higher-tier subsidiary? As discussed elsewhere in these Comments, uniformly applying the basis shift rules will also avoid disparities with gain shares.

5. Novel Basis Shifting

The Proposed Regulations rely on novel basis shifting rules that require mechanical adjustments never previously considered in the consolidated return context. Not surprisingly, these new mechanics require substantial additional guidance beyond the basic issues address in the Proposed Regulations. More importantly, we are very concerned that the new mechanics will become the source of entirely new and unintended tax planning, because the mechanics disregard the historic concern of the consolidated return regulations with preserving location:

Example 22. 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 deconsolidates the preferred share of S3 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.

87 See, e.g., Notice 94-49, 1994-1 C.B. 358 (in connection with the intercompany transaction system, discussing the need to preserve location to avoid undermining “mirror subsidiary” legislation unless location is preserved).
Example 23. Viral basis shifting. P, the common parent of a consolidated group, owns all of the stock of T, an existing subsidiary. P acquired the T stock for $100, and that stock now has a $175 value. P plans to sell the T stock to an unrelated buyer. P and T jointly form S1 with each making a $10 contribution for common stock. Separately, P contributes an asset with de minimis value and $100 basis to S1 for one preferred share. P takes a $100 basis in the preferred share, while S1 takes a $100 basis in the asset. P then contributes the preferred share to a partnership owned by members of the P group. The contribution does not deconsolidate S1 from the P group, but does deconsolidate the contributed share. Under the Proposed Regulations, the basis of the preferred share is redetermined immediately before its contribution, with the approximately $100 excess of basis over value shifting $50 to P’s S1 stock, and $50 to T’s S1 stock. As a result, P and T each have a $60 basis in their S1 common stock. Under the investment adjustment rules, the $50 increase in T’s inside, net asset basis tiers up and increases P’s basis in the T stock from $100 to $150.

Next, S1 and T jointly form S2 with each making a $10 contribution. Separately, S1 contributes the depreciated asset to S2 for one preferred share, and S1 takes a $100 basis in the preferred share, while S2 takes a $100 basis in the asset. S1 then contributes the preferred share to a partnership owned by members of the P group. The contribution does not deconsolidate S2 from the P group, but does deconsolidate the contributed share. Under the Proposed Regulations, the basis of the preferred share is redetermined immediately before its contribution, with the approximately $100 excess of basis over value shifting $50 to S1’s S2 stock, and $50 to T’s S2 stock. As a result, S1 and T each have a $60 basis in its S2 common stock. Under the investment adjustment rules, the $50 decrease in S1’s inside, net asset basis (resulting from the $50 shift of basis to the S2 stock owned by T) tiers up and decreases the basis of the S1 stock owned by P and T (each reducing the basis of their S1 common stock by $25). Moreover, T’s inside, net asset basis increases by $50 for the basis shift to its S2 stock, and decreases by $25 for the basis reduction to its S1 stock, for a $25 net increase. Under the investment adjustment rules, the net $25 increase in T’s inside, net asset basis ($50 increase in S2 stock basis, and $25 decrease to S1 stock basis) tiers up and increases P’s basis in the T stock from $150 to $175. Finally, P sells the T stock for $175 and recognizes no gain or loss, and the S1 and S2 stock owned by T is later redeemed at a loss to T.

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88 Because there is no loss on the S2 stock, the special rules for lower-tier subsidiaries 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).

89 Because there is no loss on the T stock, the special rules for lower-tier subsidiaries and reimporting loss are inapplicable. Because S1 and S2 are deconsolidated by the sale of T, basis shifting is limited to the amount of items
These examples illustrate the potential for so-called “mirror subsidiary” transactions that arise from the type of basis shifting adopted by the Proposed Regulations. While the drafters might believe that basis shifting merely relocates basis within the group to where it more accurately reflects the economics, we do not agree. Instead, as described with respect to the current investment adjustment rules, we find that the results are simply different from current law. But, because the Proposed Regulations introduce entirely new mechanics that are based on flawed assumptions, important existing balances inherent in the current regulations are entirely disrupted, and the resulting new problems may be as problematic as the loss duplication concerns addressed by the Proposed Regulations. Basis shifting has been tried in the past, and almost universally determined by the government to be problematic. For example, it existed under former Reg. §1.267(f)-1T(c)(6) and (c)(7), and still exists under Reg. §1.302-2(c). The section 267(f) regulations were recently modified to eliminate their basis shifting because of these concerns, and the section 302 regulations are currently under study because of similar concerns. Because the Proposed Regulations are not confined to loss duplication and will apply much more frequently than the government anticipates, they have the potential to introduce a new generation of abusive transactions.

An unstated assumption that is critical to the Proposed Regulations is that the tax profiles of consolidated group members are uniform, and therefore basis recovery is the same wherever it occurs within the group. But a consolidated group can include regulated members (e.g., a utility company or cable company), members that have special status under the Code (e.g., a bank or life insurance company), and members that have minority shareholders. In an environment where there can be significant distinctions among the members, both as to their tax and nontax profiles, location within the group becomes critical to clear reflection of consolidated taxable income and tax liability. While the parties might be able to address some issues created by the Proposed Regulations through private tax sharing agreements, it is doubtful that any existing agreement reflects the new forms of basis shifting and loss elimination, and virtually every existing agreement will require reexamination. In effect, a revised tax sharing agreement must attempt to unwind the basis shifting and disallowance, in order to allocate the original attributes to the originating member. If a member’s business operations are regulated, problems might

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90 We also attempted to consider how circular stock ownership structures might interact with the Proposed Regulations, but found that this was the source of monumental headaches. Cf. Notice 94-93, 1994-2 C.B. 563 (study of inversion transactions). We are confident that these structures present additional planning opportunities, but because we believe that an adequate variety of problems has already been uncovered, we are reluctant to continue contemplating these structures.

91 See, e.g., CO-11-91, 1994-1 C.B. 724 (“The proposed regulations eliminate the rule that transforms S’s loss into additional basis in the transferred property when S ceases to be a member of the controlled group. Instead, the proposed regulations generally allow S’s loss immediately before it ceases to be a member. This conforms to the consolidated return rules, and eliminates the need for special rules. An anti-avoidance rule is adopted, however, to prevent the purposes of section 267(f) from being circumvented, for example, by using the proposed rule to accelerate S’s loss.”). Even though basis shifting was within the authority of section 267(f), it led to anomalies that arguably extended beyond the purposes of the rules. See, e.g., Unionbancal Corp. v. Commissioner, 305 F.3d 976 (9th Cir. 2002).

arise in the regulatory process because it will be difficult for a regulatory commission to predict the regulated member’s tax costs.

It might be impossible to unwind all of the effects of the Proposed Regulations in cases where the members are subject to different tax regimes (e.g., different actual or effective tax rates, or basis recovery rules). We believe the basis shifting will necessarily alter the tax results for some groups simply by reason of the shifting the location of basis recovery, even if all of the basis is ultimately recovered in taxable transactions. This type of basis shifting was the very planning tool that taxpayers sought to achieve in the late 1950s and early 1960s, and that ultimately compelled an overhaul of the intercompany transaction regulations. We anticipate that comparable overhauls might be required for the intercompany transaction and investment adjustment systems in an environment where selling an asset can produce dramatically different results from selling member stock that is equivalent to the asset (i.e., stock issued in exchange for the asset in an intercompany section 351 transaction).

At the very least, substantial additional guidance is required to understand the implications of the Proposed Regulations. Different components of basis in a subsidiary’s stock might reflect different tax attributes, but the Proposed Regulations do not provide any guidance on how to track these components. For example, P and S1 can both have basis in the stock of S2, and before any basis shifting, P’s basis in its S2 stock (but not S1’s basis in its S2 stock) might reflect previously recognized built-in gain under Reg. §1.337(d)-2T(c) (2002), might be limited by section 382(h) and Reg. §1.1502-91(g) or Reg. §1.1502-94(c), might be the source of corresponding items under Reg. §1.1502-13(c), might have a different holding period, might be limited as to recovery potential by section 306, or might be the “appropriate” source of basis reduction under section 108(b). Alternatively, P’s unrealized gain in its S2 stock (but not S1’s unrealized gain in its S2 stock) might be the source of recapture under sections 1017(d), or recognized built-in gain under section 382(h) and Reg. §1.1502-91(h) or Reg. §1.1502-94(c). If basis or unrealized gain in the S2 stock is not uniform throughout the group, how are particular components tracked following a basis shift?94

Example 24. Tracking attributes. P, the common parent of a consolidated group, owns 80% of the stock of S, an existing subsidiary. P acquires all of the stock of T from an unrelated person, resulting in an ownership change of T under section 382(g). Among T’s assets is the remaining 20% of the S stock, which is included in T’s net unrealized built-in loss computations under section 382(h) and Reg. §1.1502-94(c). If the S stock basis is shifted under the Proposed Regulations, and

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93 See, e.g., Notice 94-49, 1994-1 C.B. 358 (“The current deferred sale system was adopted in 1966 because of the many problems with the prior carryover basis system. The prior system permitted intercompany items to be recognized by the wrong member and at the wrong time, to be characterized improperly, and sometimes to be eliminated completely. See, e.g., Beck Builders, Inc. v. Commissioner, 41 T.C. 616 (1964), appeal dismissed (10th Cir. 1965) (intercompany income from the performance of services was eliminated without any corporate or shareholder level tax.).”).

94 Even if there is a uniform amount of basis in every share of a subsidiary’s stock before any basis shifting, and therefore basis shifting does not change the amount of any share’s basis, the basis shifting can have an impact if the attributes of basis are not uniform throughout the group. In this regard, the government should consider addressing its views about the potential for a single share of stock to have a split basis. See, e.g., Rev. Rul. 85-164, 1985-2 C.B. 117.
P succeeds to some of T’s basis in the S shares, is P’s additional basis in its S stock subject to limitation under section 382 and Reg. §1.1502-94(c), and how does P identify the amount of available section 382 limitation? Do any of these results change if T leaves the P group before P recovers the shifted basis?\(^\text{95}\)

Basis shifting can also affect other tax attributes. For example, does shifting a member’s basis in the stock of a subsidiary correspondingly shift the member’s earnings and profits or deficit in earnings and profits (“E&P”) (i.e., does a member’s tax balance sheet parallel its E&P balance sheet, with shifts in one causing corresponding shifts in the other)? If not, the Proposed Regulations will generate significant disparities between taxable gain and E&P that are not contemplated by the current E&P rule.\(^\text{96}\) Might this create new sources of problems, such as the ability to eliminate the gross E&P of particular members within a group, or the interaction with the alternative minimum tax adjusted current earnings (“ACE”) rules, which depend on E&P concepts? If E&P is shifted, are still other new tax planning opportunities created by the opportunity to shift the location of gross E&P within a group, perhaps to a particular subsidiary, despite the lack of overall E&P in the group, and resurrect opportunities for special purpose subsidiaries that generate dividends-received flows for outside investors?\(^\text{97}\)

Basis shifting also creates new practical problems. For example, the aggregate amount of a subsidiary’s stock basis might be adjusted after the disposition or deconsolidation, triggering application of the basis shifting rules. If the subsidiary’s stock is held in several corporate chains, the sale of a single share at a loss will affect the stock basis throughout each of the relevant chains (as illustrated above), but if the Service subsequently adjusts the subsidiary’s income or loss for the period before the sale, the corresponding change in the amount of the subsidiary’s investment adjustments will interact with the basis shifting mechanics and change the aggregate amount of basis that tiers up through the corporate chains. This amplifies the complexities of the adjustment, because the effect on basis shifting might be disproportionate in the aggregate.\(^\text{98}\)

6. Suspension Loss

The Proposed Regulations also rely on novel loss suspension and elimination rules. In circumstances that present the opportunity for two tax deductions with respect to a single

\(^{95}\) The opposite case could just as easily arise, in which T has a net unrealized built-in gain with respect to its S shares, and basis shifting under the Proposed Regulations increases T’s basis in its S shares. Does T’s potential for recognized built-in gain shift to P’s S shares, what if no aggregate gain remains, and what if T leaves the P group before any of the S stock basis is recovered?

\(^{96}\) See, e.g., section 312(f). Cf. Reg. §§1.267(f)-1(g) and 1.1502-33(c)(2) (special rules deferring E&P impact until taken into account).

\(^{97}\) Section 1503(f) prevents a group from isolating income and E&P generation in a special purpose subsidiary, by preventing the tax attributes of other members from sheltering the subsidiary’s earnings. But creating the ability to isolate E&P in the subsidiary through basis shifting, without any corresponding income, is beyond the section 1503(f) mechanics.

\(^{98}\) For example, the amount of the basis shift absorbed by the subsidiary’s preferred stock might change disproportionately to the subsidiary’s common stock. As discussed elsewhere in these Comments, an audit adjustment can even change a gain share to a loss share, or loss share to a gain share, and thereby change whether the basis shift rules apply at all.
economic loss, the Proposed Regulations resolved the dilemma as to which deduction to permit by favoring asset-based deductions over stock-based deductions. This objective is achieved by shifting stock basis, suspending any surviving stock loss, and eliminating the loss as inside deductions and losses are taken into account.99

In view of the many single and separate entity conflicts under the consolidated return regulations, we believe reconsideration should be given to whether it is always appropriate for the only deduction or loss to be the inside item rather than the stock loss. Transactions with respect to member stock are generally given significant separate entity treatment under the consolidated return regulations, and simply denying the ability to claim the stock loss is tantamount to an anti-acceleration policy. As noted elsewhere in these Comments, rather than suspend the stock loss, consideration should be given to allowing the stock loss, and adopting alternative mechanisms, such as thereafter treating the subsidiary’s duplicate items of deduction and loss as subject to the SRLY rules, or suspending them until the subsidiary has a separate return year.

Example 25. Limitations on tax attributes. Individual A forms T to undertake a risky business venture, and finances T entirely with equity. After T operates at a substantial loss, all of the T stock is acquired by P, the common parent of an unrelated consolidated group, in a reorganization described in section 368(a)(1)(B). P succeeds to A’s basis in the T stock, which corresponds to the aggregate amount of T’s inside asset basis and NOLs (i.e., T has made no distributions and has engaged in no other transactions that deplete its aggregate inside basis and tax attributes). P’s acquisition of T results in an “ownership change” of T, and because of T’s small value, the resulting section 382(a) limitation on T’s NOLs and built-in loss is small. But section 382 does not impose any limitation on P’s basis in the T stock.100 Suspending T stock loss due to the presence of T’s NOLs and built-in loss has the economic effect of denying P any loss from its investment in T until T leaves the P group. While A might recognize a deduction by selling the P stock received in the earlier reorganization, that loss is outside the corporate tax system and is not relevant to determining the proper amount of corporate-level taxation.

As with the basis shifting rules, it is not surprising that these new mechanics require substantial additional guidance beyond the most basic issues addressed in the Proposed Regulations. As noted elsewhere in these Comments, loss suspension can operate to disallow a group’s only deduction or loss. Our focus here is simply on problems associated with loss suspension in any context.

What is the nature of a suspended loss—who carries the loss, what are its attributes, and how does it interact with other rules applicable to tax attributes? The loss suspension rules bear a

99 There are exceptions, such as with respect to the anti-loss reimportation rules. We note that the regulations do not appear to envision the case where the only economic loss is with respect to member stock, and the group attempts to duplicate this stock loss.

100 But see Reg. §1.1502-15. Whether section 384 can limit the built-in T stock loss is beyond the scope of these Comments.
surface resemblance to the deferral rules underlying the intercompany accounting regulations, but the loss suspension rules implement very different concepts, and therefore both the mechanics and purposes of the rules are distinguishable. The intercompany transaction rules focus solely on tax concepts, by generally preserving the relationship between intercompany items and corresponding items. Moreover, the intercompany transaction rules abandon single entity principles in favor of acceleration where matching becomes impossible. By contrast, the Proposed Regulations attempt to match tax deductions with economic loss, and as the tracing and valuation concepts underlying the Proposed Regulations demonstrate, this relationship is much more difficult. Moreover, the point at which the Proposed Regulations abandon single entity treatment is different from intercompany accounting:

Example 26. Intercompany transaction. Same as Example 14, “Intercompany transaction.”

The deferral of S’s loss under Reg. §§1.1502-13 and 1.267(f)-1 also defers the suspension of S’s loss under the Proposed Regulations, and loss suspension does not begin until S’s loss is taken into account. The Proposed Regulations are unclear as to what happens to S’s loss if S leaves the group before the loss is either eliminated or allowed. We believe that the suspended loss should remain with the group, rather than travel with S to a separate return year, because permitting the loss to leave the group creates the potential to eliminate the group’s only deduction or loss. In effect, a suspended loss would be treated as a tax attribute of the entire group, rather than a tax attribute of any particular member. This approach might be consistent with the general mechanics of the Proposed Regulations, which reduce the outside stock basis of the loss member and its E&P immediately, despite the loss suspension. But the Proposed Regulations need to be clarified in this respect.

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102 The Proposed Regulations compute duplicated loss by adopting a modified version of the loss duplication formula under Reg. §1.1502-20(c)(2)(vi). That formula mechanically compares the amount of outside stock loss to the amount of the subsidiary’s inside items, without inquiry as to whether these amounts have a common economic origin. The extent to which the Proposed Regulations redetermine stock basis, or eliminate suspended stock loss, can depend on whether the subsidiary’s subsequent items were “reflected” in the duplicated loss computation. Informal discussions with government representatives have indicated that the intent of the Proposed Regulations is to affect duplicated loss only if the outside basis and inside items have a common economic origin. Thus, if a subsidiary already has a net unrealized built-in loss when it issues new shares for cash, any subsequent stock loss from the new shares should be treated as unrelated to the pre-existing built-in loss (e.g., suspended loss from the new shares should not be eliminated because the built-in loss is subsequently recognized). The intended relationships are far from clear under the actual language of the Proposed Regulations.

103 We note that the Proposed Regulations are unclear regarding the effects of deferring the suspension of stock loss in circumstances where the issuing member takes into account deductions or losses during the deferral period. Until the T stock loss is taken into account and becomes a suspended loss, T’s own deductions and losses cannot eliminate any of the deferred stock loss (i.e., the items only eliminate a suspended loss, but S’s loss on the T stock is not suspended until the loss is taken into account). Once the loss is taken into account, and becomes suspended, some or all the loss should be eliminated to reflect T’s interim items (as if suspension of the loss had never been deferred). Any other result would seem to invite inappropriate planning, but the mechanics of the Proposed Regulations are unclear.

104 This approach would be consistent with the discussion in the preamble to the Proposed Regulations regarding the possible results of an insolvent subsidiary dissolving, and its historic contribution to the group’s CNOL or consolidated net capital loss not being apportioned or otherwise eliminated.
We have concerns with any approach that disassociates a tax attribute from a particular member because virtually all of the existing consolidated return regulations rely on location rules and do not anticipate free ranging tax attributes. Anomalies are therefore likely to arise. To avoid these concerns, perhaps the suspended loss could be assigned to the members still owning stock in the issuing subsidiary (perhaps in the same ratio that basis would have been assigned to the members, and shifting based on future events in the same manner as basis would have shifted).

It is also unclear why the amount of stock loss to be suspended is determined by reference to the subsidiary’s net amount of built-in loss, but the subsequent elimination of the suspended loss is determined by reference to the subsidiary’s gross items of deduction and loss taken into account. Focusing on a net amount tends to conform the treatment of a consolidated group subsidiary to a separate return subsidiary that is capable of absorbing its own items, while focusing on gross items adopts a different approach. This dichotomy results in potentially small differences in timing making significant differences in the operation of loss suspension. For example, if stock loss is suspended first, subsequent recognition of deduction or loss by the issuing subsidiary eliminates suspended loss through adverse stacking. But, if the issuing subsidiary recognizes its deduction or loss first, only a proportionate amount of these items has the effect of eliminating stock loss.

Curiously, stock loss remains suspended following a group’s termination if there is a “successor group.” No explanation is provided for the continued suspension for duplication between separate groups, but it appears to reflect a judgment that the same corporate entities (or their section 381 successors) will benefit (in whole or in part) from the duplication. In effect, the holding in Rite Aid is inapplicable if the acquiring group acquires the stock of Rite Aid rather than the stock of its subsidiary. Economically equivalent, separate return loss duplication is permitted by the Proposed Regulations if a group contributes built-in loss assets to a controlled, separate return subsidiary (e.g., a REIT), perhaps along with some built-in gain assets to ensure that the loss is absorbed. It is difficult to distinguish these two cases, and therefore the successor rule appears to be inconsistent with the general approach of the Proposed Regulations.

Equally curious is the failure of the Proposed Regulations to provide a mechanism for suspended loss to be taken into account before the subsidiary leaves the group. This might be appropriate to

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105 To avoid these types of issues, even newly created tax attributes are typically assigned to particular members when the regulations focus on the issue. See, e.g., Reg. §1.108-3. If there were to be COD in a particular member that is excluded from gross income under section 108(a), is a suspended loss available for reduction, and is it more like a loss or like tax basis?

106 If the loss were to travel with S to a separate return year, we do not believe that it is practical for S to continue coordinating with the group going forward, and we do not believe that the anti-duplication policies of the Proposed Regulations compel any such coordination between separate taxpayers. Instead, S should be permitted to deduct the remaining balance of any suspended loss immediately after leaving the group.

107 A successor group is a group that acquires the stock of the common parent (or its assets in a reorganization described in section 381(a)(2)), or survives after applying the principles of Reg. §1.1502-75(d)(2) or (d)(3).

108 The concept underlying the treatment of a successor group (i.e., stepping into the shoes of the original group) appears analogous to the concept underlying the anti-loss reimportation rules (i.e., resurrecting the original treatment of the group). To the extent that the government retains the proposed approach regarding both of these rules, it should consider integrating the two concepts in an effort to simplify the Proposed Regulations.
the extent that a subsidiary maintains the potential to take into account items that will eliminate
the suspended loss while it remains a member, but the subsidiary might reach a point after which
there can be no further elimination. After that point, continued loss suspension appears
inappropriate. Thus, once the subsidiary has recovered every basis amount and absorbed every
tax attribute reflected in the computation of its duplicated loss, any remaining suspended loss
should be allowed.

7. Lower-Tier Subsidiaries

The Proposed Regulations include two special rules for lower-tier subsidiaries: (i) basis shifting
for lower-tier subsidiaries in circumstances not otherwise requiring shifting under the general
rules, and (ii) loss suspension for lower-tier subsidiaries in circumstances not otherwise requiring
suspension under the general rules.\footnote{The rules under Prop. Reg. §1.1502-35(c)(5)(i) should be clarified to confirm that loss suspended under Prop.
Reg. §1.1502-35(c)(2) is allowed once the specified event (e.g., ceasing to be a member) occurs with respect to the
lower-tier subsidiary.}

The special basis shifting rule appears targeted at cases in which P owns the stock of S1, S1
owns some or all of the stock of S2, and P sells or deconsolidates only a small amount of S1
stock so that S1 remains a member of the P group.\footnote{If P sells enough S1 stock to deconsolidate S1, and S1 owns less than 80\% of S2, a lower-tier member of the P
group, this will automatically deconsolidate the S2 stock owned by S1 under the general basis shifting rules, and no
special rule is required for S2 shares other than perhaps the ordering rule described in the text. If S1 owns at least
80\% of S2, the remaining S2 shares owned by other P group members are deconsolidated, and again the general
basis shifting rules apply. If S1 owns 100\% of S2, there does not appear to be any need for a special rule because
the basis shifting has no tiering up effect.} Although no rationale is provided, the
purpose for adjusting the S2 stock basis in these circumstances appears to be an underlying
assumption that any unrealized loss in the S1 stock is related to unrealized loss in the S2 stock,
and basis stuffing has been frustrated by isolating a portion of the S2 stock basis in S1 with no
other location to which the S1 stock basis can shift. The special basis adjustment rules eliminate
the overlapping loss duplication between the S1 and S2 stock, and avoid additional rules that
otherwise would have been required if the Proposed Regulations operated from the top-down.\footnote{Separately suspending stock loss, from the top-down, without special basis adjustment rules, could result in
complete elimination of some or all of the group’s only loss. For example, if P contributes a built-in loss asset to S1
in exchange for 10\% of S1’s stock, and S1 contributes the asset to S2 in exchange for 10\% of S2’s stock, suspending
the S1 stock loss first will prevent duplication at this higher-tier level, but then also suspending the S2 stock loss will
not only prevent duplication at this lower-tier level, but the resulting adjustment under Reg. §1.1502-32 has the
effect of also eliminating 90\% of the corresponding basis in the S1 stock even though the duplicated loss was
already eliminated. There is no generally applicable tracing mechanism for the suspended S1 stock loss to be
specially allocated under Reg. §1.1502-32 to the corresponding 10\% of S1 stock.}

To avoid special tracing rules, the Proposed Regulations alter the generally applicable ordering
rules by requiring the basis shifting rules to apply first at lower-tier levels, and then rely on Reg.
§1.1502-32 to tier up these adjustments and automatically eliminate corresponding duplication in
the higher-tier basis before there is a loss suspension event with respect to the higher-tier stock.
But the Proposed Regulations might be incorrect in assuming that there is a relationship between the higher- and lower-tier stock loss. Where there is no such relationship, the consolidated group’s taxable income and tax liability will be distorted by the special ordering rule:

*Example 27. Lower-tier basis shifting.* P, the common parent of a consolidated group, forms S1 by contributing $80 of cash and Asset A, with a $40 basis and $20 value, for 100 shares of S1 common stock (representing all of S1’s outstanding stock). P takes an aggregate $120 basis in the S1 stock, and S1 takes a $40 basis in Asset A. P and S1 jointly form S2, with P contributing Asset B with a $0 basis and $50 value for 50% of the S2 common stock, and S1 contributing $50 for the remaining 50% of the S2 common stock. P later sells 10 shares of S1 stock for $10, at a time when the S2 shares have declined in value by a de minimis amount. Because there is an unrealized loss in the S1 stock; S1 owns stock of S2; S1 has an unrealized loss in its S2 stock immediately before P’s sale; and immediately after P’s sale, P owns S2 stock, the S2 stock basis must be redetermined immediately before P’s sale. Under the Proposed Regulations, S1’s basis in the S2 stock is reduced from $50 to $25, and P’s basis in the S2 stock is increased from $0 to $25. Under the investment adjustment rules, the $25 reduction to S1’s inside net asset basis results in a corresponding $25 reduction to P’s basis in the S1 stock, from $120 to $95, with the basis of the sold shares reduced from $12 to $9.50. Thus, P recognizes a $0.50 gain, rather than a $2 loss, from the sale. S1 later sells Asset A, and the $20 loss offsets the income of other members. P’s basis in its remaining S1 stock is reduced under the investment adjustment rules from $85.50 to $67.50. P later sells all of its remaining S1 stock for $90, and P recognizes a $22.50 gain.

In effect, the P group recaptures $23, while only obtaining a $20 benefit from Asset A. The only opportunity for correction will be if P later sells its S2 common stock and recovers the basis that shifted from the other S2 shares. But what if S2 liquidates under section 332 and this basis simply disappears? We are concerned that the P group’s consolidated taxable income and tax liability will be distorted by the inaccuracy of the underlying assumptions.

The special subsidiary rule is not limited to cases in which P sells an insufficient amount of S1 stock to cause S1’s deconsolidation. We believe that the special subsidiary rule should not apply if S1 is deconsolidated, because any built-in loss in the S2 shares owned by S1 will not be recognized until after S1 leaves the group. In fact, even the general basis shifting rules should not apply to the basis of the S2 shares owned by S1 in this case. Unlike other deconsolidation events, such as S1 transferring the S2 shares to a partnership, and the stock loss being taken into account in the P group’s return, S1 will have a separate tax year on departure from the group and separately report any loss from the S2 shares. The possibility that any S2 stock basis taken by S1 out of the P group might relate to prior negative adjustments under Reg. §1.1502-32 with respect to S2 shares that remain in the P group represents a potential for gain duplication rather than loss duplication. The risk of distortion that results if no relationship exists between S1 and

\[112\] Even if S1 elects to pro rate its items under Reg. §1.1502-76(b)(2)(ii), its subsequent loss from the S2 stock is almost certain to be an “extraordinary item” and cannot be shifted into the period of S1’s inclusion in the P group return.
S2 stock loss is sufficiently great to outweigh any benefits from shifting S2 stock basis to counter the potential for future gain duplication. Of course, the general rules of the Proposed Regulations will separately apply to any loss with respect to the S1 stock, as appropriate.

8. Valuations, Tracing, and Recordkeeping

Critical to the ability of the Proposed Regulations to clearly reflect consolidated taxable income and tax liability is the ability of taxpayers to value different blocks of subsidiary stock that are unlikely to be traded in active markets or have other objective indicia of value, as well as each asset of a subsidiary that might have any amount of unrealized loss. For certain tiered subsidiary structures, a transaction involving even a single share of a higher-tier subsidiary’s stock might require these types of valuations to be made with respect to all of the stock and every asset throughout the chain.

Example 28. Multiple blocks of subsidiary stock. P, the common parent of a consolidated group, owns all of the stock of S1, an existing member. P and S1 jointly own all of the stock of S2, another existing member. Each corporation has been a member of the P group for several years, and there is no market activity that provides any indication regarding their separate stock value. P owns all of the S2 Class A common stock and preferred stock, while S1 owns all of S2 Class B common stock, which might reflect a de minimis built-in loss. P sells a small block of its S1 shares at a loss. Under the Proposed Regulations, the aggregate basis of the outstanding S2 stock might have to be reallocated, first to the preferred stock to the extent of its value, and then between the Class A and Class B common stock, based on their relative values.

How are these values to be determined, and what records must the P group retain regardless of whether the valuations show there is a loss in the S2 Class B common stock? Are P’s proceeds from the sale of a single S1 preferred share indicative of the value of the preferred shares, are blockage or minority discounts relevant, would the P group be well advised to hire an appraiser, what comparables and market place should the appraiser take into account (liquidation value, wholesale value, replacement cost value, etc.), what valuation techniques should the appraiser prefer (discounted cash value, modified book value, and multiples of book earnings, etc.)? If different approaches yield widely disparate amounts, is one technique more appropriate depending on the circumstances? Is the credibility of an earlier valuation threatened by a subsequent sale for a different amount, if the earlier valuation has adequate documentation? What will the Service do with the benefit of hindsight that it will inevitably possess in the context of an audit process?

Proper operation of the Proposed Regulations also relies on the ability of taxpayers to trace a subsidiary’s inside deductions and losses to particular elements of outside basis in the subsidiary’s stock. Taxpayers are permitted to trace these relationships in order to avoid inappropriate elimination of a group’s only loss. Tracing requires establishing the extent to which the deductions and losses were previously “reflected” in the duplicated loss computation. Based on informal discussions with government representatives, we understand that the intended inquiry requires more than a simple coincidence in the existence of an amount of outside loss and
inside items—the outside and inside amounts must have common economic origins. Unless taxpayers can establish the necessary facts, adverse assumptions regarding a prohibited relationship have the potential to distort a group’s income and tax liability. But the Proposed Regulations provide no meaningful guidance for identifying the relevant relationships, despite the critical nature of the process.\textsuperscript{113}

\textit{Example 29. Fluctuating values.} P, the common parent of a consolidated group, forms S by contributing $80 of cash and Asset A, with a $50 basis and $20 value, for 100 shares of S common stock (representing all of S’s outstanding stock). If Asset A subsequently appreciates in value to $50, and then declines in value to $20, P sells some S shares at a loss (but not enough to deconsolidate S), and S then sells Asset A and recognizes a $30 loss, was S’s loss reflected in the duplicated loss computation for the S stock? Would the answer be different if P made an additional investment for new S shares after Asset A had appreciated, and instead sold these shares at a loss (without deconsolidating S)?

\textit{Example 30. No stuffing.} P, the common parent of a consolidated group, buys all of the stock of S for $100 and an election is made under section 338(h)(10) with respect to the purchase. S’s assets subsequently fluctuate in value, with some assets appreciating, other assets depreciating, and the aggregate value of S declining relative to basis. In addition, P infuses additional cash in exchange for preferred shares, but due to subsequent changes in market interest rates, the preferred stock declines in value. P sells both S common and preferred shares at a loss, but S remains a member. How does P determine which gross built-in loss assets relate to the sold shares of common stock? Do any of the built-in loss assets relate to the sold shares of preferred stock? Would the preferred stock relationship be different if S used P’s cash investment to buy an asset that declined in value (but this decline is economically unrelated to the reason for the preferred stock’s decline in value)?

\textit{Example 31. Stacking of inside loss.} P, the common parent of a consolidated group, owns all of the stock of S1 and S2, both historic subsidiaries. S1 and S2 each owns 50% of the stock of S3, a recently purchased subsidiary, with a $50 basis and value. S3’s assets have an aggregate $75 basis and $100 value. As a result of S3’s assets declining in value to $74, there is $1 of duplicated loss. S1 and S2 each sell one share of S3 stock at a loss, and S3 remains a member of the P group. The Proposed Regulations provide that the $1 of duplicated loss is taken into account only once, but does not provide guidance for determining whether the loss of S1 or S2 is subject to suspension?

\textsuperscript{113} To the extent that limited guidance is provided, numerous questions arise. For example, the Proposed Regulations imply that all of a built-in loss asset’s tax depreciation is first treated as recognized built-in loss, while a more theoretically accurate analysis would examine the relationship between the tax depreciation and the asset’s decline in value (e.g., the extent to which the tax depreciation captures the built-in loss, rather than corresponding to a new decline in value). See, e.g., Prop. Reg. §1.1502-35(e), Ex. 2. The Proposed Regulations also imply that intervening value fluctuations can result in an asset’s recognized loss being different from its earlier unrealized loss, yet there is no explicit discussion confirming this important relationship and the need for periodic valuations. See, e.g., Prop. Reg. §1.1502-35(g)(4)(ii), Ex. 3.
Example 32. Minority shareholders. P, the common parent of a consolidated group, and X, an unrelated person, jointly form S. P contributes $45 in exchange for 90% of S’s common stock, and X contributes Asset A with a $0 basis and $5 value in exchange for 10% of S’s common stock. S invests the cash from P in a high-risk venture that uses Asset A. S’s business proves unsuccessful, and its assets are sold for approximately $0. S recognizes a $45 loss that offsets P’s income on the group’s return, and under the investment adjustment rules, P’s basis in its S stock is reduced by a pro rata share of the $45 loss, with the result that its S stock has an $4.50 basis. P subsequently sells 10% of the S shares for approximately $0 and recognizes an additional $0.45 loss. The Proposed Regulations attempt to prohibit loss duplication, but to what extent should any of P’s loss from the S stock be treated as duplicated loss? Should the answer depend on whether P and S have a tax sharing agreement, and the extent to which the agreement preserves X’s economic interest in the tax benefit from S’s loss? To what extent might the results change if, rather than cash, P contributes an asset with a $50 basis and $45 value (while X contributes Asset A)? To what extent might the results change if X is a nonincludible corporation (i.e., a corporation described in section 1504(b)) or partnership controlled by P?

What are the relevant principles for identifying problematic loss duplication and differentiating it from acceptable separate return loss duplication, and how can a group be expected to know the value of every asset, at the time of every stock sale, as well as at the time of the asset’s sale, and at every interim point in time? If the Proposed Regulations are genuinely interested in disallowing stock loss only to the extent that there is an economic relationship between S’s items of deduction and loss, and P’s loss on the S stock, how should the fact that S’s stock is rarely priced by reference to the value of the underlying assets (e.g., a multiple of book earnings, a modified amount of book value, etc.) be taken into account?

The preamble to the Proposed Regulations notes that the government is “concerned about, and specifically request[s] comments regarding, the administrability aspects.” Upcoming comments on Reg. §1.337(d)-2T, by individual members of the Affiliated and Related Corporations Committee and the Corporate Tax Committee, will describe our administrability concerns with any approach that requires valuations and tracing, and the Proposed Regulations introduce even more problems with their concept of economically relating S’s gross deductions or losses to P’s loss on the S stock. In our view, valuation, tracing, and recordkeeping burdens of the magnitude required by the Proposed Regulations are impractical, and have the potential to be the source of endless controversy between taxpayers and the Service. Taxpayers have no guidance regarding the relevant principles, or the types of evidence that will be persuasive or the degree of certainty that the Service will require for adverse regulatory presumptions to be overcome.

It is impractical for taxpayers to undertake the task of continually anticipating every possible Service challenge in every possible combination of circumstances, so that they are prepared for the events that actually transpire. Instead, taxpayers will likely take what they believe to be the most basic, reasonable steps, and then wait for the Service to raise objections to which they can respond during the examination process. At least for the first few years following adoption of
the Proposed Regulations, whether a taxpayer has done enough to substantiate its position will be unknown. Finally, several years after a transaction is complete and its results reported in a tax return, and the matter has proceeded through the controversy process, a determination will be made for the first time as to the requirements imposed by the Proposed Regulations. While rulings, court opinions, and other forms of guidance will eventually exist, this offers little interim comfort. Because these issues are essential to proper operation of the Proposed Regulations, it is critical for relationships to be clarified and standards to be established today, so that taxpayers can know the law that applies as transactions arise and their effects must be determined. Otherwise, the Proposed Regulations will generate substantial uncertainty and may potentially produce essentially random results for taxpayers. While we recommend that the Proposed Regulations be reconsidered in their entirety, we believe that, if the government decides to retain the proposed approach, new Service forms might be developed to guide taxpayers in the timely gathering and maintenance of the necessary information, and more completely describing the relevant relationships that must be identified.

9. Loss Share of Subsidiary Stock

The Proposed Regulations apply only if a loss share of subsidiary stock is disposed of or deconsolidated. For dispositions and deconsolidations involving gain shares, the current rules are fully preserved. This asymmetry is troubling for both policy and practical reasons.

From a policy standpoint, as described elsewhere in these Comments, the basis shifting provisions of the Proposed Regulations appear designed to align a subsidiary’s stock basis with the negative adjustments under Reg. §1.1502-32 arising from its recognition of deduction and loss. As we have indicated, we disagree with the assumptions embedded in the Proposed Regulations but, if the government decides to retain the proposed approach, it should consider applying the Proposed Regulations uniformly to all dispositions and deconsolizations of shares, regardless of whether a loss is involved. There is no reason consolidated taxable income and tax liability will be more clearly reflected if basis shifting applies only to loss because, if the government is correct, the inaccuracies under current law are as likely to create inappropriate gain duplication as loss duplication.

A more balanced approach might be achieved, as we have suggested for simplification purposes, by replacing Reg. §1.1502-32(c) in its entirety with the basis shifting components of the Proposed Regulations. Like basis shifting under the Proposed Regulations that can transform a loss share into a gain share, our recommended additional basis shifting might increase or decrease the amount of unrealized gain otherwise inherent in a share. Although taxpayers might argue that they should have the right to separately determine the amount of basis in each share of subsidiary stock in circumstances not presenting opportunities for loss duplication, these cases will be outweighed by the administrability benefits if basis shifting has more uniform application to gain and loss transactions.  

114 Corresponding changes would also have to be made to the special basis shifting and loss suspension rules applicable to lower-tier subsidiaries.  

115 Of course, this will only exacerbate the problems that we have described regarding the distortions that we believe basis shifting introduces. Whether the government is correct or not, this recommendation focuses solely on the benefits of uniformity.
From a practical standpoint, we are concerned that it will not always be possible to know whether a share is sold at a gain or loss and the uncertainty will inhibit ordinary course planning by consolidated groups. For example, if a share is sold for a contingent amount (e.g., based on the subsidiary’s subsequent earnings) and open transaction accounting is used, a substantial period of time might transpire before the final purchase price is determined, and the existence of stock loss is confirmed. Alternatively, a share might be sold at a gain, but due to post-transaction disputes, some of the purchase price may be refunded, transforming an initial stock gain into a stock loss under Arrowsmith or rescission principles.\textsuperscript{116} It is also likely that the investment adjustments with respect to the disposed of or deconsolidated share will not be known with certainty until several years after the event, when the subsidiary’s years within the group have been fully audited, controversies with the Service resolved, and the final amount reflected in a subsidiary’s investment adjustments has been determined. If the subsidiary’s stock is owned in more than one corporate chain within a group, the inability to know the applicability of basis shifting will affect stock basis throughout each of these chains, and it will not be possible to determine with certainty the results of other transactions affected by the subsidiary’s stock basis. While these problems cannot be eliminated, the cliff effect of the Proposed Regulations can be eliminated by uniformly applying the basis shifting rules without regard to whether a share reflects unrealized gain or loss.

10. Debt/Equity Issues

The basis shifting rules of the Proposed Regulations apply only to a subsidiary’s common and preferred stock. Thus, they do not apply to any basis associated with the creditor’s interest in intercompany debt. In our experience, groups do not always carefully document their intercompany debt arrangements, and may not always take the steps necessary to ensure that intercompany debt arrangements satisfy general debt/equity requirements under the Code.\textsuperscript{117} Historically, the failure to maintain proper formalities and substantive distinctions between intercompany debt and equity had few significant implications for basis analysis because the basis of each stock share, as well as the creditor’s interest, was separately maintained, and even if the debt was recharacterized as equity, it was most likely to be recharacterized as a type of preferred equity that bore only limited adjustments under the current investment adjustment rules.\textsuperscript{118} These traditional relationships are disrupted by the basis shifting rules of the Proposed Regulations.


\textsuperscript{118} See, e.g., Burr Oaks Corp. v. Commissioner, 43 T.C. 635, 649 (1965), aff’d, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967); Piedmont Corp. v. Commissioner, 25 T.C.M. 1344, 1349 (1966), rev’d, 388 F.2d 886 (4th Cir. 1968). If debt were recharacterized as equity, interest accruals would transform into equivalent dividend accruals. See Reg. §1.1502-13(f)(2).
One practical safe harbor to avoid the complexity of the basis shifting rules is that basis shifting could ordinarily be disregarded if a subsidiary has formally issued only a single class of common stock, the shares were issued at the same time, and every share has the same amount of basis. In these circumstances, it would appear that basis shifting is irrelevant. But the Proposed Regulations can nevertheless have an impact if the subsidiary’s intercompany debt is recharacterized as equity (presumably preferred stock). The group would then have to evaluate whether the creditor’s basis in the intercompany obligation equals its fair market value, and if not, basis would have to be shifted between the common stock and the obligation.

Taxpayers frequently fail to consider the tax consequences of creating intercompany debt. Large amounts of this debt are often created in the ordinary course of business. The government should have an interest in reducing the unintended consequences of the creation of this debt, but the Proposed Regulations significantly increase the consequences for situations in which there has been no sophisticated tax planning. The nature and importance of the adjustments cannot be predicted, but we are very concerned about the degree of uncertainty introduced into even the most common capital structures.

11. Worthlessness

The Proposed Regulations apply a new basis reduction mechanism to worthless stock of subsidiaries, including certain cases in which a subsidiary’s existence is terminated. A subsidiary’s stock basis must be reduced by the amount of the CNOL and net capital loss that would be attributable to the subsidiary (and its subsidiaries) as though the losses were absorbed. The basis reduction can deny a group’s only deduction if the group is unable to absorb the subsidiary’s inside losses. The rules apply whether the group recognizes “any gain or loss” from a subsidiary’s dissolution, or the worthlessness of subsidiary stock results in “the allowance of any loss or inclusion of an excess loss account.” The need for the worthlessness

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119 As noted elsewhere in these Comments, this safe harbor theory also relies on each component of share basis having identical tax attributes. Even though basis shifting would not alter the amount of any common share’s basis in the simplest circumstances, it might shift tax attributes if there are basis components with different attributes.

120 One case demonstrating the problematic nature of intercompany debt arrangements in most consolidated groups is Peoplefeeder, Inc. v. Commissioner, T.C. Memo. 1999-36 (1999). Peoplefeeder was the parent of a subsidiary that operated a chain of pizza restaurants. Every few days, cash receipts from the restaurants were swept into an intercompany bank account, and all restaurant expenses, as well as the parent’s outside loans, were paid from the account. In evaluating this sweep account arrangement, the Tax Court held that there was no debt because there were no maturity dates, no interest, no repayment terms, no enforcement mechanism, and no evidence that the subsidiary ever requested repayment. Emphasis was also placed on the parent-subsidiary relationship. Thus, there was simply a single cash pot for purposes of the group’s cash management, credit enhancement, and payment of bills. See also In re Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976) (another intercompany arrangement).

121 The provision takes the form of two separate rules that apply similar mechanics. One rule applies to certain taxable subsidiary stock dispositions that do not result in a separate return year, and the other applies to subsidiaries that are “treated” as worthless under section 165. The relative scope of these rules is ambiguous. Stock loss resulting from a taxable dissolution is deductible under section 165, and therefore both rules could apply to taxable dissolutions. The second rule appears targeted at circumstances in which a subsidiary’s stock is treated as worthless, but the subsidiary remains in existence as a member. Because the second rule merely incorporates the mechanics of Reg. §1.1502-80(c), the overlap of the two rules perpetuates an existing problem for taxable dissolutions, making the problem more acute. The government should take this opportunity to resolve the existing confusion rather than increase it.
rules is not explained, other than through an example in the preamble that provides (with emphasis added):

For example, suppose P owns all of the stock of S. P’s basis in its S stock is $100 and the value of the S stock is $0 because S is insolvent. S liquidates into P. In that case, P will recognize a loss of $100 on the disposition of the S stock. Because S is not a member of the P group immediately after the disposition of S stock, the loss suspension rule will not apply. The portion of the group’s consolidated net operating and net capital loss carryforwards attributable to S, however, may remain with the P group. Therefore, to that extent, any loss on the stock of the subsidiary duplicates those losses.

Ironically, the general effect of the worthlessness rules is comparable to the effect of the withdrawn LDR loss reattribution rules -- but with the CNOL surviving without the need for reattribution.\textsuperscript{122} We gather that the stock basis reduction was required as a result of concern that the subsidiary’s inside loss might survive the subsidiary’s dissolution because it is a consolidated tax attribute.\textsuperscript{123} Even if it survives the subsidiary’s dissolution, the tax attribute may be rendered useless (e.g., by a $0 limitation under section 382(g)(4)(D)) after the stock loss. While the fate of tax attributes in these circumstances may not be free from doubt under current law, to the extent they do not survive the subsidiary’s dissolution, the Proposed Regulations can be interpreted as denying any loss -- inside or outside -- with respect to the subsidiary.

The worthlessness rules do not apply if the subsidiary has not contributed to a CNOL or consolidated net capital loss (e.g., because the subsidiary’s asset basis was always low). This leads to the anomalous result that a true economic stock loss is more likely to be allowed if the subsidiary’s inside basis has always been low. Equally surprising is the fact that no stock basis reduction is required if the subsidiary has only unrealized asset loss. If the subsidiary is not dissolved, there are no special limitations in the Proposed Regulations on subsequent absorption of unrealized loss.\textsuperscript{124}

We appreciate the government’s concerns about the potential for duplication of loss as a result of uncertainty concerning the application of the loss carryover rules to worthless subsidiaries. Rather than reducing stock basis, we recommend that the government’s concerns be resolved by clarifying the rules applicable to a subsidiary’s inside loss. Thus, when a worthless subsidiary is dissolved, or its stock is treated as worthless, stock loss would be allowed to the extent allowable

\textsuperscript{122} See Reg. §1.1502-20(g).

\textsuperscript{123} The argument that S’s contribution survives its dissolution appears to be based on a reading of dicta in United Dominion Industries, Inc. v. U.S., 532 U.S. 822 (2001), in combination with the requirement for S to have a separate return year in order to cause apportionment of the consolidated tax attribute under Reg. §1.1502-21(b)(2) or Reg. §1.1502-22(b). We also understand that the preamble description of S’s dissolution as a “liquidation,” despite S not making any distributions to its shareholders in their capacity as such, was not intended to signal that the transaction is a liquidation for purposes of any particular rule, such as the successor rule, the application of which might depend on the status of the transaction as a liquidation.

\textsuperscript{124} Because of the compromises inherent in section 382(h), it is also possible that unrealized asset loss is not limited by section 382(g)(4)(D).
under current law, but the duplicate inside loss would be explicitly eliminated.\footnote{125} This can be achieved by amending (i) the consolidated return loss carryover rules to eliminate duplicate inside loss following a subsidiary’s dissolution (after absorption in the current consolidated return year, and after carryback to prior years),\footnote{126} (ii) the investment adjustment rules to confirm that this loss elimination does not cause a negative investment adjustment like that required for expiring loss,\footnote{127} and (iii) the consolidated section 382 regulations to provide that, if stock is treated as worthless, but the subsidiary remains in existence as a member, the inside loss becomes subject to limitation under section 382(g)(4)(D).\footnote{128} In the aggregate, these more tailored responses are preferable to the overbroad approach of the Proposed Regulations, and it will be much simpler to clarify the existing system than to create an overlapping system. This approach also has the advantage of eliminating uncertainties that will have to be eliminated under any set of rules.

If the government does not accept our recommendation, we request that it reconsider the purpose of the worthlessness rules. The general rules can be adequately adapted to address worthlessness issues without imposing a more sweeping regime. For example, stock loss can be suspended if that is the generally applicable approach to loss duplication (as opposed to our suggested alternatives), and subsequently eliminated or permitted as appropriate (e.g., permitted to the extent that duplication becomes impossible), or an election can be provided at the time of the stock loss to either permit the stock loss or eliminate it in favor of the inside loss surviving. In any event, we do not believe that new rules should apply to generate income or gain on subsidiary stock. The preamble explains that new rules were developed “rather than rely on existing rules, including the excess loss account recapture rules, to prevent the possible duplication of the unabsorbed losses.” It is unclear why this one source of loss is singled out, when the subsidiary might have other items (either offsetting income and gain, or additional

\footnote{125} We understand from informal discussions with government representatives that the preamble and the worthlessness rules were not intended to signal that the government has made a decision regarding the survival of consolidated tax attributes. Instead, the focus of the Proposed Regulations is on stock basis issues, and the significant issues presented by the survival of tax attributes warrant separate consideration. Nevertheless, the worthlessness rules represent an aggressive response to a limited problem and warrant reconsideration of the basic tax attribute rules.

\footnote{126} Once an inside loss is eliminated, it could not be used subsequently for any purpose, including subsequent applications of section 108(b). Any absorption of the inside loss results in a negative adjustment under Reg. §1.1502-32(b)(2)(i) that reduces the subsidiary’s stock basis by a comparable amount immediately before the stock loss.

\footnote{127} See Reg. §1.1502-32(b)(3)(iii). The different investment adjustment results reflect the different underlying principles. A negative investment adjustment was required for expiring losses to preserve the congressional decision regarding a loss carryover’s limited life. See T.D. 8560, 1994-2 C.B. 200. By contrast, eliminating the subsidiary’s loss under the worthlessness rules would be for the sole purpose of eliminating loss duplication.

\footnote{128} See, e.g., Reg. §1.1502-97. We note that, to the extent S’s losses or deductions are absorbed before the $0 limitation is imposed, the absorption results in a corresponding negative investment adjustment that should create an excess loss account in S’s stock that is taken into account in that same year. See, e.g., Reg. §1.1502-19(c)(1)(iii)(A). The government might consider whether additional rules are required to address the potential for curing a subsidiary’s worthlessness through asset contributions, to facilitate loss absorption before the beginning of the following year. Perhaps the inside loss should be eliminated regardless of whether the subsidiary dissolves.
deductions or losses) that can also impact stock basis. Until the need for the worthlessness rules is clarified, and the focus balanced to address the full range of issues, we believe that the problems introduced by the Proposed Regulations outweigh their benefits.

One possible government concern might relate to the fact that any surviving CNOL is not associated with a particular member if the subsidiary dissolves, and additional rules might be required for subsequently tracking the loss. But, as noted elsewhere in these Comments, this problem can be resolved more simply by clarifying that the inside loss does not survive.

As with the general approach of the Proposed Regulations, the worthlessness rules demonstrate a preference for requiring the group’s one deduction or loss to be from a subsidiary’s inside items rather than its outside stock loss. In the worthlessness context, the government might have believed that accelerating a basis reduction simply eliminates the subsidiary’s overlapping inside/outside amounts, so that only a permanent inside/outside difference remains for purposes of stock gain or loss. To some extent, this argument is reminiscent of the principles underlying Reg. §§1.1502-19(c)(1)(iii) and 1.1502-80(c), which defer certain stock recognition events due to their potential duplication of inside amounts. But the worthlessness rules extend much further, because they permanently eliminate a valuable tax attribute in the form of subsidiary stock basis, in circumstances where the subsidiary’s inside tax attributes are often eliminated or useless, and even potentially create phantom stock gain.

As noted elsewhere in these Comments, we do not believe the preference for the inside loss is compelled by loss duplication concerns, and might be more directly related to concerns with acceleration. Section 165(g)(3) reflects its own single entity treatment, and assuming that a subsidiary can qualify, Congress intended for ordinary stock loss to be available. This single

129 The government might reconsider the range of tax attributes that might be thought to survive S’s dissolution, such as loss that might be deferred through the successor rules under Reg. §1.267(f)-1(b). In addition, income, gain, deduction, and loss, can be deferred through the successor rules under Reg. §1.1502-13(j)(2).

130 For example, if the group consists of a life insurance company, a regulated utility, and a software company, with each subject to different tax and non-tax regimes despite joining in a single consolidated return, failure to associate a tax attribute or suspended stock loss with a particular member can significantly alter consolidated taxable income and tax liability. But even this possible government concern does not explain application of the worthlessness rules if S survives as a member following a worthlessness event under section 165(g) and Reg. §1.1502-80(c).

131 See CO-30-92, 1992-2 C.B. 627 (“If P is required to include the ELA in income before S recognizes any corresponding gain with respect to its assets and liabilities, S’s gain may be duplicated in the group’s computation of consolidated taxable income. For example, if S borrows and loses funds, which causes P to have an ELA in S’s stock, P’s inclusion of the ELA in income may duplicate the group’s later income associated with S’s discharge of the indebtedness. Once the ELA is included in income, §1.1502-20 prevents S’s subsequent discharge income from being offset by a loss on P’s disposition of S’s stock.”); (“The potential for P to recognize loss with respect to the worthlessness of S’s stock before any corresponding loss is recognized by S with respect to its assets and liabilities may result in the complete elimination of the loss at the corporate level. For example, if S’s stock becomes worthless, §1.1502-20(a) may disallow P’s deduction under section 165(g). Nevertheless, P’s basis in S’s stock is reduced to zero, and S’s later recognition of the corresponding loss with respect to its assets may result in P having an ELA in S’s stock. If S remains worthless, the ELA is immediately included in P’s income under §1.1502-19, and effectively eliminates S’s losses. Although §1.1502-20(g) may permit S’s losses to be reattributed to avoid the effect of §1.1502-20(a), the courts may prevent the reattribution to preserve S’s attributes for its creditors. See G, 2, above; see also section 382(g)(4)(D), under which S’s losses may be subjected to a zero section 382 limitation if S’s stock is treated as worthless.”).
entity treatment is as appropriate for consolidated return filers as for separate return filers, and is particularly appropriate in the context of worthlessness where the inside loss is subject to various limitations that generally render it useless.\textsuperscript{132}

If the government nevertheless determines that the worthlessness rules are necessary, we believe that they require substantial modification to ensure their operation does not distort consolidated taxable income or tax liability. Assuming that the worthlessness rules are intended to address only loss duplication, they operate based on a presumption that there is a duplication relationship between S’s stock loss and S’s contribution to the consolidated tax attributes. This will be incorrect in some cases, and therefore the required reduction should be subject to the general valuation, tracing, and recordkeeping exceptions that we have suggested for purposes of the loss suspension rule. For example, if S’s contribution to a CNOL can be traced to a minority shareholder’s contribution of a loss asset to S, none of its stock basis should be reduced even though subsequent absorption of the loss would have produced a negative adjustment under Reg. §1.1502-32 if S had remained in existence. If S’s stock basis is reduced despite the lack of any duplication potential, the reduction will have the effect of either inappropriately disallowing stock loss or recapturing absorption of S’s own tax attributes, and thereby eliminating the group’s only loss rather than preventing loss duplication.

Because the amount of basis reduction is not capped, it might not only eliminate duplicate stock basis but also produce an excess loss account. Creating an excess loss account will have the effect of recapturing S’s future losses and deductions, an approach that extends beyond mere prevention of loss duplication. To the extent the worthlessness rules reflect concerns with possible future absorption of deductions and losses, and the fact that this absorption would have resulted in an excess loss account had S remained in existence, we believe the concerns are unrelated to the purposes of the Proposed Regulations. We are particularly concerned that requiring immediate gain recognition due to perceived concerns about future loss absorption will be a source of distortion because future loss absorption is speculative. For example, S’s contribution to a CNOL might expire due to a $0 limitation under section 382(g)(4)(D), or the lack of future consolidated taxable income in subsequent periods. Even if the CNOL is absorbed, the group might have been able to avoid recapturing the excess loss account through generally available planning.

To the extent that a subsidiary’s tax attributes are not treated as surviving its dissolution (e.g., to the extent the government believes current law is unclear, perhaps a waiver can be offered as part of the worthlessness rules), the taxpayer should not be required to reduce stock basis because no duplication is possible.\textsuperscript{133} In addition, to the extent that subsidiary stock basis is reduced under

\textsuperscript{132} Moreover, if a dissolved subsidiary’s loss is to be preserved as a group loss, rules are required to establish its location for computational purposes. For example, what is the result if a subsidiary leaves the group and must be apportioned a share of the CNOL, another consolidated group acquires the group, or the group terminates because its common parent liquidates?

\textsuperscript{133} The worthlessness rules are unclear as to whether S’s outside stock basis must be reduced even if the potential duplicate inside loss does not survive the stock loss. The result might be clarified mechanically under the worthlessness rules by distinguishing between (i) the time as of which the reduction is required (i.e., immediately before the stock loss), and (ii) the time as of which the attribution of the CNOL is determined (i.e., immediately after the stock loss, under the same principles as if the stock loss resulted in S having a separate return year).
the worthlessness rules, the potential for loss duplication has been fully eliminated, and no further basis reduction should be required for any subsequent loss absorption (or expiration).\footnote{134} If further basis reductions were required, the worthlessness rules would have the effect of eliminating the group’s only loss, rather than preventing loss duplication.\footnote{135}

### 12. Anti-Avoidance Rules

The Proposed Regulations include anti-avoidance rules that are designed to prevent taxpayers from circumventing the purposes of the Proposed Regulations. We believe that the anti-avoidance rules do not serve their intended purpose because the Proposed Regulations do not consistently address many loss duplication transactions that are economically indistinguishable. Many distinctions are intentionally drawn by the Proposed Regulations between circumstances that seem to be economically identical (e.g., varying the treatment of a stuffed asset’s basis recovery depending on whether its value remains stable or fluctuates, allowing netting of built-in gain and loss in the measurement of loss duplication but eliminating loss based on gross items of deduction and loss, distinguishing duplication through nonmembers from duplication through a subsidiary that generates its own income to absorb its own deduction and losses, etc.). These distinctions create difficulty in determining whether the results of particular transactions should be considered inappropriate. Consequently, we have not identified consistently applied principles that would make the application of anti-avoidance rules predictable.

The starting point of our confusion is the fact that the rules are both over- and under-inclusive. For example, the anti-loss reimportation rules are over-inclusive in adopting adverse presumptions to deny deductions or losses, while requiring taxpayers to satisfy burdensome evidentiary requirements to avoid the resulting distortions of consolidated taxable income or tax liability. The rules apply to all duplicated loss stock dispositions in which a subsidiary leaves the group for the 10-year period following the disposition, and taxpayers must be prepared to establish economic and tax attribute relationships through valuation, tracing, and recordkeeping burdens that we believe are impractical. Certainly, the 5-year period of section 1504(a)(3) should represent the outer boundary of limitations imposed by the Proposed Regulations on planning that straddles between single and separate entity treatment.\footnote{136} While we recognize that

\footnote{134} This might already be clear under the anti-duplication rule in Reg. §1.1502-32(a)(2), but the Proposed Regulations clarify this relationship in other contexts, and inconsistency with respect to the worthlessness rules creates the potential for a negative inference. The need for coordination is readily apparent in circumstances where the subsidiary remains a member, but might also be useful in circumstances where it dissolves -- due to the potential existence of a successor.

\footnote{135} The relationship of the worthlessness rules to the general loss suspension rules is somewhat ambiguous. Loss suspension seems to apply if the subsidiary remains a member. But, if the subsidiary dissolves, it might have a successor because the preamble describes the dissolution as a liquidation, and a “liquidation” can create successor status. Neither the worthlessness rules nor the loss suspension rules refer to the relevance of successors, so the potential applicability for successor status appears irrelevant. We believe that there is no need for loss suspension in these circumstances because the basis reduction has eliminated the remaining potential for loss duplication. It appears that suspension is not intended, because the allowance of loss for worthlessness generally permits any previously suspended loss to be taken into account.

\footnote{136} The example in the Proposed Regulations illustrating these rules needs to be revised to reflect the fact that neither a former member, nor its successor, is permitted to rejoin the consolidated return for five years without waiver from the Service. For the applicable waiver procedures, see Rev. Proc. 2002-32, 2002-20 I.R.B. 959.
straddle relationships are problematical for the government, we believe they should be addressed with more targeted rules.

We anticipate that a group’s ability to absorb most reimported deduction and loss will be subject to the SRLY rules (or their surrogate under section 382, through the SRLY overlap rule). In general, a group’s ability to absorb SRLY items is analogous to the ability of a separate return subsidiary to absorb items under the Code—the subsidiary must generate its own income and gain (disregarding subgroup principles and the overlap rule), and therefore the relevance of consolidated return principles is diminished. In any event, the potential for abuse presented by these tax attributes does not warrant the imposition of such administratively burdensome requirements to overcome the adverse presumptions. For example, if a member happens to succeed to an NOL of a target corporation that, in turn, happens to have been a successor to a former member, will the NOL be nondeductible unless the group somehow establishes otherwise?\textsuperscript{137} Even if an NOL could be traced to a former member, if the successor happens to have incurred its own NOL in the same year (i.e., the successor’s current NOL represents a combination of NOLs attributable to the former member and the successor), what stacking rules will apply for purposes of any interim absorption?

To the extent the adverse presumptions cannot be overcome, the group cannot deduct the successor’s NOL, and the disallowed deduction will be treated as a noncapital, nondeductible expense that results in a negative adjustment under Reg. §1.1502-32. This treatment can have the effect of eliminating the group’s only loss rather than preventing duplication of loss. For example, if a group purchases a successor’s stock for $100, disallowance of the successor’s NOL and the resulting negative investment adjustment will reduce the $100 stock basis. But the NOL might not be reflected in the group’s $100 basis for the stock (i.e., the NOL is a built-in amount), and the group will therefore recognize artificial gain on the subsequent sale of the successor’s stock for $100. This artificial gain effectively recaptures the group’s one deduction for the earlier stock loss on the sale of the predecessor.\textsuperscript{138}

An example of under-inclusiveness is the application of the anti-loss reimportation rule only if a member recognizes loss on the disposition of subsidiary stock. Can a group avoid this rule by simply deconsolidating the subsidiary first, because the subsequent stock loss will be from stock of a nonmember, and later reimporting the subsidiary to claim its inside deduction or loss?\textsuperscript{139} Perhaps deconsolidating a subsidiary shifts the analysis sufficiently close to the case of a corporation that was never a member (particularly if the group recognizes the full extent of any

\textsuperscript{137} Literally, the adverse presumption applies to “any losses or deferred deductions of the subsidiary member (or any successor)” that are inherited from the target corporation. But, to the extent the group cannot establish that the target corporation’s NOL is unrelated to the former member, is the NOL presumed to be attributable to the former member and therefore subject to disallowance? Is the burden on the Service to initially establish that the target was a successor before the burden shifts to the taxpayer, or must a group always be prepared to establish the lineage of every NOL in order to avoid 100% disallowance? Or, is the burden on the Service to first establish that there is some relationship between the NOL and a former member, and then the burden shifts to the group to establish that the NOL’s origins are unrelated to built-in loss assets, losses, or deferred deductions of the former member?

\textsuperscript{138} Other scenarios are possible, depending on the extent to which the group’s basis in the stock reflects the NOL before it is treated as a noncapital, nondeductible expense.

\textsuperscript{139} A similar question arises as to whether deconsolidation can avoid the worthlessness rules.
gain or loss on the subsidiary’s shares), and the Proposed Regulations do not prevent the group from duplicating loss in the nonmember context. Yet, if the anti-loss reimportation rule is so easily circumvented, its only role will be as a trap for the unwary.

It is difficult to know where to draw the line among cases that the anti-avoidance rules fail to address, but theoretically present prospects for loss duplication. What if the group owns only 80% of S’s stock when S generates a loss that offsets P income (i.e., the remaining 20% held by a minority shareholder is not subject to investment adjustments), and P subsequently acquires the remaining 20% in a reorganization described in section 368(a)(1)(B). Does any loss subsequently recognized by P from the new 20% block inappropriately duplicate S’s loss, when this new source of basis represents a nonmember tax attribute that the Code permits to be duplicated? What if a former member simply carries losses back into the group under section 172, rather than reimporting the subsidiary? While this form of reimportation is subject to the SRLY rules under existing law, the reimportation rules clearly disregard the SRLY rules (as well as section 382, etc.).

What if the group recognizes loss from the sale of a subsidiary’s stock, but the subsidiary pro rates its items for the disposition year under Reg. §1.1502-76(b)(2)(ii), with the result that some of its post-sale items are allocated to the period of inclusion in the group’s return (i.e., is it enough that these items produce a negative investment adjustment, or does it depend on the extent to which the group disposed of the subsidiary’s stock)? What about the case of “viral basis shifting” illustrated elsewhere in these Comments?

We raise these questions not to encourage the promulgation of further mechanical anti-avoidance rules, but to illustrate the complexities created by the Proposed Regulations, as well as the potential for new loss duplication planning opportunities.

It is also unclear whether some of the under-inclusiveness of the anti-avoidance rules was actually intended. For example, it may be that the absence of an anti-stuffing rule comparable to the LDR rules is intentional, perhaps based on the premise that duplicating gain ameliorates the problems of duplicating loss. But P should not be permitted to contribute appreciated assets to S and avoid gain on those assets by selling high-basis S stock. Perhaps there is a presumption that the planning associated with gain stuffing is adequately addressed by the basis shifting rules, because built-in gain stuffing will tend to produce low-basis shares that will steal from high-basis shares under the basis shifting rules. But we anticipate that careful tax planners will frustrate any such presumptions. For example, the anti-avoidance rules restrict a group’s ability to stuff built-in loss assets through an intermediary nonmember (e.g., a partnership), and also restrict the ability to deconsolidate built-in gain shares, but a careful planner might weave between these

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140 Might the proper treatment depend on the nature of any tax sharing agreement with respect to the carryback?
141 For example, why do the basis shifting and worthlessness rules focus on gross items of deduction and loss, but the loss suspension rule effectively nets unrealized gain with unrealized loss? These types of disparities produce anomalies that are difficult to evaluate in an anti-avoidance context. For example, if stock loss is recognized first and suspended, the subsidiary’s subsequent gross items of deduction and loss are first applied to eliminate the suspended loss. Yet, a different stacking can be achieved by simply reversing the order, and recognizing the inside items before the stock loss. In this case, the inside items are allocated across all of the subsidiary’s shares under Reg. §1.1502-32 and a different amount of stock loss will survive. Does this imply that planning to optimize the results is inappropriate, and if so, which result is more appropriate?
142 See Reg. §§1.337(d)-2T(e) (2002); 1.1502-20(e).
two rules by stuffing built-in gain assets through the intermediary to manipulate a lower-tier member’s net amount of duplicated loss without creating low-basis shares within the group that steal basis under the basis shifting rules.

Are the limitations on stuffing built-in loss assets by use of a nonmember intermediary intended to be so narrowly focused that they do not address similar transactions that could not have been achieved directly within the group? For example, if the group transfers cash to a subsidiary through a nonmember intermediary, and the cash is invested in assets that decline in value, should the group be able to duplicate loss through its investment in the intermediary? How should the results compare to the economically identical transaction where the group has already stuffed the subsidiary, and then transfers the subsidiary’s stock to the intermediary nonmember? If it depends on whether the built-in loss exists at the time the intermediary first holds the subsidiary’s stock, does this represent the full extent of the government’s concerns with planning through nonmembers?

We are concerned that the distinctions drawn by the Proposed Regulations between economically similar cases will render the Proposed Regulations a complex trap for the unwary. The anti-avoidance rules will need to play a significant role for the government in preventing what it believes to be “intended planning.” But the government must advise taxpayers regarding the scope of “unintended planning.” For example, if taxpayers cannot divert built-in gain stock to a nonmember in order to avoid the effects of basis shifting, can taxpayers resort to section 355 split-off transactions, or section 305(a) distributions of rights to acquire stock, in order to achieve the equivalent diversion of basis or value?

Example 33. Intercompany splitoff. P, the common parent of a consolidated group, owns all of the stock of S1, an historic subsidiary. P contributes to S1 Asset A, with a $50 basis and $20 value, in exchange for a separate block of S1 preferred stock. P’s basis in the preferred stock is $50, and S1’s basis in Asset A is $50. S1 later sells Asset A to an unrelated party for $20, and recognizes a $30 loss that offsets P’s income on the group’s return. Under the investment adjustment rules, P’s basis in each share of S1 common stock is reduced by a pro rata share of the $30 loss, while the basis of the preferred stock is unchanged. Subsequently, S1 forms S2 with one of its active trades or businesses, and redeems all of its preferred stock held by P in exchange for the S2 stock. The formation and exchange transactions are an intercompany reorganization and splitoff transaction that is subject to sections 355 and 361. Consequently, no gain or loss is recognized by P, S1 or S2, and P’s basis in the S2 stock is $50. S1 later deconsolidates (e.g., by issuing additional shares to a nonmember), and P subsequently sells all of the S2 stock, recognizing another $30 loss. Although the loss suspension rules of the Proposed Regulations apply to S2 stock, as successor property to S1 stock, no loss duplication remains at the time of the stock sale and neither S1 nor S2 remains in the P group. The Proposed Regulations do not apply.

\[143\] Literally, this rule applies only if the built-in loss asset contributed to the intermediary nonmember is subsequently contributed back into the group. Is this rule intended to be inapplicable if, for example, the intermediary transfers exchanged basis property (under section 7701(a)(44)) into the group, rather than the original asset?
include a successor asset principle for purposes of the basis shifting rules, which would blend the basis of the S1 and S2 stock, and eliminate the disparity between the basis of their shares (i.e., prevent the P group from isolating high and low basis in what had originally been shares of S1 stock).

Other problems we have identified include whether taxpayers can exploit the effects of basis shifting by deconsolidating virtually all of a subsidiary’s shares in order to concentrate the shifted basis in only a few shares retained by the group, and whether taxpayers can manipulate the basis recovery rules by combining gain and loss assets in order to avoid prohibited forms of basis recovery.

We do not believe our questions can be addressed by further mechanical anti-avoidance rules, because it is impossible to identify all of the variations that exist now, or might subsequently arise through continued evolution of the Code and regulations. But we are concerned that adopting vague anti-avoidance rules to backstop complex mechanical rules that for reasons of administrability, intentionally distinguish between economically equivalent circumstances will introduce entirely new administrability problems. Combined with the already complex mechanical rules, the ability of even experts in the area to reach the intended results will be sorely tested, even for commonplace transactions.

V. Technical Issues

In addition to the policy issues discussed elsewhere in these Comments, we have identified technical problems that we believe either prevent or distract the reader from understanding the intended concepts. We have separated this technical discussion from our policy discussion, because we believe that these observations are noncontroversial, though they may be difficult to resolve. As an overview, we suggest that in revising the Proposed Regulations, the government focus on improving reader comprehension by setting out the general principles and presumptions on which the mechanical rules are based, rather than simply providing a series of mechanical rules.

1. “Deconsolidation” of a Share

The Proposed Regulations define the concept of deconsolidation as “any event that causes a share of stock of a subsidiary member that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.” 144 Many of the rules in the Proposed Regulations apply based on the deconsolidation of a share. Some of the rules, 145 and many of the examples, 146 envision that the nonrecognition transfer of a loss share (e.g., the transfer of a share to a partnership under section 721) constitutes the deconsolidation of only the transferred share even if the transfer happens to have the effect of deconsolidating the subsidiary. But the deconsolidation of a subsidiary has the actual effect of deconsolidating

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144 Prop. Reg. §1.1502-35(d)(2). The definition appears to be based on Reg. §1.1502-20(b)(2).
146 See, e.g., Prop. Reg. §1.1502-35(e), Ex. 2 & Ex. 3; Prop. Reg. §1.1502-35(g)(4), Ex. 1.
every share of the subsidiary (unless at least 80% of the subsidiary’s shares are transferred to another corporation with which the subsidiary subsequently joins in filing a consolidated return). We believe that the scope of the definition is intended and proper, and that the problem is in the definition’s application.\(^\text{147}\) Accordingly, the Proposed Regulations should be revised to reflect the definition of deconsolidation.\(^\text{148}\)

2. **Share-by-Share Approach**

If a subsidiary deconsolidates, the amount of basis to be shifted is the “amount by which the basis of the disposed of or deconsolidated stock exceeds the value of such stock.”\(^\text{149}\) Informal conversations with government representatives have indicated that basis shifting is to apply on a share-by-share basis, without netting between gain and loss shares.\(^\text{150}\) To clarify the intended scope of the rules, we believe that references in the Proposed Regulations to “stock” should be replaced by “share” where appropriate, to convey that there is no netting between gain shares and loss shares.\(^\text{151}\)

3. **Shifting Basis Solely to Shares Held by Members**

If basis is to shift in the context of a subsidiary’s deconsolidation, the Proposed Regulations limit the shift to “preferred shares of stock of the subsidiary member that are held by members of the group immediately after the disposition or deconsolidation” and to “common shares of subsidiary member stock held by members of the group immediately after the disposition or deconsolidation.”\(^\text{152}\) Basis should never disappear, and the Proposed Regulations should address the possibility that no shares of the subsidiary’s stock continue to be held directly by members (e.g., 100% of a subsidiary’s stock is contributed to a partnership controlled by the group), or the only retained shares are preferred shares with basis already equal to fair market value.\(^\text{153}\)

\(^{147}\) If the definition is changed, we are concerned that the basis shifting rules of the Proposed Regulations will apply to lower-tier subsidiaries whenever another consolidated group acquires an entire chain of subsidiaries (or an entire group). As currently defined, there is no deconsolidation, because each lower-tier subsidiary continues to join in filing a consolidated return with its shareholder (assuming no problems under section 1504(a)(3), etc.).

\(^{148}\) Revisions might be difficult for Prop. Reg. §1.1502-35(b)(3), which determines the amount of a share’s basis shifting by reference to items of deduction and loss reflected in “other” shares. Proper application of the deconsolidation definition results in every share being an “other” share with respect to every other share.

\(^{149}\) See Prop. Reg. §1.1502-35(b)(3).

\(^{150}\) If basis shifting nets gain and loss shares, several questions would seem to arise. For example, is the aggregation limited to shares involved in a single transaction, and if so, why impose such a limitation? Given that deconsolidating a subsidiary has the effect of deconsolidating every share, does Prop. Reg. §1.1502-35(b)(3) apply only with respect to the aggregate net amount of loss in subsidiary stock in every case? While Reg. §§1.337(d)-2T(a)(3) and 1.1502-20(a)(3) permit netting, this might be a response to unrelated concepts (e.g., limiting the potential for stock loss disallowance exceeding the requirements to enforce repeal of the General Utilities doctrine).

\(^{151}\) It might also be useful to clarify that any debt associated with shares is not taken into account (i.e., the rules focus on gross, rather than net, stock basis).


\(^{153}\) This problem is separate from the issue discussed elsewhere in these Comments regarding a group’s potential manipulation by retaining only a small number of shares in order to concentrate basis shifting into those few shares.
4. Dispositions by the Group

An exception to certain rules in the Proposed Regulations applies if “the group disposes of its” entire or remaining equity interest in a subsidiary.\(^{154}\) Other rules in the Proposed Regulations apply if a member makes the disposition.\(^ {155}\) Because we believe the concept of the group engaging in transactions with respect to particular member’s stock raises issues, we believe that these references should be replaced by references to a member engaging in the relevant transaction.

5. “Subsidiary Member,” “Member of the Group,” and “Member of the Consolidated Group”

The Proposed Regulations make numerous references to a “subsidiary member,” a “member of the group,” a “member of the consolidated group,” etc. The consolidated return regulations provide basic definitions, including “subsidiary” and “member,” and these definitions apply throughout the consolidated return regulations unless otherwise provided.\(^ {156}\) We believe that the reference in the Proposed Regulations can be simplified by conforming to the general definitions used throughout the consolidated return regulations (e.g., references to a “subsidiary member” would simply be to a “subsidiary”).\(^ {157}\)

6. Items “Reflected” in Duplicated Loss

The Proposed Regulations adopt tracing, valuation, and recordkeeping principles, by which adverse presumptions can be overcome to the extent the taxpayer establishes that a subsidiary’s items of deduction and loss are not “reflected” in a computation of the subsidiary’s duplicated stock loss.\(^ {158}\) The formula for computing the amount of duplicated stock loss in the Proposed Regulations does not take into account any particular source of deduction or loss. Instead, the formula compares (i) aggregate asset basis and equivalents, to (ii) aggregate stock value and debt.\(^ {159}\) Based on this formula, we believe that the concept of “reflected” might be interpreted as automatically treating the basis of an asset (or equivalent item of the subsidiary) held at the time of the duplication measurement as reflected, without regard to the relationship between the

\(^{154}\) See, e.g., Prop. Reg. §1.1502-35(b)(4), (b)(5)(iii), and (e), Ex. 8(ii).

\(^{155}\) See, e.g., Prop. Reg. §1.1502-35(b)(1), (b)(5)(i), (f).

\(^{156}\) See Reg. §1.1502-1(b) and (c). This principle has generally been followed, except in the earliest regulations, with minor deviations based on readability.

\(^{157}\) The Proposed Regulations also refer to “upper-tier,” “lower-tier,” and “higher-tier” (although these terms, when referring to a member, are not used in conjunction with “of the group”). We believe that these reference might be the source of more confusion than clarification. For example, if P owns all the stock of S, and S happens to own a few shares of P stock, is S an upper-tier member, a lower-tier member, or both depending on the P shares in question? Rather than using these terms, the Proposed Regulations might simply refer to P and S (much like Reg. §1.1502-32), or simply refer to “members” or “stock” with the relationship made clear from the context. In general, a rule that applies to S’s shareholder should apply without regard to the shareholder’s location in the group.

\(^{158}\) See, e.g., Prop. Reg. §1.1502-35(b)(3) and (c)(4).

\(^{159}\) See Prop. Reg. §1.1502-35(d)(4). Basis equivalents include loss carryovers and deferred amounts. The aggregate stock value and debt is a surrogate for the gross value of the subsidiary’s assets, and represents an approach similar to section 338. Cf. Reg. §1.338-4 (aggregate deemed sale price).
asset’s value and its basis. In essence, the reflected concept only takes into account basis tracing. But we understand from informal conversations with government representatives that the intended concept is much more involved. Taxpayers should consider the relationship of an asset’s value to its basis, the occurrence of any intervening value fluctuations between relevant measurement dates, and the relationship of any loss in the asset (i.e., its basis in excess of value) to the source of the stock loss (i.e., economically relating the stock’s loss to the asset’s loss).

We believe that the articulation of “reflected” in the Proposed Regulations should be amended to convey the more involved scope of the process, including amending the description of “reflected” and its implementation in the examples. For example, the Proposed Regulations currently imply that a group will not be able to disprove the relationship between a built-in loss asset’s depreciation deduction and the subsidiary’s stock loss.\textsuperscript{160} But any conclusion regarding the relevant relationships should first require examination of the asset’s basis and value at all relevant times (i.e., the time of the stock loss, the time of the particular year’s depreciation deduction, and the possibility of value fluctuations at any intervening moment), how the particular year’s depreciation deduction relates to recovery of the asset’s value in that year, and the relationship between the asset’s loss and the stock’s loss.\textsuperscript{161}

We are concerned that the difficulties previously encountered in providing guidance on these types of issues in the context of sections 382 and 384 must be resolved in the effort to provide critical guidance with respect to the Proposed Regulations.\textsuperscript{162} We believe that the government hoped to avoid many of these issues in Reg. §1.337(d)-2T(c) (2002), by limiting the relevant burdens to the “recognition of built-in gain on the disposition of an asset (including stock and securities).” But even this limited scope did not avoid many significant complexities, and by contrast, the Proposed Regulations take into account every gross item of deduction or loss.\textsuperscript{163} We do not believe that the government can avoid these issues in the context of imposing rebuttable presumptions that have the potential to distort consolidated taxable income or tax liability, unless adequate guidance is provided regarding the ability to rebut the presumptions.

In addition to the foregoing, all of the examples in the Proposed Regulations rely on stuffing transactions to illustrate prohibited loss duplication. We understand that loss duplication can arise in other contexts, and the examples should be expanded to illustrate other contexts in which problematic loss duplication can arise.\textsuperscript{164} Thus, if a subsidiary is formed with a cash contribution in exchange for common stock (or 100% of a subsidiary’s stock is purchased in conjunction with an election under section 338(h)(10)), to what extent can problematic loss duplication relationships arise? On the other hand, can loss duplication exist but be merely

\textsuperscript{160} See, e.g., Prop. Reg. §1.1502-35(e), Ex. 2.
\textsuperscript{161} We have observed elsewhere in these Comments that we have no idea how the relevant tracing, valuation, and recordkeeping can be achieved in actual practice, and we are focusing here solely on the articulation and illustration of the intended concepts.
\textsuperscript{162} See, e.g., Office of Tax Policy and Internal Revenue Service 2001 Priority Guidance Plan (April 26, 2001), \textit{reprinted in} 2001 TNT 84-36 (LEXIS, Fedtax Library, TNT File) (one project, which did not reappear in the following year’s business plan, was entitled “[g]uidance regarding built-in items under section 382”).
\textsuperscript{163} Further detail will be provided in upcoming comments on Reg. §1.337(d)-2T, by individual members of the Affiliated & Related Corporations Committee and the Corporate Tax Committee.
\textsuperscript{164} The ambiguities requiring guidance are described throughout these Comments.
coincidental, and therefore not problematic? For example, if a subsidiary’s assets already reflect a built-in loss at the time the subsidiary issues preferred stock for cash, and the preferred stock happens to subsequently decline in value due to circumstances unrelated to the built-in asset loss (e.g., the preferred stock bears a fixed rate of return, and prevailing market interest rates increase), any “apparent” loss duplication should be considered merely coincidental, and tracing can establish that subsequent recognition of the built-in asset loss is unrelated to the preferred stock loss.

7. Conflict Between Deference Rules

Perhaps out of concern for its novel mechanics, the Proposed Regulations provide that stock loss is not suspended to the extent that it is subject to redetermination, deferral, or disallowance under other applicable provisions of the Code or regulations. This same type of deference to other rules is found in LDR. Mutual deference between two provisions creates a conflict, with each rule attempting to clear the way for the other rule. This (and any equivalent) conflict should be evaluated, and the interactions clarified.

8. Excess Loss Accounts

Basis shifting under the Proposed Regulations is such a novel mechanism that some of its basic elements should be illustrated to confirm its fundamental operation. An example should address the treatment of excess loss accounts. For example, in the case of basis shifting with respect to a subsidiary that remains a member, an example could illustrate that an excess loss account in some shares is netted with positive basis in other shares, and only the net amount is shifted among shares.

9. Value Indicators

The Proposed Regulations provide irrebuttable presumptions regarding the value of subsidiary stock in specified circumstances. We understand that these rules are intended to apply when

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165 See Prop. Reg. §1.1502-35(c)(7).
166 See Reg. §1.1502-20(a)(3). See also Reg. §1.337(d)-2T(a)(3) (same).
167 A similar, but perhaps less significant conflict might arise under the ordering rules of the Proposed Regulations for stock basis determinations. See Prop. Reg. §1.1502-35(b)(7). All investment adjustments under Reg. §1.1502-32 are made before basis shifting under Prop. Reg. §1.1502-35(b). Yet, lower-tier basis shifting can have investment adjustment consequences, which must then be taken into account in applying basis shifting at higher tiers. A lower-tier basis shift creates more basis at a higher-tier, and Reg. §1.1502-32(c)(4) would allocate the additional higher-tier basis to preferred stock, but Prop. Reg. §1.1502-35(b) would allocate the additional basis to common stock (based on the value of the preferred stock at that time). Which controls?
168 We have observed elsewhere in these Comments that numerous tax attributes might be associated with basis and need to be addressed, but we are focusing here solely on the basic operation of basis shifting.
169 But see Prop. Reg. §1.1502-35(e), Ex. 3 (illustrating some excess loss account principles for purposes of Prop. Reg. §1.1502-35(b)(3), but not more generally, such as for purposes of Prop. Reg. §1.1502-35(b)(2)). But see FSA 200128014 (July 13, 2001) (potential assertion of Reg. §1.1502-19(e) anti-avoidance principles if an excess loss account eliminated through a section 332 liquidation); Rev. Rul. 85-164, 1985-2 C.B. 117 (potential for a single share of stock to have a split basis).
a share is deconsolidated in a nonrecognition transaction, or its basis is subject to shifting, and its value must be determined in the absence of any actual transaction. If there had been a qualifying purchase of the subsidiary’s stock, this transaction establishes the value for purposes of the Proposed Regulations. But the Proposed Regulations do not identify the timing of when the qualifying purchase must occur relative to when the value is being used for purposes of the Proposed Regulations. Presumably, the qualifying purchase should be a surrogate for value only if it is somewhat contemporaneous with the valuation (e.g., within 12 months of the valuation), and this relationship should be clarified.

The Proposed Regulations define a qualified purchase as involving an unrelated transferor and “the transferee’s basis in the stock is determined wholly by reference to the consideration paid for such stock” While this might have been an attempt to define cost basis under section 1012, it also appears to include exchanged basis property under section 7701(a)(44), such as stock acquired in a section 351 transaction with the resulting basis under section 358 determined by reference to the historic basis of the property transferred rather than its value. The intent of this rule should be clarified.

10. “Attributable” or “Allocable” Items

The Proposed Regulations require a lower-tier subsidiary’s items of deduction and loss to be attributed to stock of higher-tier members. Moreover, a subsidiary’s inside loss is to be applied only once to suspend stock loss. No guidance is provided regarding how an amount is to be attributed or allocated, and guidance should be provided regarding the relevant principles.

11. Timing of Relevant Relationships

The Proposed Regulations refer to a subsidiary or member, or the stock of a subsidiary. Sometimes there is an express statement that the relevant status or relationship is determined “before” or “after” a specified event. Other times, there is no indication regarding the relevant timing. The Proposed Regulations should be examined to ensure that the relevant timing of specified status or relationship is clear in all circumstances. This is particularly important because the Proposed Regulations can make significant distinctions between transactions involving stock of a subsidiary, and those involving stock of a former subsidiary.

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171 Cf. section 382(h)(8); Reg. §§1.108-2(f) and 1.1502-32(b)(4)(ii).
172 See, e.g., Prop. Reg. §1.1502-35(c)(2), (c)(4), and (g)(3)(ii)(A).
174 See, e.g., Prop. Reg. §1.1502-35(c)(4), (f), and (g)(3).
175 See, e.g., Prop. Reg. §1.1502-35(b)(1), (c)(1), (c)(2), (c)(5), and (c)(6).
12. Successors

The Proposed Regulations refer to circumstances in which successor property, a successor to a subsidiary, or a successor to a group, is relevant. Other times, there is no indication regarding the relevance of a successor. The Proposed Regulations should be examined to ensure that the relevant successor principles are clear in all circumstances. It might also be possible for a subsidiary to have more than one successor (e.g., a section 332 liquidation of a subsidiary with more than one shareholder in the group), and potential conflicts of this nature should be addressed.

13. Loss Reimportation

The anti-avoidance rules include elaborate provisions designed to prevent an NOL (or its equivalent) from being reimported into the group and achieving duplication despite an interim period of separate return years. The elaborate and repetitive descriptions of the various forms of prohibited reimportation are designed to identify the original subsidiary’s built-in loss asset or NOL and their equivalents (whether a successor asset, recognized built-in loss, or otherwise). The essential concepts are very simple, and we believe that the articulation should be revised to reflect principles, illustrated by examples to improve the readability.

14. Typographical Errors

-35(b)(1): “basis that exceeds it value” should be “basis that exceeds its value”
-35(e), Ex. 1(ii): “preferred stock of S” should be “preferred stock of S3”
-35(e), Ex. 3(i): “the sale of Asset C” should be “the sale of Asset A”
-35(e), Ex. 5(ii): “the sale Asset A” should be “the sale of Asset A”
-35(e), Ex. 7(ii): “Year 5 on which S” should be “Year 5 on which S2”
-35(e), Ex. 7 (ii): “from $80 to $56. S1 recognizes $0 gain/loss” should be “from $104 to $80. S1 recognizes a $24 loss”
-35(e), Ex. 8(ii): “S1 recognizes a loss of $6” should be “P recognizes a loss of $6”

VI. Alternatives

177 For a successor asset, see, e.g., Prop. Reg. §1.1502-35(c)(6). It appears that successor asset principles should also be included in Prop. Reg. §1.1502-35(g)(2). For a successor subsidiary, see, e.g., Prop. Reg. §1.1502-35(c)(4), (d)(5), and (g)(3)(i)(C). For a successor group, see, e.g., Prop. Reg. §1.1502-35(c)(5) and (d)(6).
179 See Prop. Reg. §1.1502-35(g)(3).
We believe it is extraordinarily difficult to address loss duplication in all of its forms in a balanced manner. Rather than attempting to identify the many amendments required to eliminate distortions under the Proposed Regulations, and recognizing that the Proposed Regulations arose from a particular stuffing strategy that isolates high basis in particular shares of subsidiary stock, we believe that the Proposed Regulations would adequately address the recent concerns, without creating undue distortions or administrative burdens, by limiting the necessarily complex new anti-duplication rules to circumstances involving stuffing transactions. The consolidated return regulations have historically blended single and separate entity treatment, and tolerated some amount of ordinary course duplication of both gain and loss. We do not believe that ordinary course forms of duplication warrant the complexity necessary to eliminate it, or that efforts to eliminate it should focus exclusively on the duplication of loss.180

Anti-stuffing approach. We recognize that targeting rules at problematic stuffing transactions will necessitate defining these transactions. The Proposed Regulations identify the most basic case, in which the taxpayer transfers built-in loss assets to a subsidiary for an isolated, high-basis block of new subsidiary shares. But taxpayers can achieve equivalent results through indirect means. For example, if a subsidiary already exists with a loss reflected in both its assets and its stock, the taxpayer might transfer built-in gain property to the subsidiary for an isolated, low-basis block of new subsidiary shares. In either case, the group could then attempt to sell only the high-basis shares without deconsolidating the subsidiary. Similar results could also be achieved through reorganization transactions, such as combining a subsidiary having high-basis shares with a subsidiary having low-basis shares. Accordingly, the definition of problematic stuffing should focus on the end result through in-kind transfers, rather than the means by which it is achieved.

The design of a stuffing approach must also take into account the likelihood of disputes regarding the value of property at the time of a stuffing transaction. Although the value of a subsidiary’s stock might be clear at the time of a later stock sale (assuming an arm’s length transaction), there is unlikely to be objective evidence of the asset values at the time of an earlier stuffing transaction. To minimize disputes, stuffing transactions should not be defined as limited to circumstances where basis exceeds value at the time of the transaction. Instead, stuffing should reach all transactions in which subsidiary stock is issued for in-kind consideration, whether the taxpayer believes that built-in gain or loss property is involved. This has the unavoidable consequence of encompassing both tax planning and ordinary course transactions (e.g., the incorporation of an entire operating division, composed of both gross built-in gain and loss assets), but the applicability of the rules can be kept manageable by requiring the stuffing transaction to occur within a specified period (e.g., two years, by analogy to Reg. §1.1502-20(e)(2)) of the later stock sale.181

180 Because addressing the potential for gain duplication raises very significant policy and technical issues beyond those raised by the Proposed Regulations, and the issues presented by the Proposed Regulations are already so complicated, we do not address gain duplication issues in these Comments.

181 Because preferred stock described in section 1504(a)(4) (“vanilla preferred”) can be used to enhance the amount of subsidiary stock that can be sold without causing the subsidiary’s deconsolidation, the government might consider whether special rules are warranted for the issuance of this stock in exchange for depreciated property. If eligibility to be treated as vanilla preferred were narrowed, it would affect the application of many Code provisions unrelated to stuffing concerns, and therefore should be pursued through legislation. See, e.g., Sections 332(b)(1), 338(d)(3), 382(k)(6), and 1503(f). While the government might also consider extending section 351(g) treatment to all forms
**SRLY limitation on losses of a stuffed subsidiary.** Once the scope of stuffing transactions has been identified (i.e., a requisite in-kind asset transfer within a requisite period before a stock sale), we recommend that loss duplication in these cases be addressed through variations on existing mechanisms that reflect our views regarding the limited scope of Ilfeld, and the potential for loss acceleration being an unrelated issue. This approach avoids novel mechanics that are likely to generate unintended consequences. For example, in cases where outside stock loss has been recognized within two years of a stuffing transaction, it precedes the corresponding inside asset loss, and there is any amount of loss duplication, the stock loss can be allowed but the subsidiary’s inside items would thereafter be subjected to the SRLY rules. The SRLY limitation would apply without regard to the “overlap rule” in the event there happens to be a recently imposed section 382(a) limitation.\(^{182}\) Because allowing any amount of stock loss essentially treats the subsidiary as a separate return investment, the SRLY limitation could be imposed on all of the subsidiary’s items, as if the subsidiary joined the group immediately before the stock loss.\(^{183}\)

This approach promotes simplification by avoiding tracing between stock and assets, although it does not prevent separate return types of loss duplication (e.g., where the subsidiary generates adequate income to absorb its own loss through either historic or stuffed assets). If the government believes that preserving separate return loss duplication preserves too much tax planning, consideration could be given to adopting anti-stuffing rules. For example, if built-in gain is stuffed into a subsidiary within two years of its gain recognition by the subsidiary, the gain might be disregarded in computing the amount of the SRLY limitation.\(^{184}\)

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\(^{182}\) See, e.g., Reg. §1.1502-21(g). Consideration should also be given to the appropriateness of SRLY subgrouping. The government might conclude that subgrouping reflects single entity concerns that are inconsistent with the separate entity treatment that the loss duplication rules seek to achieve. Alternatively, a subgroup could be permitted, but limited in a manner analogous to Reg. §1.1502-91(d), which requires the subgroup members to bear a section 1504(a)(1) relationship to each other.

\(^{183}\) On the other hand, it might be appropriate to restrict the subsidiary’s items only to the extent of the loss duplication, in which case the SRLY limitation would be imposed on only the portion of the subsidiary’s items relating to the stock loss. Because we do not encourage rules that require particular sources of subsidiary built-in loss to be traced to particular sources of outside loss, any narrowly applied SRLY approach should rely on irrebuttable presumptions. For example, 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.

\(^{184}\) If the SRLY limitation applied without regard to the extent of the loss duplication, there might not be a need for anti-stuffing rules to limit the ability of taxpayers to use built-in gain to minimize the amount of loss duplication. The Proposed Regulations also permit taxpayers to minimize loss duplication through this type of planning, although in the context of broad basis redetermination rules. But, if the government is worried about taxpayers generating any amount of loss duplication, the anti-stuffing rules could require taxpayers to separate the stuffed assets from other assets for purposes of computing whether there is loss duplication at least in part. On the other
Use of section 704(c) principles. In cases where inside loss precedes outside loss, and is within two years of a stuffing transaction, section 704(c) principles can be applied to allocation of the resulting negative investment adjustments in order to prevent the isolation of outside basis in particular shares of subsidiary stock. As noted above, if the related shares were previously sold, the subsidiary’s inside loss would be subject to a SRLY limitation, and therefore could only be absorbed to the extent of the subsidiary’s own income and gain items, which ensures that the loss would not produce a net negative investment adjustment. While this approach requires tracing, applying tracing solely in the context of contemporaneous stuffing transactions might make the burdens manageable. Application of section 704(c) principles could generally be accomplished by clarifying the scope of the existing anti-avoidance rule in Reg. §1.1502-32(e)(2), 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.

Worthless subsidiaries. As previously discussed, the government’s concerns regarding duplication with respect to worthless subsidiaries can be resolved by clarifying the rules applicable to a subsidiary’s inside loss. When a worthless subsidiary is dissolved, or its stock is treated as worthless, the resulting stock loss could be allowed to the extent allowable under current law, but the duplicate inside loss would be explicitly eliminated. This can be achieved by amending (i) the consolidated return loss carryover rules to eliminate duplicate inside loss following a subsidiary’s dissolution (after absorption in the current consolidated return year, and hand, the goal of preserving an appropriate separate entity balance might favor limiting anti-stuffing rules to transactions facilitated by the consolidated return rules. 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)).

185 The section 704(c) principles would apply to all stuffed assets, regardless of whether they represent built-in gain or loss. While “reverse” section 704(c) principles could also be applied (e.g., for cash contributions to a subsidiary already possessing built-in gain or loss assets), this would enhance the complexity of the regime because our experience indicates that cash contributions to subsidiaries are much more common than in-kind contributions. To minimize the complexity, the government might conclude that SRLY principles and general anti-avoidance rules are an adequate response to these fact patterns. Applying the “traditional method” of section 704(c) principles, if stuffed built-in loss assets appreciated after the stuffing transaction, and therefore generated either less loss or even a gain, the special allocations would be limited to the actual amount recognized. Alternatively, “curative allocations” or “remedial allocations” could be adopted in an effort to achieve greater precision. To address cases where built-in gain is stuffed into a built-in loss subsidiary, the section 704(c) principles would have to apply to all of the subsidiary’s items during the requisite period, and not just the stuffed assets. If more than one method were available, the government would have to indicate how taxpayers should identify their applicable approach.

186 While stuffing can be achieved with common stock as well as preferred stock, we anticipate that tax planning is most likely to involve preferred stock. This is because some forms of preferred stock are disregarded under section 1504(a)(4) for purposes of maintaining affiliation, and vanilla preferred represents a financial instrument that is insulated in many respects from the issuer’s economic performance. Administrability concerns with tracing might compel limiting the application of section 704(c) principles to stuffing transactions that involve preferred stock. Note that, where multiple classes of common stock are used, Reg. §1.1502-32(c)(2)(ii) requires investment adjustments to take into account “the terms of each class and all other circumstances relating to the overall economic arrangement.” This would be amended to also consider the relevant inside/outside basis relationships among the different classes.

187 In any event, the government should resolve the uncertainty created by preamble discussion indicating that a subsidiary’s contribution to consolidated tax attributes may remain with the group.
after carryback to prior years),\textsuperscript{188} (ii) the investment adjustment rules to confirm that this elimination does not cause a negative investment adjustment like that required for expiring loss, and (iii) the consolidated section 382 regulations to provide that, if stock is treated as worthless, but the subsidiary remains in existence as a member, the inside loss becomes subject to limitation under section 382(g)(4)(D).\textsuperscript{189} Alternatively, the general loss duplication rules might apply to the stock loss and subsequently eliminate or allow it as appropriate (e.g., allow it to the extent that duplication becomes impossible). The government might also consider providing an election at the time of the stock loss to either permit the stock loss or eliminate it in favor of the inside loss surviving.

Anti-avoidance generally. In addition to specific, bright-line anti-stuffing rules, the government might add examples to the existing anti-avoidance rules of the consolidated return regulations to clarify their continuing role. For example, if a duplication strategy begins with an intercompany stuffing transaction, the direct and indirect items from the transaction are to be taken into account to clearly reflect the taxable income (and tax liability) of the group as a whole. Moreover, Reg. §1.1502-13(h) requires adjustments to the generally applicable rules if a transaction is engaged in or structured to avoid these purposes. An example could be added to the regulations to address the intended results of the intercompany stuffing transaction if it falls outside any bright-line stuffing period.\textsuperscript{190}

\textsuperscript{188} The regulations can confirm that any loss absorption results in a negative adjustment under Reg. §1.1502-32(b)(2)(i) as of immediately before the stock loss, and that any remaining loss that is eliminated is unavailable for any purpose (e.g., subsequent applications of section 108(b)).

\textsuperscript{189} The government might consider whether additional rules are required to address the potential for curing a subsidiary’s worthlessness through asset contributions, to facilitate loss absorption before the beginning of the following year. Perhaps the inside loss should be eliminated regardless of whether the subsidiary dissolves.

\textsuperscript{190} Compare Reg. §1.1502-20(e)(1) (generic anti-avoidance rule) with Reg. §1.1502-20(e)(2) (specific anti-stuffing rule).