Comments on § 1.337(d)-2T and § 1.1502-20T

The following comments (the "Comments") constitute 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 Committee on Affiliated and Related Corporations and the Committee on Corporate Tax of the Section of Taxation. The principal author of these comments is Don Leatherman. Substantial contributions were made by John Broadbent, Jasper Cummings, Andrew Dubroff, Victor Penico, Mark Silverman, Gordon Warnke, and Thomas Wessel. These Comments were reviewed by Terrill Hyde of the Section's Committee on Government Submissions and by Joseph M. Pari, Council Director for the Committees on Affiliated and Related Corporations and the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing the Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or 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.

Contact Persons:

Don Leatherman
(865) 974-6838
leather@libra.law.utk.edu

Gordon Warnke
(212) 259-6070
gwarnke@dbllp.com

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The Comments respond to the request for comments regarding temporary regulations published in the Federal Register on March 12, 2002 (the "new LDR" rule) that retroactively modify and prospectively replace the loss disallowance rule of § 1.1502-20 (the "old LDR" rule).¹ The new LDR rule responds to Rite Aid Corp. v. United States,² in which the Federal


² Unless otherwise noted, "section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "Code"), or applicable Treasury regulations. Further, these Comments
Circuit concluded that at least part of the old LDR rule was an improper exercise of regulatory authority. We commend Treasury for its prompt response.

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I. Executive summary

These Comments first briefly review the history of the old LDR rule. They then analyze the new LDR rule, pointing out some modest technical flaws, suggesting possible modifications and clarifications of the rule, and discussing concerns with the approach of the new LDR rule and possible alternative approaches.

generally uses the word "Treasury" to refer to the personnel in the Department of Treasury, including the Internal Revenue Service (the "Service"), who work on Treasury regulations.

2 255 F.3d 1357 (Fed. Cir. 2001).
A. Prospective guidance

The new LDR rule prospectively changes how groups determine disallowed loss on subsidiary stock. Under new § 1.337(d)-2T, a consolidated group's loss on subsidiary stock generally is disallowed, but the loss disallowance is limited to the extent the group establishes that its loss is not attributable to recognized built-in gain.

Thus, § 1.337(d)-2T requires tracing -- a group must value all subsidiary assets when the subsidiary joins the group and then must determine to what extent, if any, the subsidiary has recognized any pre-acquisition built-in gain on those assets when the group disposes of or deconsolidates the subsidiary stock. Most members of the group preparing the Comments (the "Comment Group") believe that the tracing regime imposed by § 1.337(d)-2T is unadministrable, both because it requires burdensome valuations and tracing to determine the extent to which built-in gain has been recognized. If Treasury retains the tracing regime, it should issue substantial, additional guidance to explain how groups should compute built-in gain and determine the extent to which it has been recognized.

Further, § 1.337(d)-2T is substantially underinclusive because it fails to account for built-in income, which often is how unrecognized built-in gain is taken into account. By neglecting built-in income, § 1.337(d)-2T also may promote economic inefficiency and tax-motivated transactions.

Finally, it is unclear why § 1.337(d)-2T has a netting rule. The netting rule permits a group to take an otherwise disallowed loss on subsidiary stock into account to the extent that, as a consequence of the same plan or arrangement, the group recognizes gain on subsidiary stock with the same material terms as the loss stock. Although the old LDR rule included a netting rule, the netting rule is harder to justify under a tracing regime, where its chief impact might be to eliminate tax on built-in gain.

While we recommend that Treasury not adopt a "pure" tracing regime like § 1.337(d)-2T, we note several alternatives. Some members of the Comment Group support a "modified" tracing regime, which would require tracing but allow a group to opt out of tracing under certain conditions. Those members believe that consolidated groups will accept this regime, because it would not automatically deny a group its economic loss. They find the tracing requirement of the modified regime to be administratively palatable, because they believe few groups will attempt to trace. Most members of the Comment Group do not support the modified regime, however, because they believe a significant number of groups will try to trace, raising administrative concerns comparable to those under a "pure" tracing regime.

The Comment Group also rejects as too narrow an anti-avoidance rule targeted at clear-cut "son of mirrors" transactions, both because of the difficulty of defining such transactions and the inequitable treatment of taxpayers who engage in transactions with substantially similar tax effects but with different motivations. Although this approach may be administrable, a broader rule seems necessary to satisfy the ostensible purpose of § 1.337(d)-2T, to implement an aspect of the repeal of the General Utilities doctrine.
The remaining alternative is a loss disallowance rule with "mandatory presumptions," the model for the old LDR rule. While this alternative can never be precise enough to allow all economic loss, most of the Comment Group members believe that it is the only viable candidate. We also believe that the presumptions of the old LDR rule can be used as a starting point, with refinements to more closely target economic loss. We suggest possible refinements.

B. Guidance for past years

The new LDR rule also retroactively changes how groups determine disallowed loss on subsidiary stock, adding §§ 1.1502-20T(i) and 1.1502-32T(b)(v). Retroactively, a group may elect to apply the new LDR rule, the old LDR rule, or the old LDR rule without regard to the duplicated loss factor. For calendar-year taxpayers, this election must be filed no later than September 15, 2003. However, this filing requirement does not contemplate post-filing audit adjustments, and we recommend that the regulations be amended to allow such adjustments to be taken into account.

If a consolidated group retroactively applies an approach permitted under the new LDR rule for prior periods, the group may increase the loss otherwise taken into account on subsidiary stock. This increase may have several collateral effects that the regulations recognize.

First, if the group reattributed subsidiary losses to the common parent under the old LDR rule, the regulations provide that the amount reattributed may have to be reduced or eliminated to reflect the loss claimed under the new LDR rule. To the extent the reattributed losses available to the group are reduced, they become available to the disposed-of subsidiary.

Second, to account for the loss that becomes available to the disposed-of subsidiary, the regulations do the following: (1) they permit the selling consolidated group to reattribute § 382 limitations; and (2) they permit any acquiring consolidated group to elect to treat all or a portion of the increased subsidiary losses as expiring for federal income tax purposes immediately before the subsidiary became a member of the acquiring group. The regulations deem this election to have been made if the increased loss would have been used or expired in a closed year. Although the deemed election generally helps groups, it may also eliminate a potential benefit: an increased loss could be used in a closed year but free up another loss that could then be carried to an open year. We recommend that the regulations be amended to preserve that benefit.

Third, the regulations add a "basis-bump" rule that applies if the group's newly available loss on subsidiary stock is one that would have been absorbed or expired in a closed year. Under this rule, if the group's basis in the stock of a higher-tier subsidiary had been reduced under § 1.1502-32 to account for the disallowed loss under § 1.1502-20, its basis in that stock may be increased to determine the group's federal income tax liability for any open year. Although we believe that the "basis-bump" rule is justified, we find it both over- and under-inclusive and recommend changes to the rule.

The regulations make a final retroactive change by conceding in the preamble that a group could apply the old LDR rule whether or not it filed the statement of allowed loss literally
required by § 1.1502-20(c)(3). Because of this preamble concession, a group might be able to increase its allowed loss on subsidiary stock with the collateral effects noted above. The regulations do not address those collateral effects, and we recommend that they do.

II. History of the loss disallowance rule

A. The Tax Reform Act of 1986

In the Tax Reform Act of 1986, Congress repealed most vestiges of the General Utilities doctrine and provided that a corporation generally must recognize gain on a liquidating or non-liquidating distribution of appreciated property to its shareholders. At the same time, Congress authorized Treasury to "issue regulations to ensure that [the purposes of the repeal] may not be circumvented through the use of any provision of the law or regulations . . . including the consolidated return regulations."5

B. Notice 87-14

Partially in response, Treasury issued Notice 87-14, which anticipated regulations that, among other things, would target "son of mirrors" transactions. In those transactions, a consolidated group acquired a target corporation that owned built-in gain assets the acquiring group wanted. Following the acquisition, the target distributed the built-in gain assets, recognizing gain which was deferred under the intercompany transaction rules. The acquiring group took a stepped-up basis in the distributed assets. Finally, the acquiring group sold the target stock, triggering the deferred gain immediately before the stock sale. Because of the resulting basis adjustments under § 1.1502-32, the group's basis in the target stock exceeded the stock's value by the amount of the recognized built-in gain. Accordingly, the group's stock loss matched the built-in gain recognized with respect to the distributed assets and the group retained the assets with a stepped-up basis at no tax cost. This mechanism enabled the acquiring group to

3 Under that doctrine, a corporation recognized no gain or loss on its distribution of property to its shareholders with respect to their stock. See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

4 See § 631(a) of Pub. L. No. 99-514. See also §§ 311(b) and 336(a); H.R. Conf. Rep. No. 99-841, at II-204 (1986) (providing that "[t]he repeal of the General Utilities doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context"). Even though 16 years have elapsed since the repeal, Treasury has never defined its scope. Cf. Eric M Zolt, The General Utilities Doctrine: Examining the Scope of the Repeal, 65 Taxes 819, 822 (1987) (describing two possible forms of the repeal -- the weak and strong forms).

5 § 337(d). See also H.R. Conf. Rep. No. 99-841, at II-204 (1986) (providing that Congress "expected the Treasury to issue those regulations").


7 A built-in gain asset is a target asset that has a value in excess of its adjusted basis when the target is acquired.
eliminate (or at least substantially reduce) the effective tax on the built-in gain, inconsistent with the repeal of the General Utilities doctrine.8

Notice 87-14 announced that, under new or amended regulations, a group's stock basis adjustments would "not reflect built-in gains that are recognized by target on sales of, or by reason of distributions of, its assets."9 The notice's approach revealed three apparent policy choices. First, the approach disallowed stock basis adjustments only for built-in gain recognized on asset dispositions. Thus, it seemed to permit basis adjustments for operating income that reflected the built-in gain. Second, by eliminating basis adjustments attributable to built-in gain, the approach could not only reduce a group's loss on a target stock disposition but also increase its gain. Finally and perhaps most significantly, the approach appeared to require tracing: a group had to value all target assets when the target joined the group and then determine to what extent, if any, the target recognized any pre-acquisition built-in gain as it disposed of any of those assets.

C. The old LDR rule

Treasury reversed each of these policy choices when it adopted the old LDR rule.10 Most significantly, Treasury rejected tracing, concluding it would not be feasible to administer a tracing regime. In addition, partly to avoid the administrative burden of tracing and partly to limit gain duplication within a consolidated group, Treasury adopted an approach that limited a group's loss on subsidiary stock but did not require the group to increase the gain it would otherwise recognize on the disposition of subsidiary stock.11 The old LDR rule targeted not only built-in gain reflected in asset dispositions but also in operating income.12

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8 The character of the stock loss and asset gain might not match, but if the group could otherwise absorb the stock loss and tax rates remained constant, it would incur no net federal income tax cost because of the transaction.

9 1987-1 C.B. 445 (also providing that the regulations would "be effective with respect to stock in a target that was acquired after January 6, 1987").


11 Thus, a basis adjustment for a target's built-in gain could offset an increase in value in target stock attributable to unrecognized, post-acquisition appreciation in target assets, limiting gain duplication. But cf. § 1.1502-20(e)(3), Ex. 4 (providing for a reduction of subsidiary stock basis under an anti-avoids rule; the reduction could cause a group to increase its gain on its sale of the subsidiary stock).

12 Additionally, the old LDR rule disallowed duplicated stock loss (i.e., stock loss duplicated in the asset bases (or loss carryovers) of the subsidiary).
Under the old LDR rule, a consolidated group's loss on its disposition of subsidiary stock was generally disallowed.13 This loss disallowance was limited in two ways. First, under a netting provision, the loss was allowed to the extent the group took gain into account "as a consequence of the same plan or arrangement [and] with respect to stock of the same subsidiary having the same material terms."14 Further, the loss on any share of subsidiary stock was allowed to the extent it exceeded the sum of three factors: the subsidiary's extraordinary gain, positive investment adjustments, and duplicated loss.15 If a group did not own a subsidiary for too long,16 the three factors were intended to allow the group to recognize its economic loss when it sold the subsidiary stock, except to the extent the loss was duplicated in the basis of subsidiary assets (or loss carryovers). In practice, the three factors proved less than perfect.

The general disallowance of loss was also mitigated under a "reattribution" rule. If a group disposed of subsidiary stock at a loss otherwise disallowed under the old LDR rule, the group's common parent could irrevocably elect to reattribute to itself a portion of any net operating or capital loss carryovers attributable to the subsidiary (or a lower-tier subsidiary).17 The reattributed amount could not exceed the group's loss otherwise disallowed under the old LDR rule.18 The group reduced its basis in the subsidiary stock by the amount of the reattributed loss, thereby eliminating the otherwise disallowed loss.19

Finally, the old LDR rule had two anti-avoidance rules. First, under an anti-stuffing rule, the basis of subsidiary stock could be reduced if: (i) the group transferred an asset to a subsidiary and within two years disposed of the subsidiary stock, and (ii) the transfer was with a view to avoid loss disallowance or gain on subsidiary stock.20 Second, a more general anti-

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13 See § 1.1502-20(a). As a corollary, the group reduced its basis in subsidiary stock on the subsidiary's deconsolidation to the extent that basis exceeded value. See § 1.1502-20(b).
14 See § 1.1502-20(a)(4).
15 See § 1.1502-20(c).
16 Under the old LDR rule, Treasury's "general approach" was "to phase out separate return treatment as the group and the subsidiary enjoy[ed] the benefits of consolidation." CO-93-90, 1990-2 C.B. 696, 700. Thus, Treasury adopted a single-entity approach, the likely effect of which was to eliminate the group's loss on its disposition of the stock of a long-standing subsidiary but not its loss on a disposition of the subsidiary's assets.
17 § 1.1502-20(g)(1) (also providing that "[t]he common parent succeed[ed] to the reattributed losses as if the losses were succeeded to in a transaction described in section 381(a)").
18 Id. See also § 1.1502-20(g)(2) (for a further limitation on reattribution if the subsidiary whose losses were reattributed or a higher-tier subsidiary was insolvent).
19 See § 1.1502-32(b)(2)(iii) and (3)(iii) (providing a negative adjustment for noncapital, nondeductible expenses); § 1.1502-20(g)(3), Ex. 1 (illustrating that a reattributed loss was a noncapital, nondeductible expense under § 1.1502-32).
20 See § 1.1502-20(e)(2). See also § 1.1502-20(e)(3), Ex. 2 (contribution of built-in gain asset to "loss" subsidiary) and Ex. 4 (contribution of built-in loss asset to "gain" subsidiary).
avoidance rule provided for adjustments necessary to carry out the purposes of the old LDR rule if a group acted with a view to avoid the rule or its effects.\textsuperscript{21}

\textbf{D. Rite Aid}

The old LDR rule was invalidated, at least in part, by \textit{Rite Aid Corp. v. United States}.\textsuperscript{22} In \textit{Rite Aid}, the Court of Appeals for the Federal Circuit concluded that the rule exceeded Treasury's delegated authority under § 1502.\textsuperscript{23}

Rite Aid had sold the stock of a subsidiary member, recognizing a loss. Because that loss was less than the subsidiary member's "duplicated loss" (as computed under § 1.1502-20(c)), the government disallowed the entire stock loss under the old LDR rule.\textsuperscript{24}

The Court of Federal Claims supported the disallowance, but on appeal, the Federal Circuit reversed. The lower court had concluded that the old LDR rule was valid, explaining that --

The duplicated loss rule in [§ 1.1502-20(c)] prohibits the opportunity that would exist -- without the Regulation -- for the affiliated group to recognize a loss on a sale of stock of the subsidiary and for the purchaser to recognize the same loss. By prohibiting the use of the same loss in the hands of the seller and purchaser, the Regulation assists in achieving the purpose of all regulations issued under I.R.C. § 1502 "clearly to reflect the income-tax liability" of both members and former members of the affiliated group and to "prevent avoidance of such tax liability."\textsuperscript{25}

Because the lower court treated Rite Aid's loss on the subsidiary stock and the subsidiary's built-in loss on its assets as essentially the same loss (a single-entity approach), it concluded that the old LDR rule did not deny the Rite Aid group its economic loss. It noted that the group could have recognized the built-in loss on the subsidiary assets, either by selling the assets directly or by joining with the buyer to make a § 338(h)(10) election for the sale of the

\begin{flushleft}
\textsuperscript{21} § 1.1502-20(e)(1).
\textsuperscript{22} 255 F.3d 1359 (Fed. Cir. 2001).
\textsuperscript{23} \textit{Rite Aid Corp. v. United States}, 255 F.3d 1357, 1358 (Fed. Cir. 2001). Section 1502 provides that the IRS may prescribe regulations as "deem[ed] necessary . . . clearly to reflect the income tax liability [of a consolidated group] . . ., and in order to prevent avoidance of such liability."
\textsuperscript{24} Under the old LDR rule, a consolidated group's loss on its sale of subsidiary stock was generally disallowed to the extent it did not exceed the stock's share of "duplicated loss" plus two other "loss disallowance" factors. \textit{See supra} note 15 and accompanying text (for a summary of those factors).
\end{flushleft}
subsidiary stock. It also noted that by not making the election, Rite Aid likely benefited from the asset loss, since the buyer presumably paid more for the subsidiary stock because of that built-in loss.

Without discussing the lower court's rationale, the Federal Circuit concluded that the old LDR rule denied Rite Aid its economic loss. The court used as its model an affiliated, non-consolidated group. It noted that a non-consolidated group could sell subsidiary stock and recognize a stock loss under § 165(a) without being restricted by the old LDR rule, while the buyer could preserve any built-in loss in the subsidiary assets. The court reasoned that consolidated subsidiaries should be treated no worse than non-consolidated subsidiaries, stating: "The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary." Apparently reasoning that consolidated groups should be treated no worse than non-consolidated groups, the court found the old LDR rule invalid, stating that --

the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions for the subsidiary's losses.

Citing 1928 legislative history, the court suggested that Congress granted broad regulatory authority for the consolidated return regulations to deal with "problems" in filing consolidated returns. The court added that "in the absence of a problem created from the filing ---

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26 Rite Aid Corp. v. United States, 46 Fed. Cl. 505 (also pointing out that a deemed or actual asset sale could avoid duplicated gain but that, without the old LDR rule, a "regular" stock sale could preserve duplicated loss).

27 Id. Thus, if the Rite Aid group could deduct the stock loss, it would receive an economic benefit from both the stock and asset losses. Its tax benefit, however, would be limited to its stock loss.

28 Rite Aid Corp. v. United States, 255 F.3d 1357, 1360 (Fed. Cir. 2001). This model has some historical support, since the government used the model in 1929 to justify its newly issued regulation to adjust the basis of subsidiary stock. See also Andrew W. Mellon, Consolidated Returns Regulations -- Summary of Provisions, 7 Nat'l Inc. Tax Mag. 105-06 (1929) (discussing how the government took that model into account).

29 Rite Aid Corp. v. United States, 255 F.3d 1357, 1360.

30 Id. (also stating that Rite Aid's stock loss "does not stem from the filing of a consolidated return, and the denial of the deduction imposes a tax on income that would not otherwise be taxed"). The court therefore accepted Rite Aid's argument that § 1502, though a broad regulatory grant, "does not include discretion to deny the Code's benefits without furthering the purpose of that section." Rite Aid Corp. v. United States, 46 Fed. Cl. 500, 504 (2000) (setting out this argument).

31 Rite Aid Corp. v. United States, 255 F.3d 1357, 1359 (citing S. Rep. No. 70-960, at 15 (1928), which stated that "[m]any difficult and complicated problems, however, have arisen in the administration of the provisions permitting the filing of consolidated returns"). In the 1928 legislation, Congress granted the IRS authority to issue consolidated return regulations "clearly
of consolidated returns, [Treasury] is without authority to change the application of the tax code provisions to a [consolidated group]."\textsuperscript{32} The old LDR rule, the court concluded, did not address any such problems.\textsuperscript{33}

\textbf{E. Questions raised by Rite Aid}

Because the court in \textit{Rite Aid} never described how it would identify the problems the regulations should address, it raised more questions than it answered. First, the scope of the court's decision concerning the old LDR rule is not altogether clear. Although the court focused on the "loss duplication" factor of § 1.1502-20(c)(1)(iii), it stated that "the regulation [\textit{i.e.}, § 1.1502-20] is not within the authority delegated by Congress," arguably invalidating all of § 1.1502-20.\textsuperscript{34} Despite that ambiguity, the court likely intended to invalidate only the portion of the regulation that dealt with "duplicated loss," since the remainder of the regulation was prompted in part by the "son of mirrors" transaction, which is a consolidated return "problem" that does not exist in the separate return context.\textsuperscript{35}

Second, the court's approach could threaten the validity of several other consolidated return regulations. The following is a non-inclusive list of regulations which arguably do not deal with consolidated problems:\textsuperscript{36}

\begin{itemize}
  \item[(i)] § 1.1502-13(f)(6);\textsuperscript{37}
\end{itemize}

to reflect" income and "prevent avoidance of tax liability." § 141(b) of the Revenue Act of 1928, P.L. No. 70-562, 45 Stat. (pt. 1) 791, 831 (the "1928 Act"). The current Code contains practically the same regulatory grant. \textit{See} § 1502.

\begin{itemize}
  \item [32] Id. at 1359-60.
  \item [33] Id.
  \item [34] \textit{Rite Aid Corp. v. United States}, 255 F.3d at 1358. \textit{See also} id. at 1360 (stating that "[b]ecause the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute").
  \item [35] \textit{See also} Michael L. Schler, \textit{Consolidated Return Loss Disallowance: Conceptual Issues}, 95 Tax Notes 899, 901, n. 8 (May 6, 2002) (stating that the suggestion that \textit{Rite Aid} invalidated all of § 1.1502-20 was merely "wishing thinking"). We understand that the Service has conceded issues under the old LDR rule that did not implicate "duplicated loss," perhaps because of concerns about the potential breadth of Federal Circuit's opinion. \textit{See id.} at 901, n. 10 (also reporting this concession).
  \item [36] In a September 17, 2002 letter to Senators Max S. Baucus and Charles E. Grassley concerning the CARE Act of 2002, the American Institute of Certified Public Accountants (the "AICPA") questioned the validity of several of the provisions noted below (§§ 1.1502-13(f)(6), 1.1502-30, 1.1502-31, and 1.1502-80(f)) based on \textit{Rite Aid}. \textit{See} 2002 TNT 183-32 (for a copy of the letter).
  \item [37] This provision denies a consolidated group any loss on its sale of common parent stock even though a similar non-consolidated group's loss would not be disallowed. \textit{See Schler, supra} note 34 at 922 (discussing whether this provision would be invalidated under the reasoning of \textit{Rite Aid}). Arguably, the provision is justified not only to treat a consolidated group more like a single corporate entity but also to prevent loss on common parent stock from potentially
(ii) § 1.1502-30;38

(iii) § 1.1502-31;39

(iv) § 1.1502-32, at least for certain basis reductions relating to subsidiary loss;40

and

offsetting the common parent's income. See § 1032 (providing that a corporation does not recognize gain or loss on the sale of its stock). Cf. § 1.705-2 (applying an aggregate approach in determining basis adjustments for a partnership's gain or loss recognized on its disposition of a corporate partner's stock).

38 Under this regulation, a group computes its basis in target stock acquired in a triangular § 368 reorganization, sometimes taking an excess loss account in the target stock even though a similar non-consolidated group would take a $0 basis in the stock. Compare § 1.1502-30(b)(3) (providing that the negative adjustments under § 1.1502-30 could create an excess loss account) with § 1.358-6(c)(1)(ii) (preventing a negative-basis result outside of consolidation). Arguably, the regulation is justified because it produces a single-entity result.

39 This section may adjust a consolidated group's basis in subsidiary stock following a group structure change. The adjustments are coordinated with those under § 1.1502-33(f) for earnings and profits. There is no similar provision for a comparable non-consolidated transaction.

40 Treasury first provided for basis adjustments for subsidiary stock in 1928, but until 1966, it provided negative adjustments only for certain losses and provided no positive adjustments for gain. See, e.g., Art. 34(c)(2) and (e) of Reg. 75, reprinted in 138 Internal Revenue Acts of the United States 1909-1950 Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr. ed. 1979) (providing a stock basis reduction for subsidiary loss absorbed by the group that the subsidiary would not have used if it had filed separate returns). Treasury justified the limited adjustment for loss to conform the treatment of consolidated and non-consolidated groups. See Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 69 (1934) (concluding that an adjustment for loss (but not gain) was justified because consolidation affected a group's total tax only if at least one member had a net loss; if all members had net income, the group's total tax would be the same, whether or not it filed consolidated returns).

For the first time in 1967, Treasury required a basis reduction for all subsidiary loss absorbed by the group, even if the subsidiary could have used the loss had it filed a separate return. See § 1.1502-32(b)(1)(ii) and (2)(i) and (ii) (1967), 1967-1 C.B. 248-49. As a result, consolidated groups could be treated worse than non-consolidated groups, as the following example shows:

A consolidated group acquires all T stock for $100. After the acquisition, the group has a consolidated net operating loss (a "CNOL"), $10 of which is attributable to T. T carries back that portion of the CNOL and offsets income in a separate return year. The group reduces its basis in the T stock by $10, from $100 to $90. See § 1.1502-32(b)(3)(i)(B). See also § 1.1502-32(b)(2)(i) (1967) (reaching the essentially same result). If the group had not filed a consolidated return, T still could have offset its $10 of income with the $10 loss carryforward, but the group would have retained a $100 basis in the T stock.

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(v) various subsections of § 1.1502-80, which provide that certain Code sections do not apply to transactions between members of a consolidated group. 41

F. Legislation

Proposed legislation would address these concerns by adding the following sentence to § 1502:

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 consolidated returns. 42

Although the legislative history states that the provision overrules Rite Aid "to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate return basis would produce a result different from single taxpayer principles that may be used for consolidation," the legislative history creates confusion by also stating that the provision "nevertheless allows the result of the Rite Aid case to stand with respect to the type of factual situation presented in the case." 43 The proposed legislation would apply to all taxable years.

This provision could change current law, at least if Rite Aid is broadly construed, and some of the members of the Comment Group consider its retroactive application unfair. 44

See 1990-2 C.B. 700 (preamble to Prop. § 1.1502-20, noting this case). Under Rite Aid, § 1.1502-32 may be invalid to the extent it authorizes the basis reduction in the example, because the reduction arguably is not connected with any problem created by filing consolidated returns. 41 See § 1.1502-80(b) (providing that § 304 does not apply to an intercompany transaction), (d) (providing that § 357(c) does not apply to certain intercompany transactions), (e) (providing that § 163(e)(5) does not apply to an intercompany obligation), and (f) (providing that § 1031 does not apply to an intercompany transaction). Each of those provisions would apply to a similar transaction between members of an affiliated, non-consolidated group, but each is arguably justified, even under a broad reading of Rite Aid. Section 1.1502-80(b) implements § 304(b)(4), which authorizes "proper" basis adjustments to carry out the purposes of the section on transfers between members of an affiliated group. Sections 1.1502-80(d), (e) and (f) coordinate the deferral regime of § 1.1502-13 with the relevant Code sections (and thus deal with consolidated return "problems"). See also § 1.1502-80(c) (postponing when member stock is considered worthless, arguably achieving a single-entity effect).

42 § 631 of the CARE Act of 2002.
44 See also 2002 TNT 183-32 (a September 17, 2002 letter from the AICPA to Senators Baucus and Grassley also arguing that the legislation is unfair). The legislation would promote certainty in applying the consolidated return regulations and also likely preserve revenue. Because the legislation would rationally promote those legitimate purposes, it arguably should withstand constitutional challenge. See United States v. Carlton, 512 U.S. 26, 30-31 (1994)
Others believe that broad attacks on the regulations foster needless uncertainty and favor the provision because it limits that uncertainty. In any case, if the provision were challenged, it would demand a studied review of many issues that *Rite Aid* considered only in passing (if at all). 45  Most Comment Group members would welcome this process.

**III. Treasury's response to Rite Aid**

Treasury has responded to *Rite Aid* by promulgating the new LDR rule. The new rule clarifies applicable law for consolidated groups both retroactively (principally through § 1.1502-20T(i)) and prospectively (through § 1.337(d)-2T).

**A. Prospective guidance -- § 1.337(d)-2T**

1. **Basic rules**

   Although § 1.337(d)-2T retains a general loss disallowance provision, 46 it limits the disallowed loss on subsidiary stock "to the extent the taxpayer establishes that the loss . . . is not attributable to the recognition of built-in gain on the disposition of an asset (including stock or securities)." 47 A netting rule also permits a group to take its loss on subsidiary stock into

(concluding that retroactive application of a tax statute is constitutional if it is supported by a legitimate legislative purpose furthered by rational means); *Montana Rail Link, Inc. v. United States*, 76 F.3d 991 (9th Cir. 1996) (applying the *Carlton* test).

45 Such a review would be more likely with a carefully considered legislative history supporting the provision.

46 As a general rule, it provides that "[n]o deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary." § 1.337(d)-2T(a)(1). See also § 1.337(d)-2T(b) (providing a companion rule that requires a basis reduction upon a deconsolidation). Cf § 1.1502-20(b) (for the deconsolidation provision under the old LDR rule).

Section 1.337(d)-2T generally applies "to dispositions and deconsolidations on or after March 7, 2002, unless the disposition or deconsolidation was effected pursuant to a binding written contract entered into before March 7, 2002, that was in continuous effect until the disposition or deconsolidation." § 1.337(d)-2T(g) (also providing that if a loss is recognized because stock becomes worthless, the disposition of that stock is considered to occur when the stock becomes worthless).

47 § 1.337(d)-2T(c)(2). For this purpose, built-in gain is --

   gain recognized on the disposition of an asset . . . to the extent attributable . . . to the excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share . . . after applying . . . applicable provisions of the Internal Revenue Code and regulations.

*Id.* Thus, if a subsidiary's asset gain is "reflected" in the group's subsidiary stock basis before the asset is disposed of, the gain is literally "built-in" gain. However, this literal interpretation may
account "to the extent that, as a consequence of the same plan or arrangement, gain is taken into account by members with respect to stock of the subsidiary having the same material terms."\textsuperscript{48}

Thus, like Notice 87-14, the new rule requires tracing only for built-in gain recognized on asset dispositions, not for built-in gain reflected in operating income.\textsuperscript{49} Like the old LDR rule, the new rule generally does not increase gain that a group otherwise may recognize on its disposition of subsidiary stock and permits netting of gain and loss on subsidiary stock. In a sense, § 1.337(d)-2T adopts the more favorable aspects of Notice 87-14 and the old LDR rule, but that combination clouds the new rule's purpose. Treasury will likely receive few taxpayer complaints for its choices to allow netting but not to increase subsidiary stock gain to account for built-in gain or to disallow loss related to built-in income.

It is not readily apparent why a tracing regime should disallow stock loss but not also increase stock gain.\textsuperscript{50} The old LDR rule was confined to stock loss both to minimize gain duplication and as a trade-off to avoid the administrative burden of tracing. Because the new rule requires tracing but does not limit loss duplication, it arguably follows a different set of principles than either Notice 87-14 (which increased stock gain) or the old LDR rule (which capture gain attributable to post-acquisition asset appreciation in the rare case when a subsidiary's asset gain is taken into account in the group's basis in subsidiary stock before the asset disposition in fact occurs. See § 1.1502-76(b)(2)(ii) (under which a pre-disposition reflection might occur if the group sells subsidiary stock during a taxable year, the group ratably allocates the subsidiary's items between the pre-sale and post-sale periods, and the subsidiary sells a non-extraordinary item at a gain after the group sells the subsidiary stock). To more precisely target pre-acquisition asset appreciation, the "built-in gain" definition could be refined by adding the phrase "taking into account items under § 1.1502-32 for" between the words "before" and "the" in the definition above.

Note that to qualify for the loss limitation under § 1.337(d)-2T(c), the group must include a statement with its return for the year of the disposition (or deconsolidation) that contains the name and employer identification number of the subsidiary and the amount of the loss not disallowed (or basis not reduced) because of § 1.337(d)-2T(c). § 1.337(d)-2T(c)(1) and (3). Note also that there is a typographical error in part (iii) of the Example under § 1.337(d)-2T(c)(4). The reference to "asset 2" should instead be to "asset 1."\textsuperscript{48} § 1.337(d)-2T(a)(4). See also § 1.337(d)-2T(b)(4) (for a companion netting rule for deconsolidations of subsidiary stock).

\textsuperscript{49} It also does not disallow "duplicated" loss.

\textsuperscript{50} Cf. § 1059 (accounting for built-in gain by requiring stock basis reductions in certain circumstances; the reductions could both reduce loss and increase gain). Note that eliminating a $1 gain should provide as great a tax benefit as the immediate deduction of a $1 loss. Thus, in a tracing regime, the policy that supports disallowing stock loss would also seem to support (if not compel) appropriately increasing stock gain.
avoided tracing). Neither the preamble to the new rule nor its text, however, spells out those principles. In subsequent guidance, Treasury should describe those principles.

Without any guiding principles, it often may be uncertain how to apply § 1.337(d)-2T, particularly its anti-avoidance rules. Section 1.337(d)-2T incorporates the anti-avoidance rules of the old LDR rule, "with appropriate adjustments to reflect the differences" between the two rules. Thus, the new rule's anti-stuffing provision probably does not apply to the contribution of a built-in loss asset to avoid stock gain, because the new LDR rule no longer targets duplicated loss. While the provision still could apply to the "stuff" of a built-in gain asset to avoid non-economic stock loss, the new LDR rule requires tracing but otherwise does not increase stock gain, perhaps signaling that this type of stuffing is permitted. Treasury should clarify the reach of the anti-avoidance rules.

2. The appropriate breadth of § 1.337(d)-2T

The appropriate breadth of the loss disallowance rule depends, at least in part, on the scope of the repeal of the General Utilities doctrine, since the rule implements an aspect of the repeal. For example, some believe that the repeal merely requires that gain on assets held in corporate solution be recognized or preserved. They might argue that § 1.337(d)-2T applies too broadly to a "son of mirrors" transaction where the target stock was acquired at gain from a corporate seller, because it may result in duplicated corporate-level gain.

Example 1 -- "Son of mirrors" transaction; individual vs. corporate seller

P buys T stock for $100 from X, who recognizes a $20 gain. T has built-in gain assets, which it sells at a $60 gain. Under § 1.1502-32 (and disregarding tax incurred on the gain), P increases its T stock basis from $100 to $160. P sells the T stock to an unrelated person for $100, recognizing a $60 loss.

Arguably, only $60 of net corporate-level gain related to T's built-in gain assets should be recognized. Thus, if X is an individual, P's entire $60 loss should be disallowed, since it otherwise could offset T's $60 gain on the built-in gain assets, effectively reducing corporate-level gain below $60. If X is a domestic corporation, however, arguably only

51 Perhaps as a somewhat oblique concession to tracing's complexity, Treasury limited tracing to cases in which groups sold subsidiary stock at a loss. Even with that limitation, we believe (with some dissent) that tracing remains unworkable.
52 § 1.337(d)-2T(e). The old LDR rule contained an anti-stuffing and general anti-avoidance rule. See supra notes 20-21 and accompanying text (for a description of those rules).
53 Cf. § 1.1502-20(e)(3), Ex. 4 (applying the anti-stuffing rule to the contribution of a built-in loss asset).
54 Cf. § 1.1502-20(e), Ex. 2 (applying the anti-stuffing rule to the contribution of a built-in gain asset; the example is labelled the "[b]asic stuffing case").
55 Unless otherwise noted, in each example in these Comments, P is the common parent of a consolidated group (the "P group").
$40 of P's $60 loss should be disallowed, since X, P, and T would then account for $60 of net corporate gain ($20 gain by X, $20 loss by P, and $60 gain by T).

Despite the potential appeal of the narrower approach suggested by Example 1, Treasury correctly adopted a broader approach. There are at least three reasons to reject the narrower approach. First, that approach improperly presumes that one taxpayer may appropriately recognize gain as a surrogate for another, a presumption that makes little sense since taxpayers can readily choose to avoid the "son of mirrors" transaction. Second, it is inconsistent with how Congress has responded to comparable cases. Third, it would require tracing beyond that required by § 1.337(d)-2T.

3. Problems with the fundamental approach

Of even greater moment, the fundamental approach of § 1.337(d)-2T seems flawed. Not only does it not increase stock gain, it disregards operating income that reflects built-in gain on assets and relies on tracing, which we believe (with some dissent) is unadministrable. In any event, if tracing is retained, it seems difficult to justify the netting rule of § 1.337(d)-2T(a)(4).

(a) Tracing is unadministrable

We believe (with some dissent) that the tracing required by § 1.337(d)-2T is unadministrable. This was the conclusion Treasury and the Service reached when they adopted the old LDR rule, and nothing has occurred in the intervening decade to alleviate the concerns the government identified as the basis for its conclusion. Tracing requires burdensome valuations for each acquired subsidiary, a burden that multiplies if the acquired

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56 It seems likely that taxpayers would engage in the "son of mirrors" transaction only if it achieved a net tax benefit. That benefit could arise in the preceding example, for instance, if X had been taxed on its stock gain at a rate lower than the P group was taxed on T's asset gain, a result that may occur, for example, if X had capital loss carryovers. In that case, X's stock gain should not be an appropriate surrogate for T's asset gain. Cf. T.D. 8408, 1992-1 C.B. 155, 156 (in the preamble to the "economic performance" regulations, concluding that a prepayment for property or services does not satisfy economic performance even though the payee may generate investment income on the prepayment, because the payee may be taxed at a lower rate than the payor).

57 See § 304(b)(4); § 337(d); § 355(b)(4)((D), (d) and (e); § 1059.

58 The problems presented by tracing in the example seem particularly thorny. P might have to determine not only the built-in gain amount for X but also for any corporate seller of T stock that preceded X. Further, P would have to somehow allocate those amounts among each relevant T asset, possibly redetermining the allocation any time T disposed of a relevant built-in gain or loss asset. These computations could entail significant administrative expense, and it is not clear how they should be made.

59 See Schler, supra note 34 at 902-03 (stating that tracing is "not nearly as simple as it first appears" and illustrating numerous problems with tracing).

subsidiary itself has lower-tier subsidiaries. Further, it may often be unclear how a tracing regime should be implemented except in the simplest cases.

Valuations would be burdensome. To trace, a consolidated group must separately value a new member's assets when the member joins the group but -- absent tracing -- these valuations would not typically be required on such an occasion. For example, when a group purchases new member stock, it likely prices the stock by considering the member's assets collectively, not separately.

Each subsidiary asset may have to be valued not only when the subsidiary joins a group but any time the group acquires additional subsidiary stock. Stock acquisitions typically will offer scant objective evidence of the underlying value of each separate subsidiary asset. Moreover, the relevant values of the subsidiary assets will not be simply their absolute fair market values. Instead, their absolute values must be discounted (or enhanced) in some way to

61 Although the Code currently requires tracing under other Code sections, including §§ 704(c), 382, and 1374, those sections do not justify the tracing regime adopted under § 1.337(d)-2T. Section 382 appears to require tracing that may be as problematic as under § 1.337(d)-2T, and, perhaps for that reason, Treasury has yet to issue regulations to implement that tracing. In contrast, regulations implement tracing under §§ 704(c) and 1374, but that tracing is tolerable because, among other things, those sections involve comparably simpler structures. In any event, even those provisions fail to provide meaningful guidance on numerous tracing issues.

62 The new member's assets will be separately valued if a § 338 election is made for the purchase. Further, if a § 338(h)(10) election is made and the new member is acquired from a selling consolidated group or is an S corporation, the valuations may be negotiated by adverse parties (i.e., the selling shareholders and buying group), helping to support their legitimacy.

The new member's assets also may be valued for financial accounting purposes. However, even the valuations required by purchase accounting may not be detailed enough for § 1.337(d)-2T, since it appears that purchase accounting may sometimes tolerate the valuation of asset groups, rather than requiring the separate valuation of individual assets.

Generally, then, it seems likely that a group will not determine the separate value of each subsidiary asset when it acquires subsidiary stock. First, those valuations may be too costly, since they will be relevant only if the group later sells the subsidiary stock at a loss. Second, even if the group were inclined to incur that cost, it may unaware at the start of a multi-step purchase that the subsidiary will join the group.

Absent § 1.337(d)-2T, the separate value of any subsidiary asset may be relevant only when the asset is sold, which may occur many years after the relevant stock purchases. At that time, it may be "difficult if not impossible to determine the prior value [or values] of the asset." Schler, supra note 34, at 903.

63 It is also not clear that an asset must have a single absolute fair market value. An asset's value depends not only on its use, which may change over time, but also on how it may be sold (e.g., in a retail, wholesale, or liquidation sale) and its post-sale form of ownership. See, e.g., Pope & Talbot, Inc. v. Commissioner, 162 F.3d 1236 (9th Cir. 1999)(determining § 311 gain
reflect the potential tax liability (or benefit) attributable to built-in gain (or loss), as these amounts would be reflected in the price of the stock.\textsuperscript{64} Because tracing requires these valuations, it promises expensive and acrimonious disputes between consolidated groups and the Service. It also seems certain that similarly situated groups will be treated differently.

Even if a group legitimately values each subsidiary asset at all appropriate times, the Service may question the valuations based on hindsight. Inevitably, assets will perform better or worse than expected. The Service is likely to argue that an asset's subsequent performance accurately reflects its expected value on the earlier date, an argument difficult to counter since the taxpayer will have the burden to prove that any gain is not built-in.\textsuperscript{65}

The valuation concerns are magnified when the target is acquired in a transferred-basis transaction,\textsuperscript{66} since it is not clear how the group should compute built-in gain reflected in target stock. The group could determine the relevant built-in gain amounts as of the time the stock was last purchased in a cost-basis transaction, an unpalatable solution if the target was publicly traded before its acquisition.\textsuperscript{67} As an alternative, the group could compute built-in gain amounts as of the time it acquired the stock by assuming that the target's assets had an aggregate value equal to the target liabilities plus the group's aggregate basis in the target stock.\textsuperscript{68} The latter approach does not avoid the need for valuations, however, since it will still be necessary to allocate the

\textsuperscript{64} Schler, \textit{supra} note 34, at 903. These adjustments will depend on the appropriate discount rate, the group's estimate of when target assets will be sold, and its assumption about applicable tax rates. Each of these variables could be hotly contested.

\textsuperscript{65} \textit{Cf} § 382(h)(2)(A) (providing gain is recognized built-in gain only to the extent that the taxpayer establishes that the gain existed on the change date); § 1374(d)(3) (treating all gain recognized during the recognition period as recognized built-in gain except to the extent that the taxpayer establishes that the gain exceeds the built-in gain on the relevant measurement date).

\textsuperscript{66} These transactions could include ones described in § 351 or § 368(a)(1)(B) (a "B reorganization"). \textit{See} § 362(a). They could also acquisitive asset reorganizations under § 368, where the target owns the stock of a lower-tier subsidiary. \textit{See} § 362(b).

\textsuperscript{67} This method seems more appropriate, however, if the group acquires the target stock from another group in a B reorganization and the transferring group had acquired all of the target stock in a cost-basis purchase.

\textsuperscript{68} \textit{See} Schler, \textit{supra} note 34, at 903 (suggesting this approach). If the group owns less than all of a target’s stock, the stock basis amount would have to be "grossed up." Further, if the group acquires some stock in a transferred-basis transaction and some in a cost-basis transaction, the built-in gain reflected in the cost-basis stock presumably would be determined under the "cost-basis" methodology described above.
aggregate value among target assets and allocate any built-in gain amounts among classes of target stock, or within a class if (as is likely) shares in the class have differing bases.

The computations and corresponding complexity multiply if the target has direct or indirect lower-tier subsidiaries that have built-in gain assets at the time the group acquires target stock. The group will then have to compute the extent to which that built-in gain is reflected in its target stock, the stock of any intermediate lower-tier subsidiary, and the stock of the lower-tier subsidiary itself.

Example 2 -- Lower-tier subsidiaries

P purchases all T stock in Year 2, and T and its wholly owned subsidiary X join the P group. On the purchase date, X has built-in gain assets. P must determine the extent to which X's built-in gain is reflected in its T stock and in T's X stock.

We recognize that asset valuations are regularly performed in connection with asset acquisitions and stock acquisitions under sections 338 and 338(h)(10). However, there are important distinctions that make valuations more problematical in this context: (1) in an asset (or deemed asset) acquisition, the asset values are immediately relevant, so there is a reason for groups to perform contemporaneous asset valuations which would not be the case in a stock acquisition; (2) since the values are immediately relevant in an asset (or deemed asset) acquisition, appraisals and other documentation concerning values will still be on-hand and accessible if a dispute arises, but even if appraisals are performed in a stock acquisition, it may not be possible to locate them when they become relevant decades later; and (3) there will not be any tension between buyer and seller in determining values following a stock acquisition as there would generally be following an asset (or deemed asset) acquisition.

Further clarification would be needed. If a tracing regime is retained, groups will need more guidance to compute the extent to which built-in gain is reflected in subsidiary stock basis. Without that guidance (or even with it), tracing standards would likely be heavily influenced by the well-paid tax professionals who would compute built-in gain and loss for consolidated groups, perhaps with different standards for different taxpayers, depending on which is more advantageous in a particular context.

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69 For example, the allocation could be made in proportion to the asset values, using the residual allocation method provided under § 1060, or following a § 755 approach.
70 But see § 1.337(d)-2T(a)(4) (for a netting rule that mitigates the concern with differing bases). Concerns similar to those mentioned in this paragraph may arise if a group purchases target stock in a cost-basis transaction and the purchased stock is not an affiliated interest, but the target later joins the group because other target stock is redeemed or issued.
71 See Schler, supra note 34, at 903 (describing this concern and using a similar example).
72 Assuming that T purchases X on a different date than P purchases T, the amount of X's built-in gain reflected in the T stock and the X stock likely will be different. Note that P's or T's purchase may have occurred in several steps, further complicating these computations.
73 Even the simplest cases may require fairly elaborate examples. Cf. § 1.705-2(c)(2) (illustrating how gain on stock of a corporate partner would be traced in cases involving a higher-tier and lower-tier partnership).
Taxpayers may also need additional guidance to compute built-in gain in particular circumstances, for example, when (i) a subsidiary owns a partnership interest, (ii) a group acquires subsidiary stock in several steps, (iii) a subsidiary's assets fluctuate in value, or (iv) a group engages in an intra-group spin-off.74

Example 3 -- Subsidiary owns a partnership interest

P owns all of the S stock with a $200 basis and value. S purchases a 30-percent partnership interest from a partner for $30, and the partnership has not made (and does not make) a § 754 election. At the time of the purchase, the partnership owns one asset with a $0 basis and $100 value.

The partnership sells its asset for $100, recognizing a $100 gain. S is allocated $30 of that gain and increases its basis in its partnership interest to $60.75 Under § 1.1502-32(b)(2)(i), P increases its basis in its S stock to $230.

P sells its S stock for $200, recognizing a $30 loss. It is unclear whether that loss should be disallowed under a tracing regime that permits duplicated loss. Although the $30 loss is not an economic loss, it matches the group's $30 non-economic gain on the partnership's asset sale, a gain recognized because the partnership had no § 754 election in effect. Arguably, allowing the loss would appropriately account for that match, and it should be irrelevant that P's loss on the S stock is duplicated in an S asset, i.e., S's partnership interest. Apparently, however, P's loss would be disallowed under § 1.337(d)-2T, because it would be attributable to built-in gain reflected in S's outside basis (and thus P's basis in the S stock) before the partnership sold the asset.76

Example 4 -- Disallowed loss under § 1.337(d)-2T

P buys T stock in two steps. In Year 1, it buys half of the T stock for $100.77 At that time, T owns Asset 1 with a $70 basis and $50 value and Asset 2 with a $120 basis and $150 value. In Year 2, P buys the remaining T stock for $100. At the time of the second purchase, T owns the same assets with the same bases, but Asset 1 has a $70 value while Asset 2 has a $130 value. Thus, Asset 1 has appreciated in value by $20, while Asset 2 has depreciated in value by $20.

74 In addition, regulations adopting a tracing regime should explain how to account for goodwill, since it seems impractical, if not impossible, to measure when goodwill is created or used. The regulations might also explain how built-in gain is recognized under various inventory methods.

75 See §§ 702, 704(b) and 705(a)(1)(A).

76 See § 1.337(d)-2T(c)(2) (for the definition of built-in gain). Special allocations may make this analysis even more complex.

77 Assume that T has only one class of outstanding stock.
T sells Asset 2 after it has appreciated in value to $160, recognizing a $40 gain. Disregarding the tax on the asset gain, P increases its basis in its two blocks of T stock by $20 each, taking a $120 basis in each block. Because Asset 1 has declined in value to $60, P sells the T stock for $220, recognizing a $20 overall loss (or $10 for each block). Under § 1.337(d)-2T, it is not clear whether $10 or $15 of P's $20 loss should be disallowed. The disallowed loss for the T stock purchased in Year 2 should be only $5, because P's basis in that block reflected $5 of built-in gain in Asset 2. The disallowed loss for the Year 1 block could be $5 or $10, however, depending on when built-in gain is computed. If the potential built-in gain for the Year 1 block is fixed as of the time the block is purchased, the entire $10 loss on the block would be disallowed, because P's basis in that block reflected $15 of built-in gain in Asset 2 (although only $10 was ultimately recognized). If, however, the built-in gain is redetermined as of the time T entered the P group, only $5 of the loss would be disallowed.

**Example 5 -- Mere fluctuations in asset value**

P forms S, contributing $200 for all of the S stock. S purchases Asset 1 for $50 and Asset 2 for $150. Thus, no built-in gain is reflected in P's basis in the S stock. Asset 1 increases in value to $100, while Asset 2 declines in value to $100. S sells Asset 1 for $100, recognizing a $50 gain. Under § 1.1502-32 (and disregarding tax incurred on the gain), P increases its S stock basis from $200 to $250. P sells its S stock for $200, recognizing a $50 loss.

Unless built-in gain is redetermined to account for mere fluctuations in asset values, P's basis in its S stock reflects no built-in gain, so that P's loss should not be disallowed under § 1.337(d)-2T. The built-in gain should not be redetermined, since § 1.337(d)-2T would permit the loss in a similar case: P group could have formed separate subsidiaries to hold Assets 1 and 2, recognized a $50 gain on its sale of Asset 1, and recognized a corresponding $50 loss on its sale of the loss subsidiary's stock. The regulations should clarify when built-in gain must be determined or redetermined.

**Example 6 -- Spin-off creates built-in gain**

P forms S, contributing $200 for all of the S stock. S purchases Asset 1 for $50 and Asset 2 for $150. Thus, no built-in gain is reflected in P's basis in the S stock. Asset 1 increases in value to $100, while Asset 2 declines in value to $100. As part of a plan, S

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78 That amount equals 50% of the excess of $130 (Asset 2's value when P purchased the second T block) over $120 (Asset 2's basis at that time).

79 That amount equals 50% of the excess of $150 (Asset 2's value when P purchased the first T block) over $120 (Asset 2's basis at that time).

80 For ease of administration, § 1.337(d)-2T might clarify that built-in gain should not be redetermined merely because a built-in gain asset declines in value. Cf. § 1245 (treating gain on the sale of depreciable personal property as ordinary income to the extent of prior depreciation deductions, even if the gain could be traced to the asset's appreciating in value).

81 § 1.337(d)-2T(c)(2).
forms T, transfers Asset 2 to T for all of the T stock, and distributes the T stock to P.
Assume that the transaction is described in §§ 355 and 368(a)(1)(D). Under § 358, P's S
stock and T stock each take a $100 basis.82

In a separate transaction, S sells Asset 1, recognizing a $50 gain. Under § 1.1502-32 (and
disregarding tax incurred on the gain), P increases its S stock basis from $100 to $150. P
then sells its S stock for $100, recognizing a $50 loss. Because the asset and stock sale
could eliminate any corporate-level gain on Asset 1, the loss should be disallowed under
a tracing regime. Thus, P's built-in gain in the S stock should be redetermined as a result
of the spin-off.83

By requiring tracing, § 1.337(d)-2T adds significant complexity and administrative cost
to a consolidated group's computation of its federal income tax.84 With some dissent, we believe
that the apparent precision of tracing is illusory and that tracing inevitably will lead to protracted
disputes between taxpayers and the Service. Thus, with some dissent, we encourage Treasury to
modify its prospective loss disallowance rule to eliminate any tracing requirement.85

(b) Section 1.337(d)-2T is underinclusive because it fails to account for built-in income

In addition to being unadministrable because of tracing, § 1.337(d)-2T is under-inclusive,
because it fails to account for built-in income with respect to built-in gain assets.

Example 7 -- Built-in income

P buys all T stock for $100, and T has one asset with a $0 basis and $100 value. Over the
course of a year, the asset produces $110 of operating income, and its value declines to
$0. Under § 1.1502-32 (and disregarding tax incurred on the operating income), P
increases its T stock basis from $100 to $210.86 P sells the T stock to an unrelated
person for $110, recognizing a $100 loss. Even though P's loss can be tied directly to the
$100 built-in gain in T's asset, the loss is not disallowed under § 1.337(d)-2T, since it is
not "attributable to the recognition of built-in gain on the disposition of an asset."87

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82 § 1.358-2(a)(2) (providing for an allocation of basis among different classes of stock in
proportion to the fair market values of the stock of each class).
83 In a typical case, however, that redetermination would raise many of the same concerns
as when a group acquires a target in a transferred-basis transaction. See supra notes 63 to 67 and
accompanying text (for a discussion of those concerns).
84 When examples illustrate tracing using only one or two assets, they substantially
understate the complexity raised by tracing for the typical group.
85 To eliminate tracing, Treasury will have to adopt presumptions about built-in gain, and
we recognize that effective presumptions will create winners and losers. Although even
carefully crafted presumptions are invariably imprecise, we believe (with some dissent) that the
certainty and closure they provide merit their adoption.
86 Note that the asset produced no tax depreciation, because it had a $0 basis.
87 § 1.337(d)-2T(c)(2) (emphasis added).
Although the built-in income in the Example 7 probably can be traced without difficulty, it presents an unrealistically simple case. In the typical case, it may be tremendously difficult to tie income to built-in gain, not only because the income on the asset may fluctuate over time but also because it may be unclear how much income the asset generated or what the asset's residual value is.  

By disregarding built-in income, § 1.337(d)-2T is notably underinclusive, because unrecognized built-in gain often will be accounted for as built-in income (e.g., as income related to goodwill). The approach also promotes economic inefficiency, encouraging groups to retain built-in gain assets even though their sale may make better non-tax economic sense. Finally, it may prompt groups to engage in artificial transactions to convert built-in gain to built-in income. Consider the following example:

**Example 8 -- Converting built-in gain to built-in income**

P buys all T stock for $100, and T has one asset, land with a $0 basis and $100 value. Instead of selling the land outright for $100, T enters into a 30-year ground lease, receiving an $82.59 prepayment of all rent under the lease. Under § 1.1502-32 (and disregarding tax incurred on the pre-paid rent), P increases its T stock basis from $100 to $182.59. P sells the T stock to an unrelated person for $100, recognizing a $82.59 loss. Unless an anti-avoidance rule applies or the rental is recharacterized as a sale, P's loss is

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88 See Schler, supra note 34, at 905 (discussing difficulties and questions surrounding the tracing of built-income). Further, even if a group could identify the income an asset produces, it might be unclear how much of that income should be considered built-in income, particularly if the asset is a wasting asset. (A wasting asset is an asset that declines in value over time through use or obsolescence.) Presumably, the built-in income from a wasting asset should not exceed the asset's decline in value (or, perhaps, its expected decline in value). To compute that amount, however, would require burdensome, periodic valuations. As an alternative, the decline in value might be presumed equal to the asset's tax amortization or depreciation, but those tax deductions often would not reflect either the expected or actual decline in value. In short, there appears to be no good way to compute built-in income from a wasting asset.

89 By drawing the line between built-in gain and built-in income, the regulations must answer (i) whether "non-disposition" income that is treated as gain from an asset disposition may be built-in gain and (ii) whether gain from an asset disposition that is treated as "non-disposition" income may be built-in income. See, e.g., § 301(c)(3)(A) (sometimes characterizing a portion of a § 301 distribution as gain from the sale or exchange of property); § 1248(a) (sometimes characterizing gain on the sale of foreign corporation stock as dividend income).

90 As a corollary, the approach may treat a group that sells a gain asset less favorably than a group that retains a gain asset and generates operating income.

91 Assuming a discount rate of 6% and further assuming that the rental and market values of the land remain constant over the 30-year term, the pre-paid rent should be $82.59, which is $100 less $17.41 (the present value of $100 in 30 years).
not disallowed under § 1.337(d)-2T, since it cannot be tied to gain from the disposition of an asset.92

In some fashion, the prospective loss disallowance rule should account for built-in income to avoid promoting inefficient economic behavior and artificial disposition arrangements.93

(c) The justification for a netting rule is unclear

Finally, it is unclear why § 1.337(d)-2T has a netting rule. That rule permits a group to take an otherwise disallowed loss on subsidiary stock into account to the extent that, as a consequence of the same plan or arrangement, it recognizes gain on subsidiary stock with the same material terms.94 Although the old LDR rule included a netting rule, the netting rule is harder to justify under a tracing regime, where its chief impact might be to eliminate tax on built-in gain.95

Example 9 -- Staggered purchase of subsidiary stock; netting rule eliminates tax on built-in gain

In Year 1, P purchases half of the only class of T stock for $100. At that time, T has one asset with a $250 basis and $200 value and has no liabilities. In Year 2, T's asset has increased in value to $300 but still has a $250 basis, and P purchases the remaining T stock for $150. P's $150 basis in that block of stock reflects a $25 built-in gain in the T asset.

Later, T sells its asset for $300, recognizing a $50 gain. Under § 1.1502-32 (and disregarding tax incurred on the gain), P increases its basis in each block of T stock by $25. Thus, one block has a $125 basis and the other a $175 basis. P sells the T stock for $300, recognizing a $25 gain and $25 loss on its blocks of T stock.

P's $25 loss on the second block of stock is attributable to T's recognition of built-in gain on the disposition of its asset. If P can net the $25 gain and loss, it can effectively eliminate any tax on the $25 built-in gain, arguably contrary to the repeal of the General Utilities doctrine.96

92 The Service may argue that in renting the land rather than selling it, the group acted with a view to avoid the loss disallowance rule, violating the anti-avoidance rule of §§ 1.337(d)-2T(e) and 1.1502-20(e)(1). The success of this argument, however, seems far from certain.

93 Because built-in income is even more difficult to trace than built-in gain, any prospective loss disallowance rule should not account for built-in income through tracing.

94 § 1.337(d)-2T(a)(4). See also § 1.337(d)-2T(b)(4) (for a companion netting rule for deconsolidations of subsidiary stock).

95 The netting rule was justified under the former regime to mitigate the "duplicated loss" rule.

96 The P group appropriately takes into account $50 of income related to the first block of T stock (i.e., $25 on the asset sale plus $25 on the stock sale), reflecting the $50 of economic appreciation in the stock while held by P.
Example 10 -- Asset contribution; netting rule unnecessary

P owns all of the only class of S stock with a $300 basis and value. P contributes an asset with a $0 basis and $100 value to S for a second block of S stock, taking a $0 basis in that stock. Unless P redetermines its built-in gain on its first block of S stock when it receives the second block, it has no built-in gain in either block of stock. Later, S sells the contributed asset for $100, recognizing a $100 gain. Under § 1.1502-32 (and disregarding tax incurred on the gain), P increases its basis in the first and second blocks of S stock to $375 and $25, respectively. If P does not redetermine its built-in gain on its first block of S stock when it receives the second block, S's recognized gain should not be built-in gain, because it was not reflected in P's basis in the S stock before the asset disposition.

P sells the S stock for $400, recognizing a $75 loss on the first block of S stock and a $75 gain on the second block. Under § 1.337(d)-2T(c), P can take its $75 loss into account, because the loss is not attributable to the recognition of built-in gain on the disposition of an asset. Thus, P can recognize the loss without regard to the netting rule.

A netting rule may be justified under § 1.337(d)-2T to limit gain duplication, but only in concert with an anti-loss duplication rule. It may also be justified on administrative grounds to

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97 § 358(a)(1).
98 It may be forcibly argued that P's original S stock reflects $75 of built-in gain immediately after P acquires the new S stock, because the original stock has an indirect share in 75% of all S attributes (including a 75% share of the $100 built-in gain on the contributed asset). To account for this mixing-bowl effect, P's built-in gain in its original S stock arguably should be redetermined as of the asset contribution.
99 Cf. § 1.1502-32(e)(2), Ex. 2 (applying the anti-avoidance rule of § 1.1502-32(e)(1) to prevent tax avoidance by requiring a special allocation to a member's stock on the subsidiary's sale of built-in gain property contributed by the member); § 704(c)(1)(A) (providing for special allocations to the contributing partner of a partnership's gain or loss on its disposition of contributed built-in gain or loss property).
100 See § 1.337(d)-2T(c)(2) (for the definition of built-in gain). This example illustrates a case where the "mixing-bowl" effect of P's asset contribution would not require a redetermination of built-in gain. Because P sells all of its S stock in one transaction, its S stock in the aggregate reflects no built-in gain. If P were to sell the first block of stock before the second block, however, a redetermination would be necessary (at least absent a deferral or basis-redetermination rule like in Prop. § 1.1502-35) to prevent P from recognizing a non-economic loss. If built-in gain amounts must be redetermined to account for the mixing-bowl effect illustrated by this example, a netting rule would then be necessary. The regulations should clarify when (and how) a consolidated group must redetermine built-in gain amounts to account for the mixing-bowl effect of contributed, built-in gain assets.
101 Note that the anti-stuffing rule of § 1.337(d)-2T(e) should not apply, because P's stock gain and loss both resulted from the "stuff."
limit the circumstances when tracing is required, but that justification masks the larger concern --
that a "pure" tracing regime is fundamentally unadministrable.\footnote{102}

4. Possible alternatives to § 1.337(d)-2T

(a) Tracing with an opt-out

Instead of a "pure" tracing regime, Treasury might generally require tracing but allow a
group to opt out of tracing and take some portion of its stock loss under a regime like the old
LDR rule (i.e., a loss disallowance rule based on presumptions). The opt-out might be required
uniformly for all subsidiaries or electively for any subsidiary. If permitted electively for any
subsidiary, a group might be required to make the election when it acquires or disposes of the
subsidiary.

\footnote{102 We understand that Treasury has informally justified a netting rule because a group
could achieve \textit{de facto} netting by recapitalizing its stock interest in a subsidiary and taking a
blended or average basis in the subsidiary stock. That explanation may be misguided for two
reasons. First, it is far from clear that the recapitalization results in a blended basis. See \textit{Kraus v. 
Commissioner}, 88 F.2d 616 (2d Cir. 1937) (providing that if a taxpayer acquires a corporation's
stock at different times and different prices and exchanges that stock in a recapitalization, the
bases of that stock are not blended or averaged in computing the basis of the acquired stock).
\textit{See also Oscrow v. Commissioner}, 49 T.C. 333 (1968) (citing \textit{Kraus} with approval); \textit{Bloch v. 
Commissioner}, 148 F.2d 452 (9th Cir. 1945 (permitting the basis of blocks of stock received in
an acquisitive reorganization to be traced to the basis of transferred property). \textit{Cf. Arrott v. 
Commissioner}, 136 F.2d 449 (3d Cir. 1943); \textit{Commissioner v. Bolender}, 82 F.2d 591 (7th Cir.
1936); \textit{Commissioner v. Oliver}, 78 F.2d 561 (3d Cir. 1935); \textit{Commissioner v. Van Gunten}, 76
F.2d 670 (6th Cir. 1935); \textit{Helvering v. Stifel}, 75 F.2d 583 (4th Cir. 1935); \textit{Fleishmann v. 
Commissioner}, 40 B.T.A. 672 (1939), \textsl{acq.} 1940-1 C.B. 2 (each providing that stock acquired in
an acquisitive § 368 reorganization took a blended basis; each of these cases involved the timing
of gain or loss, not potential loss disallowance). \textit{Compare} § 1.358-2(c), \textit{Ex. 1} (arguably
consistent with a blended-basis result) \textit{with Rev. Rul. 85-164, 1985-2 C.B. 117 (concluding that
each share of stock received in a § 351 transaction had a fragmented holding period and basis,
reflecting the holding period and bases of the transferred assets; fragmentation was apparently
required to the extent it could affect future tax consequences).}

Second, even if a recapitalization blends basis, the anti-stuffing rule of § 1.337(d)-2T
typically should prevent recapitalizations from being used to achieve a netting effect in the
absence of a netting rule. The anti-stuffing rule applies, for example, when (i) an asset
(including stock) is transferred, (ii) subsidiary stock is sold within two years of the asset transfer,
and (iii) the asset transfer was with a view to avoid loss disallowance on the subsidiary stock. §§
1.337(d)-2T(e) and 1.1502-20(e)(2) (requiring a basis reduction in subsidiary stock to prevent the
avoidance of loss disallowance when the anti-stuffing rule applies). If a group recapitalizes a
subsidiary to achieve a netting effect and disposes of subsidiary stock within two years, it will
have transferred an asset with the prohibited view and the anti-stuffing rule should apply,
negating any netting effect.\footnote{26}
Some Comment Group members support an "opt-out" approach as a compromise that consolidated groups will accept, because it avoids the stigma of the old LDR rule -- automatically denying some groups a deduction for their economic loss. They find an "opt-out" approach administratively palatable, because they believe that few groups will attempt to trace.

Because the "opt-out" approach could limit the circumstances in which tracing is required, it has at least superficial appeal. However, most Comment Group members do not support such a regime. Most of us believe that careful groups (or at least those with sufficient means) would compare results under the tracing regime and the opt-out approach, choosing the approach that led to the greater after-tax benefit. Because most groups would likely choose to muck through the tracing quagmire, the same systemic administrability concerns would be presented as under the "pure" tracing regime, with the additional twist that the Service would be administering two regimes. Further, Treasury might need to adopt anti-avoidance rules to prevent groups from improperly qualifying for an opt-out alternative. Finally, if a group could adequately compare the tracing and opt-out alternatives, it would generally choose the better after-tax alternative, to the detriment of the fisc. For these reasons, most Comment Group members believe that the promise of an "opt-out" approach is largely illusory and should be rejected.

(b) **An anti-avoidance rule**

Section 1.337(d)-2T could be targeted solely at what may be the most problematic transaction, the "son of mirrors" transaction. This approach should be administrable if it is structured as an anti-avoidance rule keyed to a consolidated group's intent to quickly extract wanted target assets with stepped-up bases but at no net tax. However, an anti-avoidance approach would not implement the repeal of the *General Utilities* doctrine in an even-handed way, as consolidated groups would experience dramatically different tax results depending on their intent at the time a transaction was undertaken. There is also no indication that Congress intended to restrict the repeal of the *General Utilities* doctrine to groups that are trying to circumvent the repeal, while allowing other groups to eliminate (or effectively avoid) any tax cost on their recognized built-in gain.

(c) **A loss disallowance rule based on presumptions**

There remains only one viable candidate for avoiding the administrative burdens associated with a full-blown tracing approach -- a loss disallowance rule based on "mandatory presumptions," the model used for the old LDR rule. As under the old LDR rule, the new LDR rule could provide that any loss on subsidiary stock is allowed to the extent it exceeds the sum of several factors.\(^{103}\)

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\(^{103}\) *Cf.* § 1.1502-20(c)(1). *See also* S. Rep. No. 107-211 at 94, n. 188 (2002) (providing that the legislative response to *Rite Aid* authorizes consolidated group regulations "that protect the purpose of the General Utilities repeal using presumptions and other simplifying conventions"). *See supra* note 41 and accompanying text (for the proposed legislation).
We recognize that this model offers a Hobson's choice, because effective presumptions can never be precise enough to allow all economic loss. However, with the benefit of more than 10 years of use, the factors under the old LDR rule serve as a starting point that we believe can be refined to more closely target non-economic loss. As a result of the Service's concession in *Rite Aid*, the loss duplication factor of the old LDR Rule would, of course, be eliminated.

In addition, we suggest the following changes:

Positive investment adjustment factor. Among other factors, the old LDR rule considered "the positive adjustment (if any) with respect to each share of stock under § 1.1502-32 for each consolidated return year." In computing this factor, a group was permitted to net income and loss items within a consolidated return year but generally was not permitted to net a negative adjustment from one year against a positive adjustment from another year.

Treasury rejected netting negative and positive adjustments across years, because it was inconsistent with the repeal of the *General Utilities* doctrine, allowing groups the potential to offset post-acquisition loss against pre-acquisition built-in gain. Although netting across years in some cases might better measure economic loss, we believe this rule may be overbroad, as it was based on Treasury's view that it is "more appropriate to view the group's investment in subsidiary stock as an investment in its operations rather than its stock," a view that is not consistent with the result in *Rite Aid*.

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104 Thus, a consolidated group could be better off under a tracing regime, because its tax savings could exceed its added marginal cost to trace. However, if the added marginal cost to the government were factored into the mix, the balance would be less certain. In any case, on a system-wide basis, it seems almost certain that the total administrative cost of a full-blown tracing regime would far outstrip any aggregate tax savings.


106 § 1.1502-20(c)(1)(ii) (also providing that this amount was taken into account only to the extent it exceeded the extraordinary gain disposition factor for the year). See § 1.1502-20(c)(2)(ii) (providing that the positive adjustment for a year is the sum of the amounts under § 1.1502-32(b)(2)(i) through (iii) for the year, determined by including loss carryovers in the year they arise rather than the year they are absorbed); § 1.1502-32(b)(2)(i)-(iii) (providing adjustments for taxable income or loss, tax-exempt income, and noncapital, nondeductible expenses).

107 Cf. § 1.1502-20(c)(2)(v) (permitting netting across years for pre-September 13, 1991 tax years).


The old LDR rule's overbreadth creates unfairness in many cases, preventing groups from netting post-acquisition gain and loss (or pre-acquisition gain and loss). We believe that any "positive investment adjustment" factor should permit netting across years, because netting was already permitted within a single year and netting across years would more adequately balance the goal of permitting economic loss while protecting the repeal of the General Utilities doctrine.110

Even with netting, a "positive investment adjustment" factor might include post-acquisition gain. However, nothing short of tracing would allow a group to exclude all post-acquisition gain, and most of our Comment Group members find that alternative unadministrable. We believe that this factor, or one like it, is needed in a "mandatory presumption" system to account for built-in income.111 Although its adoption would impose a significant cost -- the disallowance of some economic loss -- most of our Comment Group members believe that there is no administrable alternative.

Extraordinary gain disposition factor. The old LDR rule also took into account income or gain, net of directly related expenses, from "extraordinary gain dispositions."112 These

110 See Schler, supra note 34 at 914 (advocating netting); Tax Section of the New State Bar Association, Comments on the Modified Loss Disallowance Regulations (1991) ("NYSBA Comments"), 91 TNT 27-32 (also advocating netting). An anti-stuffing rule like in § 1.1502-20(e)(2) could target a group's "stuff" of loss assets into a subsidiary to eliminate a net positive investment adjustment on subsidiary stock.

111 Although this factor is needed to account for built-in income, its adoption presumes that net positive adjustments are entirely attributable to pre-acquisition built-in gain. For the most part, this presumption becomes increasingly inaccurate, the longer a consolidated group holds subsidiary stock. Thus, net positive investment adjustments could be disregarded as a factor after the group held subsidiary stock for a certain period of time. See Schler, supra note 34 at 914 (noting this alternative and also noting that it could lead to abusive transactions). Cf. § 1374(a) and (d)(7) (applying built-in gain rules generally for a 10-year period).

To better account for post-acquisition income, net positive investment adjustments could be reduced by a "post-acquisition income" factor. The regulations could provide that a subsidiary's annual post-acquisition income equaled a stated percentage of its asset value. Cf. § 382(b) (for a similar computation). We reject this approach, because it inaccurately presumes that all businesses generate a steady stream of income and have the same rate of return and because it could require broad anti-avoidance rules to deal with stuffing and stripping transactions.

Finally, the regulations could provide for the recovery of pre-acquisition built-in gain based on an annual fixed schedule. Cf. §§ 168 and 197 (providing similar computations for the basis recovery for certain depreciable and amortizable assets). We also reject this approach. The approach would almost always be inaccurate, and it would require anti-avoidance rules requiring something akin to tracing to prevent abusive transactions.

112 § 1.1502-20(c)(1)(i).
"dispositions" included many asset sales, positive § 481(a) adjustments, and discharge of indebtedness. 113

If this factor is retained, it could be substantially narrowed. 114 First, this factor could generally disregard gain on an after-acquired asset, at least if subsidiary took a cost or fair market value basis in the asset when acquired. 115 Although these assets would have to be identified (and in that sense "traced"), this limited tracing should be administrable, since it avoids

113 § 1.1502-20(c)(2)(i) (providing that the asset dispositions included actual or deemed dispositions of any capital assets, § 1231(b) assets (determined without the holding period requirement), assets sold in a disposition of substantially all the assets of the same trade or business, and assets sold in a § 1060 disposition. Extraordinary gain dispositions were taken into account only if they occurred after November 19, 1990).

114 See NYSBA comments, supra note 113 (recommending elimination of this factor because it presumes, inappropriately, that all "extraordinary" gain is built-in gain while all "extraordinary" loss is post-acquisition loss). The "extraordinary gain disposition" factor would backstop the "positive investment adjustment" factor. If the latter factor can be computed by netting amounts across years, the "extraordinary gain disposition" factor arguably increases in importance, since the netting may make it more likely that post-acquisition loss can offset pre-acquisition built-in gain. Note that the "positive investment adjustment" and "extraordinary gain disposition" factors would have to be coordinated in some way to prevent double counting. Cf. § 1.1502-20(c)(1)(ii) (taking into account the "positive investment adjustment" factor for a year only to the extent it exceeds the "extraordinary gain disposition" factor for the year).

115 See Schler, supra note 34 at 914 (suggesting that this factor should be determined without regard to after-acquired assets); NYSBA comments, supra note 113 (also suggesting that this factor should be determined without regard to after-acquired assets; further suggesting that gain on capital or § 1231(b) assets should be extraordinary only if those assets are disposed of in a § 1060 transaction or, alternatively, as part of the disposition of substantially all the assets of the same trade or business). It is not always clear, however, how an after-acquired asset rule would apply to inventory.

Note that an after-acquired asset rule might not apply once a group's basis in subsidiary stock reflected built-in gain in the after-acquired asset. That reflection might occur, for example, if the after-acquired asset appreciated in value and the group then purchased newly issued subsidiary stock for cash or the subsidiary was the distributing corporation in an intragroup § 355 transaction.

As a corollary to an after-acquired asset rule, a subsidiary's assets generally could be disregarded if a group acquired all of the subsidiary's stock in a qualified stock purchase and made a § 338 election for the target. Because of that election, the group's basis in the subsidiary stock generally would not reflect any built-in gain as of the election's effective date. See Schler, supra note 34 at 914 (suggesting that subsidiaries purchased with § 338(h)(10) elections could be excluded from the "extraordinary gain disposition" rule). Any exceptions to an after-acquired asset rule should also apply to a § 338 corollary. Further exceptions may be needed to account for any subsidiary assets acquired in transferred-basis transactions (e.g., under § 351 or § 368), among other things.
valuations. Second, the factor could take cancellation of indebtedness income ("COD") into account only to the extent the group's basis in subsidiary stock is greater because of the discharge.116

**Limitation on overall disallowed loss.** Finally, if all subsidiary stock is purchased in one transaction, the aggregate disallowed loss for a subsidiary could be capped at the group's purchase price for the stock plus the subsidiary's liabilities at the time of the purchase.117 Although this limitation would likely be of use only to long-held subsidiaries, the relief would be appropriate, since any excess loss would likely be attributable to post-acquisition gain.118

**B. Guidance for past years -- §§ 1.1502-20T(i) and 1.1502-32T(b)(v)**

1. § 1.1502-20T(i) generally

For dispositions and deconsolidations before March 7, 2002, a group must apply one of the following three loss disallowance rules:119

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116 See NYSBA Comment, supra note 113 (making a similar suggestion and also suggesting that COD arising in the ordinary course should be disregarded). In many cases, this income is matched by the subsidiary's corresponding basis reduction under § 108(b) or § 1017, resulting in no net basis adjustment in the subsidiary stock. See § 1.1502-32(b)(3)(ii)(C) (treating discharge of indebtedness income as tax-exempt income) and (b)(3)(iii)(B) (treating a § 1017 basis reduction as a noncapital, nondeductible expense). See also § 1.1502-32(b)(2) (providing a positive adjustment for tax-exempt income and a negative adjustment for a noncapital, nondeductible expense). Under this standard, however, if an asset's basis is reduced under § 1017 and that asset is later disposed of, gain on that disposition (at least to the extent of the basis reduction) could be "extraordinary" gain, even if the asset is an after-acquired asset.117 See NYSBA Comment, supra note 113 (making this suggestion). The rule would also have to account for § 351 transfers to the subsidiary and acquisitive or divisive § 368 reorganizations involving the subsidiary, as well as economic burdens on the subsidiary that do not constitute liabilities for tax purposes. See Rev. Rul. 95-74, 1995-2 C.B. 36 (considering "contingent environmental liabilities"). Other commentators have suggested that disallowed loss for a purchased subsidiary be capped at the excess of (i) the purchase price for the subsidiary plus the subsidiary liabilities over (ii) the aggregate adjusted basis of the subsidiary’s assets. Treasury rejected this proposed rule, because "it would permit groups acquiring subsidiaries with built-in gain and built-in loss to circumvent the repeal of the General Utilities doctrine by selectively recognizing gross built-in gain in excess of net built-in gain." CO-93-90, 1990-2 C.B. 696, 699 (the preamble to proposed § 1.1502-20). We agree with Treasury's concern.118 See NYSBA Comments, supra note 113 (making this point). Cf. CO-93-90, 1990-2 C.B. 696, 700 (preamble to proposed § 1.1502-20, rejecting this approach because it "would generally provide relief only if the subsidiary is owned for a substantial period and would be inconsistent with the general approach of the revised rules, which is to phase out separate return treatment as the group and the subsidiary enjoy the benefits of consolidation").118 § 1.1502-20T(i)(2). This choice also must be made for any disposition or deconsolidation occurring on or after March 7, 2002 if "pursuant to a binding written contract
(i) The old LDR rule;

(ii) The old LDR rule applied without regard to the duplicated loss factor ("LDR Lite");¹²⁰ or

(iii) The new LDR rule.¹²¹

The old LDR rule applies, unless the group elects to apply one of the latter two rules.¹²² A group can make a different election for each transaction (although presumably only one election for all shares involved in a single transaction).

Calendar-year taxpayers must file these elections no later than September 15, 2003.¹²³ This filing requirement does not contemplate post-filing audit adjustments for the subsidiary that may affect which loss disallowance alternative is most advantageous for the group.¹²⁴ The

entered into before March 7, 2002, that was in continuous effect until the disposition or deconsolidation." Id. See supra note 44 (for the parallel effective date for § 1.337(d)-2T).¹²⁰

Thus, a group's disallowed loss on a share of subsidiary stock would equal the sum of extraordinary gain and positive basis adjustments for that share. See § 1.1502-20(c)(1)(i) and (ii).¹²¹

§ 1.1502-20T(i)(2).

¹²² The regulations describe the form of the election. The election must include a statement that identifies the name and employer identification number of the subsidiary and the members disposing of subsidiary stock (if any). The statement must also identify the applicable rule under which the allowable loss is determined. Id. at (i)(4). By appropriately filing this statement, the group is deemed to satisfy the requirement to file a "statement of allowed loss" under § 1.1502-20(c)(3) or § 1.337(d)-2T(c)(3). Id.

¹²³ Id. at (i)(4). More precisely, the election must be filed with --

(i) An original return that includes any date on or before March 7, 2002;

(ii) An original return that includes the date of the disposition or deconsolidation of the subsidiary stock; or

(iii) An amended return that includes the disposition or deconsolidation date if the amended return is filed before the due date (including any extensions) for the original return that includes March 7, 2002.

§ 1.1502-20T(i)(4) (also providing that an original return must be timely filed (including extensions)).¹²⁴

For example, suppose that a group sold subsidiary stock at a gain in 1999 but that a 2005 audit adjustment converted that gain to a loss. As the election scheme is currently constructed, the group could not elect to apply either the new LDR rule or LDR Lite but instead would have to account for the stock loss under the old LDR rule.
regulations should be modified to allow groups full recourse to the three loss disallowance alternatives after taking into account any post-2002 audit adjustments.\textsuperscript{125}

2. Rules to deal with newly available loss

If the group elects to use LDR Lite or the new LDR rule with respect to a disposition, but has filed a valid election to reattribute losses under § 1.1502-20(g),\textsuperscript{126} it may have to reduce the original reattributed loss amount. If the group elects to apply the new LDR rule, the reattributed amount is limited to the reattributed losses absorbed by the group in closed years.\textsuperscript{127} If the group elects to apply LDR Lite, the reattributed amount is limited to the greater of (i) the reattributed losses absorbed by the group in closed years or (ii) the loss otherwise disallowed under LDR Lite.\textsuperscript{128}

To the extent the reattributed losses are reduced, the losses become available to the disposed or deconsolidated subsidiary,\textsuperscript{129} and the regulations add several provisions to deal with the newly available loss. First, if the reattributed losses were subject to a § 382 limitation, the common parent may re-apportion the limitation between the group and subsidiary.\textsuperscript{130}

Second, if the subsidiary became a member of another consolidated group, the acquiring group may elect under § 1.1502-32(b)(4) to treat all or a portion of its increased losses as expiring for federal income tax purposes immediately before the subsidiary became a member.\textsuperscript{131} Without that election, the acquiring group would have to reduce its basis in the subsidiary stock if the increased loss expires unused.\textsuperscript{132}

\textsuperscript{125} As one possible amendment, the regulations could allow a group to make an appropriate election in its return for the year that included the date of any audit adjustments that could affect the group's allowed loss on subsidiary stock.

\textsuperscript{126} § 1.1502-20T(i)(3) (providing that a valid reattribution election must have been filed with the group's return for the year that included the disposition or deconsolidation; § 1.1502-20T does not extend the time to make the reattribution election).

\textsuperscript{127} Id. at (i)(3)(ii) (also providing that if there are no such losses, the reattributed amount must be zero). A closed year for this purpose is a "year[] for which the assessment of a deficiency is prevented by any law or rule of law as of the date the election to apply [the new LDR rule] is filed and at all times thereafter". Id. at (i)(3)(ii)(B).

\textsuperscript{128} Id. at (i)(3)(i). A closed year for this purpose is a "year[] for which the assessment of a deficiency is prevented by any law or rule of law as of the date the election to apply [LDR Lite] is filed and at all times thereafter". Id. at (i)(3)(i)(B).

\textsuperscript{129} Id. at (i)(3)(vii) (also providing that the revised reattribution is binding on the subsidiary and any group of which the subsidiary becomes a member).

\textsuperscript{130} See id. at (i)(3)(iii) (for the re-apportionment of § 382 limitations).

\textsuperscript{131} § 1.1502-32T(b)(4)(v) (providing for this election if the group elects under § 1.1502-20T(i)(2) to apply the new LDR rule or LDR Lite).

\textsuperscript{132} § 1.1502-32(b)(3)(iii) (providing that the expiration of a loss is treated as a noncapital, nondeductible expense); id. at (b)(2)(iii) (providing a negative adjustment for noncapital, nondeductible expenses). Cf. id. at (b)(4)(ii) (providing that if a subsidiary's loss carryover is
An acquiring group is deemed to make this election to the extent that the increased loss would have expired or been used by the group in a closed year.\textsuperscript{133} Although this deemed election generally helps groups, it may also eliminate a potential benefit: an increased loss could be used in a closed year but free up another loss that would be carried to an open year. The regulations should be amended so that a group can override the deemed election and preserve that benefit.

3. The "basis-bump" rule

The regulations also provide a "basis-bump" rule that applies if a group elects the new LDR rule or LDR Lite, the election increases the loss that the group could take into account on its disposition of subsidiary stock, but the added loss is one that "would have properly been absorbed or expired" in a closed year.\textsuperscript{134} If the group's basis in the stock of a higher-tier subsidiary was "reduced" under § 1.1502-32 to account for the disallowed loss under § 1.1502-20, its basis in that stock "may be increased [to the extent of the newly allowed loss] for purposes of determining the group's or shareholder-member's Federal income tax liability in all years for which a refund of overpayment is not prevented by law or rule of law."\textsuperscript{135}

Example 11 -- "Basis-bump" rule

P, S, and T are members of a consolidated group. P owns all S stock with a $200 basis, and S owns all T stock with a $100 basis.

In 1991, S sells the T stock for $80, recognizing a $20 loss which is disallowed under the old LDR rule. Because of the disallowance, P reduces its basis in the S stock by $20, from $200 to $180.\textsuperscript{136} In 2002, the P group elects the new LDR rule for S's sale of the T stock. Under the new LDR rule, the group could take into account the entire $20 loss, but

\textsuperscript{133} § 1.1502-32T(b)(4)(v)(A) (providing for this deemed election if the group elects under § 1.1502-20T(i)(2) to apply the new LDR rule or LDR Lite). A closed year for this purpose is a "year for which the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which [the subsidiary] receives the notification" of the reattributed loss. \textit{Id.}

\textsuperscript{134} § 1.1502-20T(i)(3)(v)(B). For this purpose, a closed year is a year for which a refund of overpayment is prevented by law. \textit{Id.}

\textsuperscript{135} \textit{Id.} (emphasis added).

\textsuperscript{136} § 1.1502-32(b)(2)(iii) and (3)(iii)(A) (providing a negative adjustment for non-capital, non-deductible expenses).
the group would have absorbed the loss in 1991, which is now a closed year. Under the "basis-bump" rule, P's basis in its S stock apparently "may" be increased by $20.137

The rule arguably promotes horizontal equity by giving groups like the P group the benefit of a more relaxed loss disallowance regime, putting them more on par with groups that recognize the extra stock loss in (or can carry it to) an open year. Nevertheless, the rule may be both underinclusive and overinclusive.

It may be underinclusive, because it fails to benefit groups whose extra stock loss expires unused in an open year before 2002. Such a group presents as compelling a case as the P group in Example 11, since it is too late for the group to generate capital gain that could be offset by the loss.138

Note as well that the "basis-bump" rule applies only if a "member's basis in stock of a subsidiary is reduced pursuant to § 1.1502-32" because of disallowed loss.139 If the quoted language was narrowly construed, the basis-bump rule would be underinclusive, since it would not apply when the group's basis in subsidiary stock stayed the same or increased, despite the disallowed loss.

Example 12 -- Reduction requirement
P, S, and T are members of a consolidated group. P owns all S stock with a $200 basis, and S owns all T stock with a $100 basis.

In 1991, S sells the T stock for $80, recognizing a $20 loss which is disallowed under the old LDR rule. In 1991, S also has $20 of gross income.140 Because of the $20 income and $20 loss disallowance, P's basis in its S stock remains at $200. In 2002, the P group elects the new LDR rule for S's sale of the T stock. Under the new LDR rule, the group could take into account the entire $20 loss, but the group would have absorbed the loss in 1991, which is now a closed year. If strictly construed, the "basis-bump" rule does not apply, because P did not "reduce" its basis in the S stock because the loss was disallowed.141

137 Cf. § 1.1502-32(b)(3)(ii)(D) (treating certain basis shifts as tax-exempt income). By stating that the basis "may" be increased, the regulations raise a number of questions. Does the Service have the option to deny the basis increase? Under what circumstances, if any, would the Service deny the increase? If the Service cannot deny the increase, is it elective on the part of the group?

138 If the loss can be carried to 2002 or a later year, a group might have that opportunity, which arguably justifies excluding those groups from the "basis-bump" rule.

139 § 1.1502-20T(i)(v)(B) (emphasis added).

140 Thus, the facts in Example 12 are the same as in Example 11 except that in Example 12 S has $20 of gross income in 1991.

141 See § 1.1502-32(b)(2) (providing a basis adjustment for the "net" amount of a subsidiary's positive and negative items). Under a broader construction, the "basis-bump" rule should apply, because P "reduces" its basis in S stock for every negative item (and "increases" that basis for every positive item) that it takes into account in computing its net adjustment for
The "basis-bump" rule should apply in Example 12, and the rule should be clarified to assure that it applies in similar cases.142

The rule may also be overinclusive, because it can apply even if the group benefits from the stock loss.

Example 13 -- Rule applies despite benefit

P, S, and T are members of a consolidated group. P owns all S stock with a $200 basis, and S owns all T stock with a $100 basis.

In 1991, S sells the T stock for $80, recognizing a $20 loss which is disallowed under the old LDR rule. Because of the disallowance, P reduces its basis in the S stock by $20, from $200 to $180. In 2002, the P group elects the new LDR rule for S's sale of the T stock. Under the new LDR rule, the group could take into account the entire $20 loss, but the group would have absorbed the loss in 1991, which is now a closed year. Because of that stock loss, however, the P group carries forward another loss to an open year, absorbs that loss, and receives a tax refund.143 Under the "basis-bump" rule, P's basis in its S stock apparently "may" be increased by $20, so that P benefits from the stock loss without a downward basis adjustment to account for the loss.144

the S stock. But cf. § 1.1502-20(c)(2)(iii) (addressing a similar issue for positive items but providing that the share's basis must be "different" than it would have been, not that it must have been "increased").

Treasury could clarify the regulations as follows. First, the introductory language in § 1.1502-20T(i)(3)(v)(B) could be revised to read as follows:

If a member's basis in stock of a subsidiary reflects a loss with respect to stock of a lower-tier subsidiary that was treated as disallowed under § 1.1502-20, then . . .

Second, the following sentence could be added at the end of § 1.1502-20T(i)(3)(v)(B):

A loss is reflected in the basis of subsidiary stock to the extent that the basis would have been greater without the loss.

Cf. § 1.1502-20T(i)(3)(v)(B) (containing a similar definition of "reflected").

See § 1.1502-20T(i)(3)(v)(A) (amended by T.D. 8998 to provide that these "cascading" losses could be used). The facts in Example 13 are the same as in Example 11, except that in Example 13 the extra stock loss results in the carryover of another loss to an open year.

The basis-bump rule merely requires that the loss in question "would have been properly absorbed or expired" in a closed year; it appears to apply to any such absorbed loss, even if that absorption results in the carryforward of a tax attribute to an open year. Cf. § 1.1502-32(a)(2) (preventing duplicate basis adjustments under § 1.1502-32 and other rules of law).
The "basis-bump" rule should not apply in Example 13, and the regulations should clarify that the rule does not permit duplicate loss.

4. The preamble concession

The preamble to T.D. 8998 (i.e., the May 21, 2002 amendment to the new LDR rule) states that --

taxpayers determining allowable loss under § 1.1502-20 in its entirety [i.e., groups not electing LDR Lite or the new LDR rule] will generally be treated as having satisfied the requirement to file a statement of allowed loss otherwise imposed under § 1.1502-20(c) even if no such statement is filed.145

Because of this preamble language, it appears that a group can apply the old LDR rule whether or not it filed the statement of allowed loss literally required by § 1.1502-20(c)(3).146

Because of that language, a group may increase its allowed loss on the disposition of subsidiary stock, but that increase may arise in a closed year. That increased loss raises the following questions which the regulations should address:

(i) If it now appears that such a loss could have been claimed in a prior year, the loss year is closed, but a carryforward year is open, can the loss be claimed in the carryforward year? If so, how should the group document any claim for the loss?

(ii) If the year that the loss would be used is closed but the use of that loss would have resulted in the carryforward of another loss to an open year, can the carryforward of the other loss be utilized?

(iii) Can the "basis-bump" rule apply to such a loss?147

The preamble language may also affect an acquiring group, perhaps adversely. Because of that language, a selling group may increase its allowed loss on its disposition of a subsidiary and thereby reduce the amount of any loss reattributed from the subsidiary.148

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146 It is probably the rare case, however, where this statement was not filed.
147 Cf. § 1.1502-20T(i)(3)(v)(A) (clarifying that if the new LDR rule or LDR Lite is adopted, any resulting increased loss from a closed year may be carried forward and also clarifying that a "cascading" loss may be used; a similar rule was not added for any increased loss under the old LDR rule); id. at (i)(3)(v)(B) (providing a "basis-bump" rule for certain increased losses under the new LDR rule or LDR Lite; a similar rule was not adopted for increased loss under the old LDR rule).
148 If a selling group reduces the loss it reattributed from a subsidiary because of the preamble concession, it should be required to notify the subsidiary (and any acquiring common parent) of the recomputed, reattributed loss. Cf. § 1.1502-20T(i)(3)(iv) (requiring such
consequence, the subsidiary's available loss immediately after its disposition may increase, but that increased loss may expire unused, reducing the acquiring group's basis in its subsidiary stock.149 Because the acquiring group may be unable to use the increased loss, it should be able to waive that loss (and avoid the basis penalty). Section § 1.1502-32T(b)(4)(v) should be amended to permit that waiver.

5. Other issues

We commend Treasury for a quick and decisive response to problems raised by Rite Aid for past years. However, we caution that the response may not stop all litigation challenging the old LDR rule, even assuming that Rite Aid's reach is limited to § 1.1502-20. A seller may prefer the new LDR rule over the old LDR rule, elect to apply the new LDR rule, but still pursue litigation, challenging the validity of the old LDR rule and arguing that it is simply too late to apply a tracing regime (i.e., the new LDR rule) to prior periods. Even if the seller is content to apply the old LDR rule because it has reattributed the target's losses, a buyer may challenge the old LDR rule under Rite Aid to limit (or eliminate) the reattribution of loss. It is not clear whether legislation or new regulations could forestall those challenges.

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149 See supra note 132 (for the authorities requiring the basis reduction).