The Honorable John A. Koskinen  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20024

Re: Comments on Proposed Regulations Addressing Elimination of Circular Adjustments to Basis

Dear Commissioner Koskinen:

Enclosed please find comments on proposed regulations addressing elimination of circular adjustments to basis (“Comments”). These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

William H. Caudill  
Chair, Section of Taxation

Enclosure

cc: William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service  
Robert H. Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service  
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
Dana L. Trier, Deputy Assistant Secretary (Tax Policy), Department of the Treasury  
Thomas West, Tax Legislative Counsel, Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Addressing Elimination of Circular Adjustments to Basis

These comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Donald W. Bakke, Chair of the Section’s Affiliated and Related Corporations Committee (the “Committee”), with significant assistance from Peter A. Richman. Substantive contributions were made by Jasper L. Cummings, Jr., Andrew J. Dubroff, Elliot Freier, Don Leatherman, and Wade Sutton. The comments were reviewed by Jay Singer, the immediate past Committee Chair, R. David Wheat, the Council Director for the Committee, Bryan P. Collins, former Committee Chair and member of the Section’s Committee on Government Submissions, and Julian Y. Kim, the Section’s Vice-Chair (Government Relations).

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

Contact: Donald W. Bakke
(202) 327-6103
donald.bakke@ey.com

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I. EXECUTIVE SUMMARY

These Comments address a Notice of Proposed Rulemaking issued on June 11, 2015, providing guidance regarding the absorption of a consolidated return member’s losses in a consolidated return year that involves a disposition of the stock of the member (the “Proposed Regulations”). The Proposed Regulations would provide guidance to eliminate the so-called “circular basis” problem in a broader class of transactions than under the current rules of Regulation section 1.1502-11.

We commend the Internal Revenue Service (the “Service”) and the U.S. Department of Treasury (the “Treasury”) for their detailed consideration of issues in the Proposed Regulations. The purpose of the Comments is to identify aspects of the Proposed Regulations that raise tax policy concerns, including those of complexity. Our recommendations are intended to make the circular basis regime operate as simply as possible without facilitating abuse.

We make the following major recommendations, primarily in the interests of mitigating complexity and thus improving administrability:

1. We recommend that, for most subsidiary dispositions, final Regulations preclude any absorption of loss attributable to the subsidiary (“S”) in the disposition year, but retain our suggested changes to the Proposed Regulations to address certain dispositions where S remains related to the common parent of the group (“P”).

2. We also recommend that final Regulations eliminate steps two and three from the alternative computation of Proposed Regulation section 1.1502-11(b)(2)(iii)(B), if retained in final regulations.

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2 Unless otherwise indicated, all references herein to “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and all references to Regulations are to Treasury Regulations issued pursuant to the Code.
II. SUMMARY OF PROPOSED REGULATIONS

A. Background

Historically, as a result of the consolidated return investment adjustment system in Regulation section 1.1502-32 (the “investment adjustment system”), if a consolidated group absorbed a portion of a subsidiary’s loss in the same consolidated return year in which a disposing member disposed of that subsidiary’s stock, the disposing member generally reduced its basis in the subsidiary’s stock by the absorbed loss immediately before the disposition. This adjustment represents a fundamental feature of the investment adjustment system, whose purpose is to treat P and S as a single entity so that consolidated taxable income reflects the group’s income.” But the application of the investment adjustment system—which could impact the amount of the disposing member’s gain or loss on the disposition—could, in turn, impact the amount of the subsidiary’s loss that the group absorbed. Any further absorption of the subsidiary’s loss could trigger further adjustments to the disposing member’s basis in the subsidiary’s stock. These iterative computations are referred to as the “circular basis problem.”

As an example, assume a consolidated group consists of P and its wholly owned subsidiary S. The group has a $100 consolidated net capital loss carryover solely attributable to S. At year end, P sells all of the S stock to a nonmember and realizes $10 of capital gain. Without the circular basis rules described below, this $10 capital gain would be offset by $10 of the consolidated net capital loss carryover. The absorption of $10 of the loss would reduce P’s basis in the S stock by $10 immediately before the sale, causing P to recognize $20 of gain on the sale of its S stock. Similarly, that $20 gain would be offset by $20 of the consolidated net capital loss carryover, and so on, with a series of iterative stock basis adjustments continuing to be made until S’s entire net capital loss carryover is depleted.

Current Regulation section 1.1502-11(b), issued in 1972 and revised in 1994 (the “circular basis rules”), seeks to prevent these iterative computations by providing for a tentative computation of consolidated taxable income (“CTI”) without taking into account any gain or loss on the disposition of the subsidiary’s stock. The amount of the subsidiary’s losses that would be absorbed under the tentative computation then becomes a limitation on the amount of that subsidiary’s losses that may be absorbed, either in the consolidated return year of disposition or as a carryback to a prior year (the “absorption limitation”). Losses of other members of the consolidated group can be absorbed against gain from the disposition of the subsidiary’s stock without limitation. To the extent the disposed subsidiary’s deductions and losses in the year of disposition cannot offset income or gain because of the circular basis rules, the items are carried to other years as if they were the only items incurred by the subsidiary in the year of disposition.

To illustrate, assume at the beginning of the consolidated return year P has a $500 basis in the stock of wholly owned S, P sells the S stock for $520 at year end, and the P consolidated group has no income in prior years for absorption of any loss carryback. P has $30 of ordinary

3 Unless otherwise noted, our discussion herein will incorporate the nomenclature of the Proposed Regulations. Thus, references to “S” are to the subsidiary whose stock is being disposed.

4 Reg. § 1.1502-32(a)(1).
income for the year that is unrelated to the disposition of S stock and S has $80 of ordinary loss. Under a tentative computation of CTI excluding gain on the disposition of the S stock, $30 of S’s losses would be absorbed. P thus reduces its basis in its S stock to $470 immediately before the disposition, resulting in $50 of gain ($520 – ($500 - $30)) to P on the disposition. S’s remaining $50 of loss is treated as a separate net operating loss (“NOL”) attributable to S. Because S ceases to be a member, the loss is apportioned to S under Regulation section 1.1502-21 and carried to its first separate return year. As described below, however, the circular basis rules do not address all circumstances where iterative computations may be required.

B. Overview of Proposed Regulations

The Proposed Regulations were published in the Federal Register on June 11, 2015. The preamble to the Proposed Regulations (the “Preamble”) notes that, although current Regulation section 1.1502-11(b) prevents iterative computations for many taxpayers, it does not solve the circular basis problem in all cases. Specifically, the circular basis problem remains in certain fact patterns, including those where less than all of the disposed subsidiary’s absorption limitation is actually absorbed as a result of the losses of a member other than the disposed subsidiary.

As an example, assume a consolidated group consists of P and its wholly owned subsidiaries S1 and S2. At the beginning of the consolidated return year, P has a $500 basis in its S1 stock and P sells all of the S1 stock for $500 at year end. For the year, P has a $60 capital gain (determined without taking into account P’s gain or loss on the disposition of its S1 stock), S1 has a $40 net capital loss, and S2 has an $80 net capital loss. The group’s tentative computation of CTI excludes P’s gain or loss on the disposition of the S1 stock but includes S1’s and S2’s net capital losses. Accordingly, assuming a pro rata absorption of losses, $20 of S1’s loss ($60 x [$40/$120]) and $40 of S2’s loss ($60 x [$80/$120]) will be absorbed. The group’s absorption of S1’s loss is thus limited to S1’s $20 absorbed amount and P’s basis in its S1 stock is reduced by $20 immediately before P disposes of the stock. Therefore, P recognizes $20 ($500 – ($500 - $20)) of gain on the disposition of its S1 stock, which leaves P with a total capital gain for the year of $80. Because S2 has an $80 loss in addition to S1’s capital loss ($80 x ($20/$100)), that amount is less than the $20 amount determined in the tentative computation and P would need to adjust its pre-disposition basis adjustment in its S1 stock accordingly. In this regard, iterative computations are required and the circular basis problem persists.

The Preamble states that the Proposed Regulations “would provide relief and certainty to cases in which the circular basis problem persists, yet adhere to underlying consolidated return

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5 This example illustrates the need for iterative calculations in a scenario with multiple disposed subsidiaries. However, the circular basis problem can arise even in the disposition of a single subsidiary (S) where, for example, S’s capital loss is less than P’s capital gain (determined without regard to P’s gain or loss on the disposition of the S stock).
concepts without undue complexity.” Although the Preamble does not provide further explicit discussion on this point, as discussed below, the Proposed Regulations reflect an apparent policy premise that it is important for the consolidated group to utilize a fixed amount of losses of a disposed subsidiary (what we refer to as the “Loss Utilization Policy”).

C. Absorption Rule

As a threshold matter, and wholly separate from the circular basis problem, the Proposed Regulations also would provide an explicit rule addressing the absorption of both ordinary losses and capital losses. In the case of ordinary losses, the proposed rule provides that, if the group has a consolidated NOL for a consolidated return year (a “CNOL”), the amount of each member’s separate NOL (within the meaning of Regulation section 1.1502-21(b)(2)(iv)(B)(1)) for such year that offsets the income or gain of other members is determined on a pro rata basis under the principles of Regulation section 1.1502-21(b)(2)(iv). For example, if, for the consolidated return year, P and S1 have separate NOLs of $60 and $30, respectively, and S2 (the only other member of the P group) has $21 of income, $14 of P’s NOL and $7 of S1’s NOL offset S2’s $21 of income and are absorbed in the year. This absorption methodology is consistent with current law.

In addition, the Proposed Regulations would provide that if the group has a consolidated net capital loss for a consolidated return year and any member has capital gain net income for the year (taking into account only its capital gains and losses), then the amount of each member’s capital loss that offsets the sum of the capital gain net income of other members (computed separately for each member) is determined on a pro rata basis under the principles of Regulation section 1.1502-21(b)(2)(iv). For purposes of this new proposed rule regarding capital loss absorption, the Proposed Regulations also provide that the character of each member’s gains and losses is first determined on a consolidated basis, in accordance with Regulation sections 1.1502-22 and 1.1502-23.

D. Elimination of Circular Basis Adjustments

The Proposed Regulations generally require that in the consolidated return year in which a group disposes of a subsidiary, the group must determine the amount of the subsidiary’s loss that will be absorbed (the “absorbed amount”). This is similar to the absorption limitation of current Regulation section 1.1502-11(b)(2)(i), but in computing the absorbed amount under the Proposed Regulations, no income, gain, deduction or loss from any member’s disposition of any share of subsidiary stock is taken into account (whereas the current rule disregards only “P’s income and gain from the disposition”). However, in situations where less than all of the disposed of subsidiary’s absorbed amount would be actually absorbed, the Proposed Regulations provide for a four-step alternative computation of the group’s CTI (the “Alternative


Reg. § 1.1502-11(b)(2)(i).
Computation”). The Alternative Computation generally seeks to avoid iterative computations by placing a priority on the absorption of the losses of the disposed subsidiary before the absorption of losses of other members.

**Step One:** Under the Alternative Computation, any gain or loss resulting from a disposition of the stock of any subsidiary is excluded from the tentative computation of CTI and the group absorbs the disposed subsidiary’s losses in an amount and character corresponding to the disposed subsidiary’s absorbed amount (i.e., the absorption limitation in the current Regulations would be modified to become the actual amount absorbed).

**Step Two:** A disposing member offsets its gains and losses on the disposition(s) of subsidiary stock (determined after applying the unified loss rule of Regulation section 1.1502-36 (the “ULR”), including the effect of any actual election under Regulation section 1.1502-36(d)(6)). If the disposing member has net income or gain on the subsidiary stock, and if the disposing member also has a loss of the same character (other than a loss on subsidiary stock), then the disposing member’s loss is absorbed to offset the net income or gain on the subsidiary stock. Any remaining net income or gain is added to the group’s remaining income or gain as determined under Step One.

**Step Three:** If the group has remaining income or gain and a disposing member has a net loss on subsidiary stock (determined after applying the ULR, including the effect of any actual election under Regulation section 1.1502-36(d)(6)), then such income or gain is then offset by the loss on the disposition of the subsidiary stock. The offset is limited to the lesser of the total remaining ordinary income or capital gain of the group (determined after the application of Step Two) or the amount of the disposing member’s ordinary income or capital gain (determined without regard to stock loss). If the offset limitation applies to more than one disposing member, and the sum of the disposing members’ net losses exceeds the group’s remaining ordinary or capital gain, then the amounts offset capital gain or ordinary income on a pro rata basis.

**Step Four:** If the group has remaining income or gain, then the unused losses of all members are applied on a pro rata basis. To the extent the disposed subsidiary’s losses for the disposition year are not fully absorbed, the subsidiary ceases to be a member of the consolidated group, and the subsidiary’s losses are not reattributed under Regulation section 1.1502-36(d)(6), the losses are carried over to its separate return year.

Example 5 of the Proposed Regulations illustrates this four-step methodology. In the example, a consolidated group consists of P and its wholly owned subsidiaries S, M1, and M2. P has a $200 basis in its S stock and sells all of its S stock to an unrelated person for $100 at year end. For the year, P has $10 of capital gain on portfolio stock, S has a capital loss of $60, M1 has capital gain of $50, and M2 has a capital loss of $30. To determine S’s absorbed amount, the group’s CTI is computed without taking into account P’s gain or loss on the disposition of the S stock.

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Accordingly, S’s capital loss would offset $40 (60 x [60/90]) of the group’s $60 capital gain and S’s absorbed amount is $40. This $40 absorbed amount would reduce P’s basis in its S stock to $160 and P would recognize a capital loss of $60 on the sale of its S stock ($100 - $160). Under the generally applicable rules, in the actual computation of CTI, M1’s $50 of capital gain would be offset pro rata by P’s $50 capital loss ($60 of capital loss on the sale of its S stock plus $10 capital gain), S’s $40 capital loss (equal to its absorbed amount), and M2’s $30 capital loss. However, this would lead to $16.50 (50 x [40/120]) of S’s loss being absorbed – an amount less than all of S’s $40 absorbed amount. Therefore, the group’s CTI would instead be determined under the Alternative Computation.

Under the Alternative Computation, S’s $40 capital loss (the amount and character of S’s absorbed amount) first offsets $40 of the $60 capital gain (P’s $10 plus M1’s $50, determined without taking into account any gain or loss on P’s disposition of its S stock and without regard to M2’s capital loss) generated by other members. Because P has no net stock gain, Step Two of the Alternative Computation does not apply. Under Step Three, $10 (the amount of P’s capital loss on the disposition of its S stock limited by the amount of P’s capital gain) of P’s capital loss offsets the group’s $20 remaining capital gain. Under Step Four, capital losses of members other than S offset the group’s remaining $10 of capital gain on a pro rata basis.

The Proposed Regulations would also remove the requirement that, where S is a higher-tier subsidiary of another subsidiary (T), 100% of T’s items of income, gain, deduction, and loss be reflected in the basis of S’s stock in the hands of the disposing member in order for the circular basis rules to apply upon a disposition of S stock. Accordingly, the circular basis rules would apply to T if S owns less than 100% of the stock of T. In addition, the Proposed Regulations would provide that if a member’s deductions are determined by reference to or are limited by the consolidated group’s CTI (e.g., the consolidated charitable contributions deduction), then the amount of those deductions is determined without regard to gain or loss on the disposition of a subsidiary’s stock. The Proposed Regulations would also make a number of other conforming changes.

The Proposed Regulations would generally apply to dispositions of subsidiary stock occurring in consolidated return years that begin on or after the date on which the Proposed Regulations are finalized.\(^\text{12}\)

III. DISCUSSION

A. Introduction

As an initial matter, and wholly apart from the circular basis problem, we commend Treasury and the Service for proposing an explicit absorption rule of general application, as set forth in Proposed Regulation section 1.1502-11(e).\(^\text{13}\) As discussed more fully below in the context of the circular basis problem, however, we recommend that further consideration be

\(^{12}\) Prop. Reg. § 1.1502-11(b)(3), (c)(7), and (e)(3).

given to the role of holding period in the case of capital items, for purposes of an absorption rule of general application. As for the circular basis problem, the Proposed Regulations represent the latest installment in regulatory attempts to deal with the problem, at least some aspects of which have challenged both taxpayers and the government for decades. We commend Treasury and the Service for tackling this issue and offer our recommendations below for incorporation into final Regulations. The comments that follow represent concerns we believe are raised by the circular basis problem generally, as well as the Proposed Regulations in particular, with specific attention to the issue of complexity. We also focus our comments on what we understand to be the policy premise of the Proposed Regulations.

B. Complexity in the Federal Tax System

Because many of our comments below with respect to the Proposed Regulations relate to complexity, the following is an introduction to the more particular issues of complexity within the circular basis rules.

The issue of tax complexity has received increased attention in recent years, including from the Joint Committee on Taxation, which has noted that, among other things, complexity within the federal tax system leads to decreased levels of voluntary compliance. But complexity within the federal tax system is not a new issue: Judge Learned Hand famously remarked about the “inordinate” amount of time and concentration required on his part to understand the internal revenue laws. That was in 1947, when Judge Hand was commenting on the Internal Revenue Code of 1939. It seems safe to say that since then, the investment of time that is required on the part of taxpayers or their representatives to understand the tax law – or, a particular Regulation – has only increased, if not from the sheer volume of pages added to the Code and Regulations in the interim, then also from the promulgation of Regulations that continue to add additional layers of abstraction to an already complex system.

But complexity in the tax system has never been simply a function of complex, abstract rules. Another type of complexity can be computational (i.e., the quantitative skills required or implied by the tax law). The U.S. Supreme Court weighed in on computational complexity even earlier than Learned Hand’s comments on interpretational complexity. In Edwards v. Slocum, the Court considered the computation of an estate tax. At issue was whether, in the computation of the residual net taxable estate, tax-effect should be given to deductions for charitable


15 “In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross reference to cross- reference, exception upon exception -- couched in abstract terms that offer no handle to seize hold of -- leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.” Learned Hand, Thomas Walter Swann, 57 Yale L.J. 167, 169 (1947).
bequests.\textsuperscript{16} The taxpayer had asserted that no special adjustment was in order, based upon a relatively straightforward reading of the rules, while the government had averred that the tax-effect could be determined and was required, and offered an algebraic formula as evidence of how it could be effected.\textsuperscript{17} Justice Holmes, writing for the Court, rejected the government’s “algebraic formula by which it would solve the problems raised by two mutually dependent indeterminates.”\textsuperscript{18} The Supreme Court further quoted, approvingly, from the Second Circuit Court of Appeals that “[a]lgebraic formulae are not lightly to be imputed to legislators.” The Court agreed with the taxpayer on the underlying issue and affirmed the lower court. (It is worth noting that the Service responded by issuing Supplemental Instructions for Form 706 for Computation of Interrelated Death Taxes and Marital or Charitable Deductions offering a variety of methods for determining tax liability when there are “mutually dependent indeterminates.”)

C. Concerns with the Proposed Regulations

i. Complexity: General Rule

We recognize that the circular basis rules occupy a relatively small amount of space in the overall federal tax system, and by no means are we suggesting that the circular basis rules are one of the greatest contributors to complexity in the system.\textsuperscript{19} But we do believe that growing complexity within the consolidated return rules should be a concern for both taxpayers and the government, and that more consideration should be given to this issue, especially from the perspective of a non-specialist.

The consolidated return rules are already quite complex. As a summary, if a taxpayer disposes of subsidiary stock, in order to apply the circular basis rules, the taxpayer (or their representative, or the government, for that matter) must have at least a basic understanding of the following: (i) general federal tax principles, including the character of items as capital or non-capital; (ii) general consolidated return principles, including computation of CTI; (iii) the investment adjustment system; (iv) the ULR; and, finally, (v) loss absorption principles, and related calculations of the circular basis rules.

We respectfully submit that the Proposed Regulations are adding unnecessary complexity to what is already a complex area, namely the determination of stock basis in a subsidiary member in its year (or years) of disposition, and particularly in those cases in which the ULR applies. While consolidated returns are already a highly specialized area of the tax law, adopting the Proposed Regulations in their current form only increases the need for specialization. Thus, our comments are meant to represent the viewpoint of a person – whether representing a taxpayer or the government – —who is reasonably well-versed with consolidated return


\textsuperscript{17} See Edwards v. Slocum, 287 F. 651, 654 n. 1 (2d Cir. 1921).

\textsuperscript{18} Edwards, 264 U.S. at 61

\textsuperscript{19} See also Temp. Reg. § 1.861-12T(j), Ex. (2) (illustrating the optional use of a quadratic formula to compute excess related-party indebtedness of a controlled foreign corporation).
principles, but not necessarily a specialist. We believe that such a person should not be required to undertake a relatively “inordinate expenditure of time” to understand and apply the circular basis rules.

There are multiple sources of complexity in the Proposed Regulations.

First and foremost, the Proposed Regulations involve numerous specialized calculations that are outside of – or an additional layer upon – the basic investment adjustment calculations, as well as the ULR calculations. This is particularly the case if the taxpayer is evaluating a variety of alternative scenarios given the various elections that are available in the ULR. The Preamble appropriately recognizes that, under current law, given the ability, if not the need, to resort to the use of quadratic equations in addressing more complex disposition scenarios, currently applicable rules should be simplified.\(^\text{20}\) Indeed, the Preamble recognizes the problem of complexity, stating that the Proposed Regulations “would provide relief and certainty to cases in which the circular basis problem persists, yet adhere to underlying consolidated return concepts without undue complexity.”\(^\text{21}\) Although we commend Treasury and the Service for the attempt to reduce complexity through the Proposed Regulations, we respectfully submit that those regulations nevertheless are significantly more complicated than necessary to address the circular basis problem.

By asserting that the Proposed Regulations are “complicated,” we do not mean to suggest that the rules are beyond the understanding of taxpayers or their representatives, but instead only that the Proposed Regulations require numerous rounds of computations (which also increase the prospect of error). And particularly in light of the Alternative Computation (discussed in more detail below), this makes the rules difficult for taxpayers and the government to administer and apply. In this regard, the complexity of the Proposed Regulations would seem to undermine their stated purpose. What is more, while the complexity can arise from the disposition of a single subsidiary at the end of the group’s taxable year, the computational burden only increases where there is more than one subsidiary disposition and/or where the dispositions occur at various times during the year. (Interestingly, all of the examples in the Proposed Regulations posit dispositions of S stock that occur at the end of the group’s taxable year). In most situations that will be encountered by taxpayers this will not be the case – the transaction at issue will involve multiple subsidiary and/or mid-year dispositions. In addition, another significant source of complexity under the Proposed Regulations is their interaction with the ULR. Admittedly, this is an issue that already exists under the current regulations, but it would appear to be exacerbated by the additional computations required under the Proposed Regulations. Finally, it is worth considering simply the number of computational steps required for the disposition of a single subsidiary, illustrated, at least in part, by Example 11 of the Proposed Regulations.\(^\text{22}\) As

\(^{20}\) We agree that, in our experience, it is a highly specialized skill set that can ably apply the apparent purpose of the circular basis rules to more complex fact patterns, representing a combination of both highly developed quantitative skills (including a familiarity, if not a facility, with quadratic equations) and underlying knowledge of the rules and their purposes.


illustrated by the example, the steps required for the group to determine the tax consequences include:

(i) determining S’s absorbed amount, which means separately calculating, and excluding, gain or loss from the disposition of shares in other subsidiaries for such year;

(ii) reducing the basis of S stock by the absorbed amount under Regulation section 1.1502-32(b)(2);

(iii) applying Regulation section 1.1502-36(b), and reducing S stock basis if applicable;

(iv) applying Regulation section 1.1502-36(c), and reducing S stock basis if applicable;

(v) applying Regulation section 1.1502-36(d), and reducing S stock basis, if applicable, where an election to reduce S stock basis is made under Regulation section 1.1502-36(d)(6);

(vi) if there is not full absorption of the S losses under the general rule, which will frequently be the case, applying the following Alternative Computation steps, to ensure that the basis of S stock is reduced in an amount equal to the absorbed amount:

a. computing and comparing the losses of every disposed S, while segregating S items by character (e.g., capital or ordinary), while excluding income and gain of other members, but without regard to gain or loss on S stock and without regard to net losses of such members;

b. offsetting P’s gain on S stock with its loss on S stock of the same character;

c. offsetting any remaining P net loss on S stock with any remaining income or gain of group;

   i. here, further calculations are required to reflect the limitation of Proposed Regulation section 1.1502-11(b)(2)(iii)(B)(3), including P’s ordinary income and gain items from its activities exclusive of its S stock loss;

   ii. if the limitation applies to more than one P, and the sum of the amounts exceeds the group's remaining ordinary or gain, the offsets are made on a pro rata basis;

d. offsetting any remaining S stock loss (as well as any other unused losses) by the remaining income or gain of the group, on a pro rata basis.
For the reasons discussed below, there are probably additional steps required in order to address capital asset holding period concerns. In addition, the exact sequencing of the steps outlined above is not always clear. The Proposed Regulations require that the determination of the absorbed amount under Regulation section 1.1502-11(b), and its corresponding basis adjustment, be determined first, prior to applying the various ULR components, and that once determined, the absorbed amount will be, as noted in the Preamble, “immutable.” But Example 11 does not in fact illustrate the simple sequencing envisioned by Proposed Regulation section 1.1502-11(b)(2)(ii) (i.e., first determine absorbed amount, then apply investment adjustments, then apply ULR, and finally compute CTI). We accordingly believe that Example 11 illustrates the complexity and inter-relatedness between the absorbed amount and ULR calculations, making the overall exercise more iterative in more complex cases, particularly where a taxpayer is modelling out how, or whether, to reduce net inside attributes under Regulation section 1.1502-36(d), or alternatively making a ULR election that has the effect of reducing stock basis under Regulation section 1.1502-36(d)(6). Moreover, this interactive aspect will be especially likely in the case of applying the Alternative Computation, discussed in more detail below, because of its effect on the calculation of other group income, gain, deduction or loss, including the application of the ULR to the transfer of a subsidiary in another chain, which subsidiary may or may not have its own loss that would be subject to the circular basis rules.

ii. Complexity: Alternative Computation

Under the Proposed Regulations, in the case where the computation of the group’s CTI under the default formula would result in absorption of less than all of any disposed subsidiary’s absorbed amount, the group’s CTI is instead computed by applying the four-step Alternative Computation. Thus, the Alternative Computation is effectively a backstop to ensure that S’s absorbed amount is, in fact, absorbed. More so than the general rule, we believe the Alternative Computation is unnecessarily complex.

Step Two of the Alternative Computation focuses upon P, the “disposing member.” It seeks to isolate – and offset – P’s “subsidiary stock” losses against P’s gains on subsidiary stock. But to the extent P would have remaining net income or gain on subsidiary stock after this initial offset, Step Two also then requires offsetting P’s loss of the same character from sources other than subsidiary stock (e.g., on “portfolio” stock, which presumably means stock of a non-subsidiary member). Thus, Step Two is comprised of at least two computational sub-steps.

Step Three of the Alternative Computation then shifts the focus to the “group,” to determine whether the group has remaining income or gain but P still has a net loss on subsidiary stock (after applying the ULR, including the effect of any actual election under Regulation section 1.1502-36(d)(6)). In that case, Step Three generally provides that the group’s income or gain is then offset by P’s net loss, “subject to the applicable rules of the Code and regulations.”23 But this offset is limited to the lesser of (i) the total remaining income or gain of the group (determined after Step Two), or the amount of P’s income or gain of the same character.

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(determined without regard to the stock loss). Thus, like Step Two, Step Three is comprised of additional computational sub-steps.

Steps Two and Three appear to be fine-tuning designed to promote the Loss Utilization Policy (defined below). We question whether the complexity added by such further refining is warranted, in addition to questioning the tax policy premise of the Loss Utilization Policy (discussed below).

First, we expect there are many fact patterns that do not necessitate applying each of Steps Two and Three. We note that, while there are six different examples in the Proposed Regulations that invoke the Alternative Computation, none of the examples involve an application of all four steps of the Alternative Computation. For example, if the fact pattern described in the Preamble as illustrating the need to revise the circular basis rules were itself subject to the Proposed Regulations, neither Step Two nor Step Three would apply.

Second, Step Two – which focuses upon matching the character of items of a particular member – appears to represent a significant departure from generally applicable single-entity consolidated return rules regarding netting of items. That is, as general matter, Regulation section 1.1502-11(a) sets forth the mechanism for determining CTI, which is essentially a “roll up” of each member’s “separate taxable income” in calculating CTI under Regulation section 1.1502-12, as well as its other items determined at the consolidated level, including consolidated capital gain net income as determined under Regulation section 1.1502-22. It is important to note that the definition of a member’s “separate taxable income” for this purpose in no way approximates the member’s taxable income because it omits a significant number of items (e.g., charitable contributions, capital gain/loss, NOLs) that are determined on a consolidated (i.e., a single-entity) basis. Indeed, Regulation section 1.1502-22 provides that the “determinations under section 1222, including net capital loss and net short-term capital loss, with respect to members during consolidated return years are not made separately. Instead, consolidated amounts are determined for the group as a whole.” In addition, with respect to carryovers, Regulation section 1.1502-22(b)(1) provides that “[t]he net capital loss carryovers and carrybacks to a taxable year are determined under the principles of section 1212 and this section.” While the portion of any consolidated net capital loss that is attributable to a member may be carried to the member’s separate return years under the principles of Regulation section 1.1502-21(b)(2), which necessitates computation of the member’s own net capital loss

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25 See Notice of Proposed Rulemaking, supra note 1, at 80 Fed. Reg. 33213 (2015). As noted in the example, the S1 absorbed amount is $20, but only $16 of the S capital loss would be absorbed in the actual computation of CTI. Thus, under Step One of the Alternative Computation, $20 of S1’s $40 capital loss would offset $20 of P’s $60 capital gain. P, the disposing member, does not have any gains on subsidiary stock, so Step Two does not apply. Similarly, Step Three does not apply, as there is no net loss by a disposing member on subsidiary stock. Thus, in the final step, Step Four, P’s remaining $40 of capital gain is offset by $40 of S2’s $80 capital loss.

26 Reg. §1.1502-11(a).

27 Reg. § 1.1502-11(b)(1).
contribution to the consolidated amount (its apportioned loss), this separate computation is not the general rule for consolidated computations and carrying consolidated losses between consolidated return years.\textsuperscript{28}

Simply put, current law does not appear to support a particular member’s capital gains and losses being first offset at the member level (sometimes colloquially referred to as “netting within the box”), before being offset by the items of other group members.\textsuperscript{29} Moreover, current law does not support applying the holding period calculations of section 1222 on a member-by-member basis. Instead, the generally understood operation of Regulation section 1.1502-22 is that all members’ capital gains and losses are aggregated (\textit{i.e.}, the only “box” is the group box), and then segregated by holding period. Applying the “principles” of section 1222 means first making a separate determination of net short-term capital items for the group, which may be offset by a net capital loss carryover from another year if such carryover exists. Finally, long-term capital gain and losses are then determined, leading to the ultimate determination of whether the group has a net capital gain or loss for the taxable year in question. Put another way, and as a general principle, where the group has a consolidated net capital loss, any particular S may well be apportioned some amount of such consolidated net capital loss under Regulation section 1.1502-22(b)(3), even though such S has its own capital loss items that would have otherwise fully offset its own capital gain items on a separate-member basis.\textsuperscript{30} This result is consistent with the single entity principles applicable to the determination of other items (\textit{e.g.}, NOLs) in calculating consolidated taxable income. As a result, Step Two of the Alternative Computation departs from generally applicable rules (as well as the assumptions in Proposed Regulation section 1.1502-11(e)(2)) in an effort to promote the Loss Utilization Policy, a departure that is acknowledged in the Preamble.\textsuperscript{31} Although, as discussed below, we have concerns about whether this departure is justified on policy grounds, at this point we simply note that interposing the Step Two calculation adds significantly to the complexity of computing P’s basis in its S stock.

Relatedly, Step Three of the Alternative Computation involves further departure from generally applicable consolidated return principles, in isolating and matching up a disposing member’s remaining loss, if any, on subsidiary stock with other “remaining income or gain” of

\textsuperscript{28} Reg. § 1.1502-22(b)(3).

\textsuperscript{29} This is because the opening sentence of Reg. § 1.1502-22(a) provides that “the determinations under section 1222 … with respect to members during consolidated return years are not made separately.” A similar rule also applies with respect to consolidated net section 1231 gains and losses. See Reg. §1.1502-23(a).

\textsuperscript{30} This could occur where there are different holding periods for capital items. For example, assume the P group had no net capital loss carryovers, S had a $100 short-term capital gain item and a $100 long-term capital loss item in the current year, and the only other member with capital items had $100 of short-term capital loss in such year. On a separate-member basis, S would not have a net capital gain or loss. But the group would have a net capital loss of $100, and consistent with the proposed amendment to Regulation section 1.1502-21(b)(2)(iv)(B) (removing capital items from the allocation of a CNOL), all of this consolidated loss should be apportioned to S despite S not having a separate net capital loss because it is the only group member generating long-term capital loss. See Reg. 1.1502-22(a).

the group. That is, while Step Two may be viewed as permitting “netting within a box” as to the disposing member (at least as to subsidiary stock of the disposing member), if P has a net loss from subsidiary stock following application of Step Two, Step Three then extends P’s priority netting of this remaining loss against other income or gain items of the group of the same character. This step is made more complex, though, by a special limitation that would require further calculations, limiting the amount of P’s remaining net loss on subsidiary stock that may be offset to the lesser of (i) the total remaining ordinary income or capital gain of the group; or (ii) the amount of P’s ordinary income or capital gain of the same character. Presumably, this limitation further reflects “netting within a box” principles, by prioritizing P’s offsetting of the items of other members to the extent that P’s offset of its own income or gain was previously displaced by absorption of S loss necessitated in order for the S stock basis amount to be “immutable” (i.e., essentially compensating P for the displacement by prioritizing its offsetting of items of other members in a comparable amount). Notably, there are no examples illustrating such limitation.

In addition, the interaction of the Alternative Computation with the ULR raises questions. For example, where P can elect to waive S stock basis or to reattribute some or all of S’s loss under Regulation section 1.1502-36(d)(6), how do Steps Two and Three apply where S’s and P’s losses “compete” to offset a limited amount of income or gain, and the amount of P’s loss depends on the extent to which a Regulation section 1.1502-36(d)(6) election is made, but the election can change the S stock basis amount that is intended to otherwise be “immutable”? This is an important consideration given that one of the primary situations that the Proposed Regulation attempts to address is where there is both a loss on the sale of the stock of the subsidiary and the subsidiary has operating losses or loss carryovers – a situation where an election under Regulation section 1.1502-36(d)(6) frequently will be evaluated.

iii. Loss Utilization Policy of the Proposed Regulations

The policy premise of the Proposed Regulations reflects a decision that it is important for the consolidated group to utilize a fixed amount of losses of a disposed subsidiary (the “Loss Utilization Policy”); indeed, the Proposed Regulations require numerous steps, discussed above, to support this goal, including steps that depart from generally applicable rules regarding when (or where – i.e., at the separate-member or group level) items offset.32 Clearly, one reason that corporations file consolidated returns is the ability for losses of one member to offset the income and gains of another. But we question the importance placed on this particular goal versus other generally applicable consolidated return rules and tax policy goals, including administrability.

We are not aware of a compelling rationale inherent in the Loss Utilization Policy of the Proposed Regulations that warrants the resulting complexity – eliminating the need for iterative computations at the cost of this complexity is a questionable trade-off. Perhaps it reflects that, as a practical matter, the disposition of S stock may be the last best opportunity for the consolidated group to utilize such losses, because in many cases S will cease to be a member of the group.

32 We do not mean to suggest that Steps Two and Three in the Alternative Computation exceed the government’s authority; clearly, section 1502 contemplates the ability for the government to promulgate “different” consolidated return rules than might otherwise apply to a separate return filer. However, we question, whether the Loss Utilization Policy justifies departing from relatively well-established rules.
Moreover, if the S losses in question “accrued” while a member of the disposing consolidated group, then perhaps single-entity principles would support the position that the group should be entitled to absorb such losses. Conversely, a subsidiary stock disposition presents a heightened separate-member focus, and the current circular basis rules depart from single entity principles in determining the absorption of a subsidiary’s losses. However, this departure serves the purpose of avoiding the absorption of a subsidiary’s losses without offsetting CTI. In any event, there would appear to be a mixture of single- and separate-entity policies to consider; thus, the goal advanced by the Loss Utilization Policy is not obvious.

The Preamble noted that Treasury and the Service had, in fact, considered simply precluding the absorption of S’s loss (the “No Absorption Approach,” defined and described below), but concluded that such a rule would have an adverse impact on any consolidated group with ordinary income that otherwise would be offset by the subsidiary’s losses. In addition, the Preamble noted that the No Absorption Approach would be “inappropriately harsh” if a subsidiary’s stock was sold at a loss that the ULR effectively eliminates. In such a case, the Preamble states:

[T]he use of S’s loss to offset income of other members allowed under current law reduces CTI, but the basis reduction that results from the absorption of the loss has no net effect on the owning member’s basis in the subsidiary’s stock. Prohibiting the use of the disposed of subsidiary’s losses would simply increase the group’s CTI.33

However, for the reasons discussed below, we do not believe that CTI would necessarily increase if the group was simply prohibited from using S’s losses in the year of S’s disposition.

As an initial matter, it is worth noting that the priority currently accorded to utilizing S losses in its year of disposition under the Proposed Regulations may or may not coincide with the wishes of the taxpayer. For example, the disposing group might prefer to utilize another NOL from a separate return limitation year (a “SRLY”) of another member (because, for example, such NOL may be about to expire); if the group is forced to utilize an S loss instead, some or all of the SRLY NOL may go unutilized. In addition, the ULR may otherwise operate, under Regulation section 1.1502-36(d)(2)(i), to write down allocable losses of the departing subsidiary, for which there would be no corresponding S stock basis adjustment.34 In sum, there are multiple considerations in various cases – whether in the form of additional rules or simply taxpayer preferences – that are inconsistent with the apparent premise of the Loss Utilization Policy.

There are other instances in which the consolidated return rules have adopted a No Absorption Approach (e.g., Regulation section 1.1502-11(c), which limits the amount of S’s deductions and losses that the group may utilize in the year of S’s disposition, when any member realizes excluded cancellation-of-indebtedness income). It is difficult to understand the Loss


34 Reg. § 1.1502-36(d)(4)(iii) (reductions to attributes are not noncapital, nondeductible expenses under Reg. § 1.1502-32(b)(2)(iii)).
Utilization Policy inherent in Proposed Regulation section 1.1502-11(b) when the No Absorption Approach actually applies in the next subsection (i.e., Regulation section 1.1502-11(c)), perhaps to the very same S losses in certain stock disposition scenarios.

Finally, as noted above, in pursuance of the Loss Utilization Policy, the Proposed Regulations depart from generally applicable consolidated return rules, such as Regulation section 1.1502-22 (which provides that the character of each member’s gains and losses is “first determined” on a consolidated basis) and even Proposed Regulation section 1.1502-11(e)(2) (which provides that the character of each member’s gains and losses “is first determined on a consolidated basis”). We appreciate that prioritizing the absorption of S losses might be viewed as necessary in order for its stock basis to be “immutable,” and the netting contemplated by Steps Two and Three are merely a further refinement necessitated by the priority given to S losses, all of which can be rationalized as simply a hybrid application of the otherwise applicable rules. We question, however, whether the necessary complexity that results from departing from the generally applicable rules is, in fact, warranted. Furthermore, the departure from single entity principles in the current circular basis rules (i.e., preventing subsidiary losses from offsetting gain on the sale of the stock of the subsidiary) serves the sensible purpose of preventing the absorption of such losses with no net effect on CTI. The Loss Utilization Policy goes considerably further.

D. Recommendation: Disallow Disposition-Year Loss Absorption

We strongly encourage Treasury and the Service to reconsider an approach that was rejected. For the sake of simplicity and administrability, we believe there is much to commend adopting a rule that, for purposes of addressing the circular basis problem, would simply disallow any absorption of loss attributable to the disposed subsidiary in the year of its disposition, at least in typical cases where the subsidiary leaves the group because all or most of its stock is transferred to a third party (the “No Absorption Approach”). If Treasury and the Service believes this option is too harsh, we respectfully request that the government consider allowing taxpayers to elect to apply the current rule rather than the No Absorption Approach (at least in the case of S dispositions that effect a disaffiliation of S).

Our recommendation for the No Absorption Approach is limited to those dispositions of S stock that effect a departure of S from the P group. Put another way, we believe the No Absorption Approach is appropriate for the majority of dispositions that effect a third-party sale or exchange of all or most of the S stock. But conversely, and in part to protect against abuse, we would envision and recommend that the No Absorption Approach not apply in the case of either of the following dispositions: (i) those dispositions of S stock in which S remains affiliated with the P group (i.e., a non-disaffiliating disposition); or (ii) those dispositions of S stock where the transferee/acquirer of S stock is related to P, the disposing member. For purposes of testing

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35 Another alternative would be to abandon the complexity of the Proposed Regulations, but leave current Regulation section 1.1502-11(b) in place and require taxpayers to resort to quadratic equations as necessary to deal with the more complicated scenarios the Proposed Regulations are intended to address.

36 Another option might be to limit the No Absorption Approach only to those situations where there is loss in the S stock but otherwise retain the current regulations (e.g., to apply for S gain dispositions).
relatedness in the preceding sentence, we recommend adopting the definition set forth in Regulation section 1.336-1(b)(12) and applying, for this purpose, the timing principles set forth in Regulation section 1.338-3(b)(3)(ii). If the government adopted this approach, the No Absorption Approach would thus apply to the common disposition scenario, where all of the stock of S is disposed of, for example, a sale to a third party. In contrast, where only 10% of the stock of S is transferred outside the group (i.e., a non-disaffiliating disposition), the Proposed Regulations – as we have proposed to be modified – would apply.

i. Rationale

The circular basis problem has been a concern for taxpayers and the government for some 50 years. Making further refinements to address this problem, we believe, costs too much in terms of complexity as well as departing from well-established consolidated return principles. This seems especially so in an era where government resources seem only to be diminishing (both in the context of rule-writing as well as examinations). We submit that a simpler, more administrable rule serves the interests of both the government – especially front-line examining agents – as well as taxpayers.

We acknowledge that our recommendation may seem like the application of a rather blunt instrument to an area of the tax law that has become accustomed to fine-tuning. However, we believe that 50 years of proposals, rules, commentary and criticism underscore the fact that there is no easy (or perfect) solution to the circular basis problem. Moreover, a finely-tuned rule to address the circular basis problem has its own questionable policy trade-offs, such as permitting capital gains of one member to offset ordinary income of another or blurring holding period distinctions.  

We are aware that there are other alternatives, which Treasury and the Service also have considered, including retaining current Regulation section 1.1502-11(b) and using simultaneous equations to solve any circular basis problems. In this regard, we believe there is wisdom in the dicta of the Edwards court’s opinion that still resonates today: in addition to legislation, we believe that “algebraic formulae” should not be lightly imputed to regulations, either. As an example of one approach to addressing the circular basis problem under current law involving the disposition of multiple subsidiaries (and the computational complexity thereunder), see Appendix 1. In sum, we respectfully submit that any “rule” addressing a rather commonplace transaction (i.e., the disposition of subsidiary stock) whose application requires advanced mathematical skills such as the use of quadratic equations probably should be reconsidered if a simpler approach could be generally as effective. We further submit that, similarly, a blanket prohibition on S loss utilization in the year of its disposition is an administrable rule to deal with the circular basis problem, which recognizes the importance of being able to calculate S stock basis in such year but without placing a priority on the use of S losses. Finally, we also believe


38 While a minority of our Committee believes further consideration should be given to this approach, the majority of us, mindful of our discussion of complexity above, believe that such an approach is simply too complicated. See also W. Sutton, Prop. Regs. Address Circular Basis Adjustments, 42 J. Corp. Tax’n 20, 22 (Nov./Dec. 2015)
that our recommendation is consistent with consolidated return authority.\textsuperscript{39} In sum, a rule that simply precludes absorption of a disposed subsidiary’s losses in the year of its disposition would further administrability and entail less computational complexity.

ii. Illustrations

As a simple example, consider the example identified in the Preamble, in which P sells its S1 stock for $500 at the end of the year. This relatively simple example also illustrates how iterative computations would be required, absent a special rule such as the Proposed Regulations. In contrast, applying the No Absorption Approach to this example would result in no basis adjustments to P’s $500 basis in S1 stock. There would thus be no stock gain or loss with respect to P’s disposition of the S1 stock. Precluding absorption of the S1 loss would mean that more of the S2 capital loss for the year would be absorbed in offsetting the $60 capital gain of P. S1 would carry its allocable $60 net capital loss with it when it leaves the P group. Alternatively, if the group desired to retain the attribute (and assuming no ULR application), then perhaps the group could undertake steps to treat S1 as having liquidated into P prior to the sale, such as by S1 converting into an entity that is disregarded as separate from P, such that P’s sale of S1 would effect an asset sale.

Alternatively, consider the application of the No Absorption Approach to Example 1 of the Proposed Regulations.\textsuperscript{40} P has a $500 basis in S’s stock. P sells S’s stock for $520 at the close of Year 1. For Year 1, P has ordinary income of $30 (determined without taking into account P’s gain or loss from the disposition of S’s stock) and S has an $80 ordinary loss. Assume this reflects the entire activity of the P group for the year.

If P were simply prohibited from using the S loss in the year of S’s disposition, the P group would have CTI of $50, comprised of P’s $20 of gain on the sale of S’s stock and P’s $30 of ordinary income. Note that this is the same amount of CTI reported by the P group under the Proposed Regulations as well as the current rule, although CTI under the current rule would be comprised of more capital gain. In both cases, S would have an unabsoled loss carried to its separate return year, but the amount of such loss would be $80 under the No Absorption Approach, whereas it is $50 under current regulations. As illustrated, CTI would not necessarily change with a blanket prohibition rule. Because no S loss is absorbed, then there would be less stock gain, or greater stock loss.

Finally, as another example, consider application of the No Absorption Approach to Example 5 of the Proposed Regulations. (To restate the essential facts, at the beginning of Year 1, P has a $200 basis in S’s stock. P sells all of its S stock to an unrelated person for $100 at the close of Year 1. For Year 1, P has $10 capital gain on portfolio stock. In addition to S, P has two other subsidiaries, M1 and M2. M1 has capital gain of $50; M2 has a capital loss of $30, and S has a capital loss of $60.) A blanket prohibition on the use of S losses in the year of the disposition means that P would have a capital loss of $100 on its disposition of S (the example

\textsuperscript{39} See section 1502 (authorizing consolidated return regulations that “are different from the provisions of chapter 1 that would apply if such corporations filed separate returns”).

convention posits that the ULR will not cause P to adjust its basis in the S stock). The computation of the P group’s CTI would be relatively straightforward: the P group would have consolidated net capital loss of $70 (comprised of P’s $100 stock loss on the S disposition, as well as M2’s $30 capital loss, offset by P’s $10 capital gain on portfolio stock and M1’s $50 capital gain). In addition, S would carry its $60 capital loss with it, whereas under the example in the Proposed Regulations – which applies the Alternative Computation – S would carry a $20 capital loss with it. In both cases, the group would have a $70 capital loss carryover to Year 2 and in both cases the amount of S’s unabsorbed capital loss would be potentially subject to reduction under Reg. § 1.1502-36(d)(2).

In sum, the illustrations above demonstrate, we believe, that were Treasury and the Service to adopt our recommendation (i.e., the No Absorption Approach), CTI would be easier to determine, and oftentimes CTI would not vary, or not vary significantly, from the results produced by the Proposed Regulations. Of course, there may be questions with respect to the utility of the allocable losses of the departing subsidiary that could be carried to a separate return year and may be limited by section 382, but it is possible that the P group would prefer such an outcome to, say, being denied the ability to absorb another member’s expiring SRLY NOL (e.g., assume the same facts, except that another member, S2, had a SRLY $30 capital loss carryover that was about to expire). Alternatively, to the extent the P group found a blanket prohibition on the use of S losses problematic, there are likely planning techniques that the P group could undertake, such as internal restructuring transactions, the effect of which may be able to mitigate or ameliorate the effect of a blanket prohibition.

E. Alternative Recommendation: Eliminate Steps Two and Three from Alternative Computation

If Treasury and the Service decides not to adopt our primary proposal, we respectfully request that the government consider, as an alternative, eliminating Steps Two and Three from the Alternative Computation. We believe these modest measures would still meet the goal stated in the Preamble, addressing those cases in which the circular basis problem still exists, “yet adhere to underlying consolidated return concepts without undue complexity.”

As noted above, our concern with Steps Two and Three arise in part because such steps might stray from generally applicable consolidated return principles. Moreover, we do not believe a goal of full absorption of S’s losses justifies such an unprecedented departure from generally applicable rules and respectfully request that if our primary proposal is not adopted, then Steps Two and Three of the Alternative Computation, that be eliminated.

We also recognize that our alternative recommendation – if adopted within the current framework of Proposed Regulation section 1.1502-11(b) – could result in instances in which the absorbed amount is not, in fact, fully absorbed, such that the absorbed amount would need to be redetermined, contrary to the current directive of Proposed Regulation section 1.1502-11(b)(2)(i). However, we believe this result would not occur in the bulk of stock disposition cases; and to the extent it does occur, respectfully submit that such a result would represent an

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appropriate balancing of the goals of administrability and certainty with well-established consolidated return rules and principles.

F. Technical Corrections and Other Suggestions

We note the following typographical errors and non-substantive technical corrections and comments in the text of the Proposed Regulations, for your consideration, consistent with the discussion above.

- Typographical error: the reference in Proposed Regulation section 1.1502-11(b)(2)(iii)(B)(2) to “paragraph (b)(2)(ii)(B)(1) of this section” should be “paragraph (b)(2)(iii)(B)(1) of this section.”

- To the extent the Alternative Computation is retained, consider adding language to the preamble of final regulations, with respect to Proposed Regulation section 1.1502-11(b)(2)(iii)(B), to make clear that as to the disposed member, any contemplated computations (e.g., in Step One) involving such member are limited by the absorbed amount.

- If Step Two of the Alternative Computation is retained, consider providing a definition for “portfolio” stock, or otherwise clarifying that such stock means capital stock in a corporation that is not a “subsidiary” within the meaning of Regulation section 1.1502-1(c).

- If Step Four is retained, and consistent with the general recommendation above, consider confirming that any further loss absorption in this step does not exceed the absorbed amount of the disposed member.

- If Step Four is retained, consider confirming that this step does not envision mixing or matching of character, as envisioned by Proposed Regulation section 1.1502-11(b)(2)(iii)(C) with respect to Step Three.

- Consider revising and conforming statements in Regulation section 1.1502-36(a)(3)(i) and Regulation section 1.1502-11(c) regarding the order of application of the ULR vis-à-vis other provisions, including the circular basis rules.
APPENDIX 1

Example 1

P owns all stock of S1, S2, S3, and S4 and sells the S2, S3, and S4 stock for $500 each. Before adjustment for subsidiary losses, P's bases in the S2, S3, and S4 stock are $470, $480, and $490, respectively. In the year of the sale S1, S2, S3, and S4 have losses of $100, $25, $50, and $75, respectively and the P group's only income or gain is on its stock sales. If:

\[ x = \text{S2's loss absorbed}, \]
\[ y = \text{S3's loss absorbed}, \]
\[ z = \text{S4's loss absorbed}, \]

P's bases in its S2, S3, and S4 stock will be reduced by those absorbed losses under Regulation section 1.1502-32, and the P group's total gain to be offset by the S1, S2, S3, and S4 losses equals $60 + x + y + z. Note that, in the following computations, the determination of a particular member’s unlimited loss is multiplied by an expression that takes into account the sum of the gain from other members’ stock. For example, in the case of S2, the number 30 in the following computation represents the aggregate stock gain of other disposed members, namely S3 stock gain of 20 and S4 stock gain of 10.

Under current law:

\[ \text{S2's unlimited loss} = (25/250) \times (30 + y + z), \]
\[ = 3 + .1(y + z) \]
\[ \text{S3's unlimited loss} = (50/250) \times (40 + x + z), \]
\[ = 8 + .2(x + z) \]
\[ \text{S4's unlimited loss} = (75/250) \times (50 + x + y), \]
\[ = 15 + .3(x + y) \]

Including S1’s $100 loss, the total loss taken into account in the allocation formula therefore equals:

\[ 126 + .5x + .4y + .3z \]

Because each subsidiary's loss absorbed equals its unlimited loss multiplied by the total gain and divided by the total loss:

\[ x = [(3 + .1(y + z))/(126 + .5x + .4y + .3z)] \times (60 + x + y + z) \]
\[ y = [(8 + .2(x + z))/(126 + .5x + .4y + .3z)] \times (60 + x + y + z) \]
\[ z = [(15 + .3(x + y))/(126 + .5x + .4y + .3z)] \times (60 + x + y + z) \]

\[ 60 = [100/(126 + .5x + .4y + .3z)] \times (60 + x + y + z) \]

It is not clear that these formulas can be solved simultaneously. However, using a computer program by trial and error, the following conclusions may be reached:

\[ x = 2.82495 \]
\[ y = 6.418656 \]
\[ z = 10.66385 \]

**Example 2**

The facts are the same as in Example 1, except that P's bases in its S2, S3, and S4 stock before any adjustment for any subsidiary absorbed loss are $480, $540, and $470, respectively. Assume that any loss that P has on the S3 stock can be used without limitation under Regulation section 1.1502-36. Assume as well that:

\[ x = \text{S2's loss absorbed}, \]
\[ y = \text{S3's loss absorbed}, \]
\[ z = \text{S4's loss absorbed}. \]

P's bases in its S2, S3, and S4 stock will be reduced by those absorbed losses under Regulation section 1.1502-32, and the P group's total gain (assuming that P generates a loss on its S3 stock sale) to be offset by the S1, S2, S3, and S4 losses and P's loss on its S3 stock equals $50 + x + z.

Under current law:

\[ \text{S2's unlimited loss} = (25 \times (30 + z)/(290 - y) \]
\[ \text{S3's unlimited loss} = (50/250) \times (50 + x + z), \text{ or} \]
\[ = 10 + .2(x + z) \]
\[ \text{S4's unlimited loss} = (75 \times (20 + x)/(290 - y) \]

Including S1’s $100 loss, the total loss taken into account in the allocation formula after "simplification" is:

\[ (150 - y) + .2(x + y) + [(2,250 + 75x + 25z)/(290 - y)] \]
Therefore:

\[
x = \left(\frac{25 \times (30 + z)}{290 - y}\right) \times \left(\frac{50 + x + z}{150 - y + 0.2(x + y) + \left(\frac{2250 + 75x + 25z}{290 - y}\right)}\right)
\]

\[
y = \left[10 + 0.2(x + z)\right] \times \left(\frac{50 + x + z}{150 - y + 0.2(x + y) + \left(\frac{2250 + 75x + 25z}{290 - y}\right)}\right)
\]

\[
z = \left(\frac{75 \times (20 + x)}{290 - y}\right) \times \left(\frac{50 + x + z}{150 - y + 0.2(x + y) + \left(\frac{2250 + 75x + 25z}{290 - y}\right)}\right)
\]

It is similarly not clear that these formulas can be solved simultaneously. However, using a computer program and trial and error, and subject to rounding, the following conclusions may be reached:

\[
x = 0.946302
\]

\[
y = 3.593436
\]

\[
z = 1.866078
\]