REPORT #703

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATIONS
UNDER §§ 1502-15, 21 AND 22

December 13, 1991

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New York State Bar Association

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The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

Please find enclosed a report prepared by our Committee on Consolidated Returns relating to Proposed Regulations Sections 1.1502-15, -21 and -22. The principal authors of the report were Irving Salem, Eugene L. Vogel, John F. Settineri and Jonathan Kushner.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M Peaslee
Chair

Enclosure

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20020

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

cc: Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

Stuart Brown, Esq.
Associate Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3527
Washington, D.C. 20224

John G. Broadbent, Esq.
Counsel to the Assistant Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 4 008
Washington, D.C. 20224

Michael J. Graetz, Esq.
Deputy Assistant Secretary of
the Treasury for Tax Policy
Department of the Treasury
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Tax Legislative Counsel
Department of the Treasury
3064 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Andrew Dubroff, Esq.
Associate Tax Legislative Counsel
Department of the Treasury
4206 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

NEW YORK STATE BAR ASSOCIATION TAX SECTION
COMMITTEE ON CONSOLIDATED RETURNS

REPORT ON PROPOSED REGULATIONS
UNDER §§ 1502-15, 21 AND 22

December 13, 1991

This report comments on proposed treasury regulations §§ 1.1502-15, 1.1502-21 and 1.1502-22 issued on January 29, 1991 (the "Proposed Regulations").[1]

I. Introduction

The Proposed Regulations make a number of appropriate and very worthwhile changes to the existing consolidated return regulations. In particular, the Proposed Regulations properly correct certain anomalies created by the separate return limitation year ("SRLY") rules contained in the present regulations by computing the SRLY limitation (i) on a cumulative basis, based on a member's cumulative contribution to the group's consolidated taxable income for all years during which it was a member and (ii) on a subgroup (rather than a member-by-member) basis. Although the subgroup rules add considerable complexity to the regulations, we believe this approach is nevertheless preferable to the fragmentation rules of the existing SRLY system. Further, we see no conceptual reason why such rules

[1] This report was prepared by the Committee on Consolidated Returns, chaired by Irving Salem and Eugene L. Vogel who, with John F. Settineri and Jonathan Kushner, were the principal authors. Helpful comments were provided by Peter C. Canellos, Patrick C. Gallagher, Richard M. Leder, James M. Peaslee and Michael L. Schler.

should not also be made applicable to all other carryover items, including foreign tax credits. We urge that similar rules be adopted for all other carryover items at the earliest possible date.

In addition, the proposed coordination of the built-in deduction (loss) rules of Treas. Reg. § 1.1502-15 with the essentially similar rules regarding built-in losses that are already provided in section 382(h) is a welcome and appropriate simplification to the numerous (and often duplicative) loss limitation rules currently contained in the tax law. Simplification also has been achieved through the proposed repeal of the consolidated return change of ownership ("CRCO") rules of Treas. Reg. S 1.1502-21(d).[2]

We believe, however, that the "extreme prospectivity" of the effective date of the Proposed Regulations is unwarranted and unnecessary. In addition, we offer suggested revisions of the offspring rule and some comments on the continuing viability of the SRLY concept (as well as a proposed relief rule for combining brother-sister corporations).

II. The Effective Date Provisions Should Be Amended So That The Proposed Rules Would Apply To Taxable Years Ending On Or After January 29, 1991 And To Losses Incurred Prior To That Date.

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[2] The preamble to the Proposed Regulations states that these rules are proposed to be repealed because "[t]he policies underlying the CRCO rules have been subsumed by the single entity approach to the application of section 382 to consolidated groups (see proposed SS 1.1502-90 through 1.1502- 99), and old section 382 has been repealed by the Tax Reform Act of 1986." This rationale, however, is not entirely convincing in light of the retention of the SRLY rules against a very similar background. Nevertheless, we believe that the repeal of the CRCO rules is a welcome simplification and does not result in a significant danger to the fisc.

A. Effective date rule under Proposed Regulations

As currently drafted, certain parts of the Proposed Regulations (i.e., those relating to the proposed revisions to the SRLY rules) appear to apply to an acquired subsidiary only to the extent that the deductions and losses of such subsidiary arise in a taxable year ending on or after January 29, 1991. See Prop. Reg. §§ 1.1502-21(g)(1) and 1.1502-22(g)(1). Thus, for example, if a calendar-year subsidiary were acquired by a consolidated group at the close of business on June 30, 1991, these proposed rules presumably would apply only to losses, if any, incurred by the subsidiary in its short taxable year beginning on January 1, 1991 and ending on June 30, 1991 and not to its net operating loss carryovers arising in prior taxable years.

In Notice 91-27, however, the Internal Revenue Service (the "Service") indicated that the Proposed Regulations would be modified so that the provisions of Prop. Reg. § 1.1502-21 would apply to an acquired subsidiary without regard to when the losses or deductions of the subsidiary arose (or were incurred). We believe that this change is fair and reduces the complexity of the regulations. We also presume that a similar modification would be made to the effective date provisions of Prop. Reg. § 1.1502-22.

In addition, the Proposed Regulations, as currently drafted, generally apply only to corporations that become members of the consolidated group (or, in the case of the repeal of the CRCO rules, to a CRCO occurring) on or after January 29, 1991. In Notice 91-27, the Service indicated that the Proposed Regulations would be amended so that certain of the rules contained in Prop.

Reg. § 1.1502-21 -- including, presumably, the proposed repeal of the CRCO rules, as reflected in Prop. Reg. § 1.1502-21(d) — would apply to consolidated return years ending after January 28, 1991. However, the Service stated that this modification to the general effective date rule would not apply to the changes set forth in Prop. Reg. § 1.1502-21(c) (which provides for the proposed computation of the SRLY limitation on a subgroup and a cumulative basis) and Prop. Reg. § 1.1502-15 (which contains proposed revisions to the built-in loss rules). As a result, while the proposed repeal of the CRCO rules would seem to be effective under this Notice for consolidated return years ending on or after January 29, 1991 in all cases (without regard to the date of acquisition), the proposed rules set forth in Prop. Reg. §§ 1.1502-21(c) and 1.1502-15 would continue to apply under this Notice only to losses and deductions of corporations that become members of the consolidated group (and acquisitions occurring) on or after such date.

We fail to see the need for the degree of prospectivity presently contained in the Proposed Regulations and continued, to a large extent, under Notice 91-27. In its current form, the effective date rule set forth in the Proposed Regulations would require taxpayers and the Service to maintain two sets of regulations; that is, one set that would apply to subsidiaries (or consolidated groups) acquired on or after January 29, 1991 and another set that would be effective for a great many years in the case of subsidiaries (or consolidated groups) acquired before that date. Such duplication is a significant drawback of the proposed effective date provision. Furthermore, since the proposed rules apparently were designed primarily to correct certain anomalies created under the prior regulations (or to coordinate certain loss limitation rules contained in the consolidated return regulations with the loss limitation rules

already provided in section 382), we fail to understand why, as a policy matter, these corrective (and coordinating) changes should not be equally applicable to subsidiaries (or consolidated groups) acquired before (as well as on or after) January 29,1991. Moreover, a modification of the current proposed effective date rule (along the lines discussed below) should not present any significant technical or administrative problems.

B. Recommended Effective Date Rule

We recommend that the effective date provisions of the Proposed Regulations be changed so that the proposed rules in their entirety, on a non-elective basis, would apply not only to subsidiaries (or consolidated groups) acquired on or after January 29, 1991 (regardless of when the losses and deductions were incurred), but also to subsidiaries (or consolidated groups) acquired before such date that have SRLY losses, CRCO losses, or built-in losses determined under the rules contained in the existing regulations, which after the application of those rules have not been utilized (or realized) as of the beginning of the first consolidated tax year ending on or after January 29, 1991 (or, if later, the acquisition date of the subsidiary or consolidated group). In addition, we recommend that the rules contained in the Proposed Regulations (for example, the subgroup rules) also be applied in the case of a carryback of a post-acquisition loss of an acquired subsidiary to a separate return year if the loss was incurred in a consolidated tax year ending on or after January 29, 1991.

To illustrate the application of this effective date provision in the context of the proposed computation of the SRLY limitation on a subgroup basis, assume that a calendar-year consolidated group (M) acquired a SRLY subgroup composed of a

parent (P) and a subsidiary (S) on January 1, 1990. At the time of the acquisition, S had a net operating loss carryover of $100 (which would be a SRLY loss in the M consolidated group). In each of 1990 and 1991, P generates income of $100, and S has no income or loss. Under the Proposed Regulations and our recommendation, the SRLY subgroup principles of Prop. Reg. § 1.1502- 21(c) (2) would not be applied with respect to 1990 (so that none of P's income would be taken into account in computing the SRLY limitation for that year). However, our recommendation would change the proposed effective date rule and would apply the SRLY subgroup rules with respect to 1991 and subsequent years. As a result, P's income would be taken into account in each of these years in computing the limitation on the use of S's SRLY loss which, after the application of the SRLY rules contained in the current regulations, was still not utilized as of January 1, 1991 (i.e., the beginning of the first consolidated tax year ending after January 29, 1991). (This recommended change to the effective date provision could be applied in a similar manner with respect to the proposed computation of the SRLY limitation on a cumulative basis.)

This effective date provision also could be applied in the context of the proposed revisions to the built-in loss rules. Thus, for example, any built-in loss (or deduction) of an acquired subsidiary (as defined and otherwise determined under the current regulations) that was still unrealized as of the beginning of the first consolidated tax year ending on or after January 29, 1991 (or, if later, the acquisition date of the subsidiary) would be subject to the SRLY limitation only if such loss (or deduction) were recognized within the remaining, unexpired portion of the 5-year recognition period provided for under the Proposed Regulations. Similarly, a consolidated group with an unused CRCO loss as of the beginning of this tax year

(or, if later, the acquisition date of the group) would be, under this effective date provision, free of the CRCO limitations with respect to any profits of an acquired subsidiary that were realized in that tax year (or subsequent tax years). (This proposed effective date rule for the repeal of the CRCO limitations would appear to be consistent with the one that was apparently intended under Notice 91-27.)

We recognize, however, that the proposed changes to the built-in loss rules (as reflected in Prop. Reg. § 1.1502-15) and the proposed repeal of the CRCO rules (as reflected in Prop. Reg. § 1.1502-21(d)) were primarily made in order to better coordinate these rules with the loss limitation rules already provided under Section 382 (as amended by the Tax Reform Act of 1986). Accordingly, as an alternative, our recommended effective date provision could be revised so that the proposed changes to these rules would apply to a subsidiary (or consolidated group) acquired before January 29, 1991 but only if such acquisition were also after the effective date of new Section 382 (which, in general, is effective for acquisitions after December 31, 1986). We realize too that the recommendation that the Proposed Regulations be applied to subsidiaries (or consolidated groups) acquired before January 29, 1991 (without the provision for an option on the part of taxpayers to elect out of the proposed rules) may produce disadvantages to certain taxpayers that acquired subsidiaries (or consolidated groups) prior to that date. For instance, the proposed computation of the SRLY limitation on a cumulative basis may be disadvantageous to such taxpayers. As an example, assume that a subsidiary (S) with a SRLY loss of $90 was acquired by a calendar-year consolidated group ("P Group") on January 1, 1990 and that this SRLY loss, after the application of the SRLY rules contained in the current regulations, remains unutilized as of January 1, 1991. Assume

further that S generates a loss of $150 in 1991 (a year when other members of P Group generate profits of at least $150 to fully absorb the loss) and then generates income of $100 in 1992 (a year when each other member of P Group has no income or loss). In this case, based on our proposed effective date rule, the SRLY limitation would be computed on a cumulative basis in the 1991 and 1992 consolidated return years. Such computation would prevent P Group from utilizing S's SRLY loss in 1992 since S's income generated in that year ($100) would not have exceeded the loss that it incurred in 1991 ($150). As a result, P Group's consolidated taxable income in 1992 would be $100 in this case. (In contrast, under the SRLY rules contained in the existing regulations, P Group would have been able to utilize S's SRLY loss in 1992 since S's income in that year would have exceeded the amount of the SRLY loss; hence, P Group's consolidated taxable income would be only $10 in 1992 in this situation.)

Even though our proposed effective date rule may produce disadvantages to certain taxpayers (as indicated above), we believe that any such disadvantages should be, on an overall basis, relatively modest and, even where a given taxpayer is significantly disadvantaged by the application of the proposed rules, that it would still be appropriate to apply the Proposed Regulations to that taxpayer in the interests of ensuring that a uniform set of rules now be applied to all taxpayers. Moreover, it is unlikely that a taxpayer could accurately predict the pattern of profit and loss that would arise following an acquisition. In any event, a taxpayer should have no reasonable expectation that an acquisition that was made prior to January 29, 1991 would be forever exempt from any changes in the tax law (including the changes, such as the cumulative SRLY concept, that are contained in the Proposed Regulations).

III. The Offspring Rule Should Be Modified In A Number Of Respects.

A. Existing law

Under the current regulations, an "offspring rule" is set forth in Treas. Reg. § 1.1502-79(a)(2), as an exception ..to the general carryback rule of Treas. Reg. § 1.1502-79(a)(1).[3] This rule provides that if part of a consolidated net operating loss ("CNOL") is attributable to a member that was not in existence in a prior year to which the loss might be carried, but has been a member of the consolidated group "immediately after its organization," that portion of the CNOL is included in the CNOL carryback to the equivalent consolidated return year of the group. If the group did not file a consolidated return for the earlier year, the portion of the CNOL attributable to the member that was not in existence is carried back to a separate return year of another member of the group. The regulation, however, is silent as to which member of the group is entitled to such carryback in the separate return year. Certain authorities have resolved this ambiguity by permitting a carryback of the loss to

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[3] There is little known of the tax policy rationale underlying the offspring rule. Intuitively, it would appear to reflect the single entity theory of consolidation, so that the losses of a new entity created by the group could be used by the group as if the new entity were a branch. The litigation and regulatory history lends no support to this theory. After winning a series of cases (e.g. Trinco Industries. Inc. v. Commissioner, 22 T.C. 959 (1954) and Midland Management Company v. Commissioner, 38 T.C. 211 (1962)) which disallowed carrybacks of a member to a prior year of the group (or the common parent, if separate returns were filed) when the subsidiary was not in existence in such prior year, the Commissioner, without much explanation, began renouncing its victories. In Rev. Rul. 64-93,1964-1 C.B. 325, it suggested that the IRS(and the courts)had been misreading its own regulations, and a loss of a member not in existence in a prior consolidated return year could indeed be carried back to a prior consolidated return year of the group. Note that under this reading, the carryback rule was not limited to a newly organized subsidiary. The 1966 consolidated return revision extended the capitulation to carrybacks to prior separate return years (§ 1.1502- 79(a)(2)), but limited the offspring rule to newly created members.

the member that would have sustained the loss if the loss subsidiary had not been incorporated. See Rev. Rul. 74-610, 1974-2 C.B. 288; J.A. Tobin Construction Co. v. Commissioner, 25 T.C. 1005 (1985).

A few PLR's have fleshed out the meaning of being a member immediately after organization. In a private letter ruling that involved a newly formed subsidiary that acquired the assets of a target corporation in exchange for stock of its parent in a tax-free, section 368(a)(2)(D) triangular reorganization, the Service has applied the offspring rule so as to permit any CNOL attributable to the newly-formed subsidiary to be carried back to the parent corporation's consolidated or separate return for the taxable year prior to the acquisition. See PLR 8816002 (Dec. 31, 1987). Similarly, the offspring rule has been applied to a carryback of a loss attributable to a target where the loss is incurred after the target has been “born again” as a new corporation that was treated as having purchased the target's assets because of an election under section 338(g). See PLR 8802006 (Sept. 30, 1987) and PLR 8742006 (July 1, 1987). (Although these letter rulings applied the offspring rule where a regular section 338(g) election was made, the rule also should apply where a section 338(h)(10) election is made.)

B. Description of Proposed Offspring Rule

1. Circumstances in which loss may be carried back to a year a loss member not in existence.

The Proposed Regulations (§ 1.1502-21(b) (2)(ii)(B)) contain a revised offspring rule which generally follows existing law. The basic rule would permit a CNOL attributable to a member to be carried back to a year before its existence provided it

"has been a member continuously since its organization." The next sentence, however, greatly confuses the issue.[4] It provides: "See § 1.1502- 21(f) (relating to predecessors and successors)." That section in turn is unclear since it merely provides that a member "includes, as the context may require, a reference to a successor or predecessor as defined in § 1.1502-1(f)(4)." (Emphasis added) As defined by Prop. Reg. § 1.1502-1(f)(4), a successor or predecessor includes a transferor corporation in a tax-free reorganization to which section 381(a) applies or a transferor in certain section 351 transactions. Thus, where the common parent of a consolidated group organizes a new subsidiary to acquire the assets of an unrelated target corporation in a tax-free (a)(2)(D) triangular reorganization, the term "member" may refer to the target, in which case the newly formed acquiring subsidiary would not be a member continuously since its organization. Under this interpretation, the offspring rule would not apply.[5] But when does "the context require" the predecessor rule to apply? For example, would it matter if before the acquisition the newly formed subsidiary were larger than the acquired corporation?

2. Choosing the entity to which the loss should be carried.

If the loss of the offspring can be carried back to a consolidated return year of the group, then the loss would be available to the group under the Proposed Regulations. If, however, the group did not exist in the carryback year, or filed

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[4] The confusion will also apply to built-in losses since such losses are subject to the SRLY rules pursuant to Proposed Regulation § 1.1502-15(a).

[5] Accordingly, the subsidiary's post-acquisition loss in this case may not be carried back at all, either to a prior consolidated return year or to a prior separate return of a qualifying common parent (or some other member of the group) or, by reason of section 381(b)(3), to a prior taxable year of the acquired corporation.

separate returns for such year, the Proposed Regulations allow the loss attributable to the offspring to be carried back to separate return years of the common parent, provided the common parent was not (i) a member of a different consolidated group, or (ii) a member of any affiliated group filing separate returns. While the Proposed Regulation are not clear, the Preamble makes it clear that if the loss cannot be carried back to such a common parent (called a “qualifying common parent” in the Preamble), no other member of the group, not even one that formed the offspring, may claim the loss.

C. Summary of Recommendations

In general, we think the revised offspring rules are reasonable. They are simpler than both the existing regulations and the proposed revision in 1984 in that neither valuations nor tracing is necessary to determine if the offspring rule applies or which entity is entitled to the loss.

Our major concern is the failure to come to grips with the triangular acquisition — a subjective resolution based on an obscure test (“as the context may require”) seem inadequate and we propose an objective solution to this problem. Moreover, in resolving the issue, we have analyzed an even broader solution which would involve the elimination of the allocation rules of Treas. Reg. § 1.1502-79(a)(2) with respect to all new members which have insignificant built-in-losses. While not affirmatively recommending this approach, it does resolve a number of difficult issues and is worthy of consideration.

Finally, we question the reversal of the existing rules which presently allow a carryback to a separate return year of the common parent even though it is affiliated in the carryback year.

D. Discussion

1. Circumstances in which loss should be carried back.

The offspring issue arises in four basic types of cases; the issues are easier to analyze if dealt with one at a time.

a. Offspring created out of assets of group.

The clearest case is where the common parent transfers a division to a newly created subsidiary.[6] Intuitively, a carryback to the common parent seems appropriate. Two other allied cases are not as clear:

(i) What if the common parent acquires the stock of T, and T forms Newco? It seems that Newco would be treated as an offspring under the Proposed Regulations as long as a material amount of built-in-losses are not involved in the organization of Newco, thereby, avoiding the application of the "predecessor" rule. See § 1.1502-1(f)(4)(ii).

[6] We note the Proposed Regulation now requires that the offspring must have been a member of the group "continuously" from date of organization to the date of the loss. The new limit seems reasonable.

(ii) What if the common parent formed Newco and, with contributed capital or borrowed funds, acquired all the assets of T? Newco should qualify as an offspring since the assets of T will receive a fair market basis and all subsequent losses will be borne by the common parent.

b. Acquisition of stock followed by section 338(g) election.

The offspring rule should apply here since a section 338(g) election is the functional equivalent of an asset acquisition by a new company, which, as discussed above, results in the application of the offspring rule.

c. Acquisition via a reorganization.

The Proposed Regulations are unacceptably vague in dealing with acquisitions resulting from a tax-free reorganization. For example, assume an (a)(2)(D) reorganization into a newly created acquiring corporation.[7] The taxpayer would have no real clue as how to report this transaction. Literally, since the acquired corporation is a "predecessor" of Newco and since such acquired corporation does not meet the continuous membership test, the offspring rule would appear not to apply. However, the result of such rule is harsh since it would appear that Newco would have no

[7] The issue is the same under a straight (A) or (C) reorganization, or a triangular (A) or (C). Reorganizations raise an allied question which the final regulations should clarify. The 1984 proposed regulations would have imposed the SRLY rules with respect to the carryback losses of the acquiring corporation (regardless of source) if the acquired corporation were worth more than 50% of the surviving corporation. We do not understand the proposed predecessor rules to require — in a similar context — a similar result nor do we think any rule based on relative value to be result, a clearer statement of the rule is essential.

carryback privilege since section 381(b)(3) prevents the carryback to any prior years of the acquired corporation. Perhaps this harsh result led to the adoption of the vague "as the context may require" rule.

We believe it far preferable that the final regulations resolve the issue. We recommend that the offspring rule apply in such a case, provided the acquired corporation did not have a net unrealized built-in-loss (as determined under section 382(h)(3)(A)) that exceeds the threshold requirement of section 382(h)(3)(B).[8]

The rationale for such rule is that the losses being carried back generally are post-acquisition losses, economically borne by the common parent and thus properly available to the parent as a carryback. To prevent abuse, the rule has an exception for a new member with a significant net unrealized built-in-loss. While one might argue that all losses of the acquiring corporation should be allowed as a carryback to the common parent to the extent the taxpayer can demonstrate that the carryback is not—in fact—attributable to a built-in-loss, this would require tracing, a burden that may not be worth the difficulty.[9] If the de minimis rule is not met, then the carryback privilege

[8] We think this rule is better targeted to the real issue (i.e., are Newco's losses really the losses of the common parent) than the proposed solution in 1984 which tied the solution to whether the acquiring or acquired corporation was larger (based on a fair market value test).

[9] The use of net unrealized built-in losses as the threshold test is another compromise. The netting approach is consistent with that applied in § 1.1502-15(a) of the Proposed Regulations. We note, however, that the use of net (rather than gross) losses sets the stage for the carryback of a built-in loss well before any offsetting built-in gain is recocrnized.

would be limited by the normal rules under section 381(b)(3) and Prop. Reg. § 1.1502-21(b) (2)(i).

d. Acquisition of stock of target (and no S 338(g))

While we make no recommendation, Treasury could consider taking one further step and provide for a carryback under the offspring rules even though the target's assets do not end up in a Newco and target was in existence in the carryback years. Assume target is acquired in an (a)(2)(E) reorganization, or its stock is acquired for cash. One could argue that as long as the de minimis built-in-loss rules of section 382 are met, losses generated by any new member should be carried back to prior years of the group (or the common parent) since the group is bearing the economic burden of the losses.

Admittedly, this would be a major departure from existing law and would effectively override the long-standing (since 1942) rules under Treas. Reg. § 1.1502-79, which allocate a group's loss to a nonmember for a prior or subsequent taxable year.[10] However, it does have a number of strengths which are worthy of discussion:

(i) It would eliminate the elective feature of existing law (i.e., if the group wants to use its prior income rather than Target's, it simply acquires Target via

[10] The theory underlying the rule under discussion arguably would lead to the retention by the group of all tax attributes. Note the Treasury took one step in this direction when it provided for the reattribution of certain losses under the loss disallowance rules (Treas. Reg. § 1.1502-20(g)).

an asset acquisition or an (a)(2)(D) reorganization, rather than a taxable stock acquisition or an (a)(2)(E)).

(ii) It would eliminate the elective feature of the Proposed Regulations, since an acquired Target corporation apparently could create a qualified offspring by avoiding a transfer that would trigger the application of the predecessor rules (e.g. it could transfer assets which do not have a material built-in loss to a newly created subsidiary of Target).

(iii) It would avoid the difficult negotiation (and drafting) issues in connection with the sale of a subsidiary by one consolidated group to another consolidated group wherein the parties, in the face of a possible post-acquisition loss by the subsidiary, have to deal with the situation where such loss might be allocated to the subsidiary and carried back (and made available) to the subsidiary's former (selling) group.

(iv) A troublesome byproduct of the problems identified in (iii) above could result in the waiver of the entire carryback privilege. Thus, in dealing with the sale of a subsidiary, sellers often take the position that they don't want the buyer to carry back anything to the seller's return and often extract a contractual protection from the acquiring group to waive the carryback. The Proposed Regulations, § 1.1502-21(b)(3)(i), nails down the IRS's very harsh position that all carrybacks of the buying group must be waived, not just SRLY's. Under the rule under consideration, the carryback (assuming the built-in-loss is de minimis) must go to the acquiring corporation's year, so there is no concern that the acquiring group will have to

give up all its carryback years as the price of an acquisition.[11]

(v) The rule arguably is consistent with the single entity theory of consolidation and section 381(b)(3). Thus, the result is as if the common parent of the group acquired the assets of target, and under section 381(b)(3), the losses would be carried back to the common parent's prior years.[12]

2. If carryback allowable, which member's return?

a. No tracing reasonable

If no consolidated return had been filed by the group for the equivalent carryback year, the Proposed Regulations provide that the loss would go to common parent. We believe this approach — which avoids tracing — is preferable to the proposed rule in 1984 which, in general, divided the loss in proportion to the fair value of the direct investment in the offspring by the various members of the group.

b. A carryback should be allowed if the group filed separate returns in prior years.

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[11] On the assumption Treasury will not adopt the rule under consideration, we believe the Treasury should consider a rule which would permit an election whereby the group could elect (i) to waive all carrybacks to all prior taxable years, or (ii) to waive carrybacks only to all SRLY years.

[12] If not treated as an (F) reorganization, this could be a harsh result if the common parent is newly formed and acquires Target.

The Proposed Regulations deny a carryback where the group filed separate returns in prior years. This represents a reversal of the existing rules and is troubling for the following reasons:

(i) It is theoretically sound to allow the parent to use the losses of a member created within the group, regardless of whether the group filed consolidated or separate returns for the prior year.

(ii) The proposed limitation on carrybacks to nonconsolidated years creates an internal inconsistency with the basic SRLY rule, which does not restrict a carryover (or carryback) from a “SRY” year (that is, a separate return, affiliated year). See Treas. Reg. § 1.1502-l(f)(2)(ii).

(iii) The proposed rule may be a trap for the unwary. A “parent” corporation may not file consolidated returns because it only owns a title holding or other inactive subsidiary which is basically ignored for tax purposes. In light of case law which suggests that the only test of affiliation is stock ownership,[13] the Service may claim in this case that the parent is a member of an affiliated group filing separate returns, and therefore is not a qualifying common parent with respect to which a new subsidiary's losses may be carried back.

We think a carryback is appropriate if the affiliated group elected to file separate returns in the prior years and the proposed rule should be reconsidered.

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[13] See Joseph Weindenhoff, Inc. v. Commissioner. 32 T.C. 1222, 1233 (1959).

IV. The Proposed Changes In The SRLY Rules Make Their Retention More Palatable; Relief From The SRLY Rules Should Be Provided For A Brother-Sister Structure That Is Combined Into A Parent-Subsidiary Format.

A. Arguments For and Against Retention of SRLY Rules

There are substantial arguments both in favor and against the Treasury's decision to retain the SRLY rules. The following support retention of the rules:

1. The legislative history to the 1986 Act provides that the “principles” of SRLY[14] “will continue to apply.” Absent a compelling reason, it would be extremely unusual for the Treasury to ignore this mandate.

2. The legislative history in 1986 spells out several other reasons why a profitable consolidated group (“P Group”) should not be allowed to use the carryover loss of a newly acquired subsidiary (“Lossco”) to offset its taxable income, including:

-- Under the heading “Preservation of the averaging function of carryovers”, the Report of the Senate Finance Committee states that the “primary purpose of the ... limitations is the integrity of the carryover provisions”, which are designed to “perform an averaging function.” However, the Senate Report notes that “no legitimate averaging function is performed” if a loss is allowed to “offset unrelated income,[15]“ which arguably

[14] S. Rep. No. 99-313, 99th Cong., 2d Sess. 233 (1986)

[15] Id. at 230.

would arise if the carryovers of Lossco could offset P Group's income.

-- Other reasons appear under the heading of "Appropriate matching of loss to income.[16]" The Senate Report concludes its analysis of this point by adding a concern over creating an incentive for acquisitions:

> Permitting the carryover of all losses following an acquisition, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss. Income generated under different corporate owners, from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions. (Emphasis supplied)

3. Lossco could invest all or a portion of its assets in tax-exempt bonds, yet its carryover losses could offset income of the P Group otherwise taxable at 34% (plus any state taxes). This would produce an arbitrage benefit if (as is often the case) the marginal tax rate exceeds the spread between tax-exempts and taxable investments.

4. At bottom, it could be argued that a system which allows P Group's income to offset the carryovers of Lossco (even over a period of time) is a form of free trade in losses, a doctrine which makes the government a partner in the loss business — a position which Congress has never been interested in assuming.

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[16] Id. at 231.

However, the arguments in favor of eliminating SRLY, at least where sections 382 and 384 apply[17], also have considerable force:

1. The SRLY rule was basically created as an anti-trafficking device, which has been largely addressed by sections 382 and 384. See Woolford Realty Co. v. Rose, 286 U.S. 319 (1932).

2. The legislative history to the 1986 Act suggests that the analogue to test the new section 382 rule is a combination of the assets of the loss and profit corporations in a partnership. In this case, the legislative history states that "for purposes of determining the income attributable to a loss corporation's assets, the Act prescribes an objective rate of return on the value of the corporation's equity." This suggests that the income of the unrelated acquiring corporation could be used to absorb losses of the target corporation, since the loss company is assumed to generate a portion of each dollar of taxable income.

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[17] There is general agreement that there should be no situation wherein neither section 382 nor the SRLY rules would apply to an acquisition. Yet, retaining the SRLY rules only to cover the relatively unusual case in which a loss company joins a consolidated group without triggering section 382 (e.g., where P Group's longstanding ownership of Lossco increases from 60% to 100%) also seems undesirable. One possible solution to this problem (assuming the SRLY rules were eliminated) would be to amend the consolidated return regulations so as to apply a rule similar to section 382 in the case of any change in ownership which makes a company eligible to join a consolidated group. On the other hand, such a rule (unlike SRLY) could restrict the ability of the acquired corporation from offsetting its own income, even where there has been a minor change in ownership upon entering the group.

3. Abandoning the SRLY concept would produce considerable simplification by eliminating large portions of the Proposed Regulations — including the new and necessary, but highly complex, provisions concerning when a company is or is not included in a relevant subgroup — and by reducing the concerns about properly allocating income and deduction items among the members of the group.

4. Since a merger of Lossco and profitable members of the P Group could effectively minimize the SRLY limitation, the SRLY rule discriminates against entities which for regulatory or other business reasons cannot merge profitable entities with Lossco.

5. Under the single entity theory of consolidation — the predominant approach currently used by the regulation writers — it follows that the income and losses of all the members of the group should be combined.[18]

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[18] This point, however, raises the fundamental question —how did the assets of Lossco get integrated with the other assets of the P Group? Was there a deemed section 332 liquidation of Lossco (and all other members) into P? If so, the losses of Lossco would carryover, but the outside stock basis would be eliminated, a particularly harsh result if a premium over the inside basis of the assets of Lossco were paid for its stock. On the other hand, the stock purchase could be viewed as an asset purchase. But this means, inter alia, the net operating loss carryovers of Lossco would disappear. It would appear, however, that only Congress can impose a section 332, section 338 or some other construct (such as a section 351). It could be argued that the present structure, where P Group would retain its outside basis in the stock of Lossco plus the loss carryover, but subject to the SRLY rules, is a reasonable compromise.

In two prior reports,[19] the Tax Section recommended that the SRLY limitations be abandoned in cases where section 382 applies. At this point it is fair to conclude the battle has been lost. As indicated above, however, we acknowledge that there are substantial reasons favoring the approach taken by the Treasury. In addition, we believe the changes in the SRLY rules in the Proposed Regulations (particularly the subgroup rules) make the operation of the limitations more rational and, if retained in the final regulations, make the SRLY rules far more palatable.

B. Relief for combining Brother-Sister Corporations

If the SRLY rules are to be retained, we suggest that consideration be given to providing relief from the SRLY rules for a brother-sister structure which is combined into a parent-subsidiary format. Assume, for example, a foreign parent (or an individual) owns 100% of two separate chains — one which operates at a profit and the other at a loss. If the smaller chain operates at a loss, a combination of the two chains will trigger the application of the SRLY rules. (If the larger group acquires the smaller group, then the smaller group would terminate and trigger the application of the SRLY rules as to its losses; however, if the smaller group acquires the larger group, then the smaller group would still terminate under the reverse. acquisition rules, with the same effect.) On the other hand, if the larger chain operates at a loss, a combination of the groups will not cause the losses to be subject to the SRLY limitation.

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[19] See the Report on the Net Operating Loss Provisions of the House-Passed Version of H.R. 3838, reprinted in Tax Notes. June 23, 1986 at 1220, and the Supplemental Report on Section 382, February 22, 1988, at 142.

Currently, Treas. Reg. § 1.1502-1(f)(2)(ii) provides an exception to the SRLY rules for loss companies which were members of the same affiliated group first in a separate return year and then in a consolidated return year. The arguments for expanding this rule to include members of brother/sister related groups (with an over 50% common ownership) would be based on Congressional intent. Thus, the change would follow the recent Congressional lead in sections 382 and 384 which does not limit the loss offset privilege if a brother-sister group (with an over 50% affiliation test) is combined. The proposed change would also be consistent with the Congressional approach to section 269, which has an exception for asset acquisitions by commonly controlled corporations.

We recognize, however, that this suggested revision may be troubling to those who believe that taxpayers which have gained an advantage from separate filing should not now be given a benefit by being allowed to consolidate free of the SRLY limitations. Accordingly, as an additional requirement (only for brother/sister groups with 80% or greater common ownership) a middle ground may be adopted which could follow the approach that is often taken by the Service in allowing a group to reconsolidate within five years under section 1504(a)(3). Thus, if the two previously separate groups with 80% or greater common ownership could demonstrate that separate filing produced no substantial net tax advantages over consolidation, the two groups should be allowed to combine without applying the SRLY rules.