REPORT #645

TAX SECTION

New York State Bar Association

REPORT ON BUILT-IN GAINS
AND THE INVESTMENT ADJUSTMENT RULES
IN THE CONSOLIDATED RETURN REGULATIONS

Prepared by the
Committee on Consolidated Returns

January 17, 1990

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TAX SECTION
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January 17, 1990

The Honorable Fred T. Goldberg
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report by our Committee on Consolidated Returns on Built-In Gains and the Investment Adjustment Rules in the Consolidated Return Regulations, the preparation of which was coordinated by Mikel M. Rollyson and Irving Salem.

The Report is directed to Notice 87-14, dealing with General Utilities repeal and “son-of- mirrors” transactions. It recommends that the consolidated return regulations be amended to adopt a net presumptive limitation on investment adjustment rule. The Report states that it is a close call in choosing that approach over a straight loss limitation rule (which it also analyzes). In addition, the Report analyzes and rejects as far less satisfactory three other alternative approaches: mark to market, modified conforming basis, and a loss disallowance rule.

The Report seeks to be sensitive to the problems of complexity and administrability. The addition of the LLR backstop to a net PLIA approach should help to reduce the greater scope and frequency with which appraisals would otherwise be needed under a gross PLIA approach. In addition, the Report recommends that a time-period safe harbor be adopted (of at least 5 years) so that in those cases where sales are not effected within that time period the complexities of the new rules will not come into play.

The Report also notes it would not be unreasonable for the net PLIA or LLR rules to be adopted retroactively to the date of publication of Notice 87-14 (January 6, 1987). But in light of the difficulties in establishing the value of assets in acquisitions going back that far in time, it suggests that it may be more equitable to make only the loss limitation aspect of the proposal retroactive to that date. In addition, it recommends that whatever approach is adopted be applied only prospectively to the extent that the scope or effects are not clearly within what the Service announced in Notice 87-14. In particular, it recommends against retroactive application with respect to lower-tier subsidiaries acquired prior to January 6, 1987.

Sincerely,

Wm. L. Burke
Chair

Enclosure

cc (w/encl.): Kenneth Klein, Esq.
Associate Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Edward S. Cohen, Esq.
Branch Chief, Branch 2
Room 4430IR (CC:C0RP:BR2)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Virginia S. Voorhees, Esq.
Branch Chief, Branch 4
Room 4230IR (CC:CORP:BR4)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

John Broadbent, Esq.
Acting Senior Technical Reviewer
Corporate Tax Division, Branch 2
Room 4426IR (CC:CORP:BR2)
Internal Revenue Service
1111 Constitution Avenue
Washington, D.C. 20224

The Honorable Kenneth W. Gideon
Assistance Secretary of the Treasury
for tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

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

Terrill A. Hyde, Esq.
Acting Deputy Tax Legislative Counsel
(Regulatory Affairs)
Department of the Treasury
4206 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Thomas F. Wessel, Esq.
Associate Tax Legislative Counsel
Room 4206 MT
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Ronald A. Pearlman
Chief of Staff
Joint Committee on Taxation
1015 Longworth
Washington, D.C. 20510

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REPORT
ON BUILT-IN GAINS
AND THE INVESTMENT ADJUSTMENT RULES
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Prepared by the
Committee on Consolidated Returns
New York State Bar Association
Tax Section

January 17, 1990

New York State Bar Association, Tax Section

Committee on Consolidated Returns

Report on Built-In Gains and the Investment Adjustment Rules in the Consolidated Return Regulations[*]

I. Introduction.

The investment adjustment rules presently set forth in Treas. Reg. § 1.1502-32 (the “Investment Adjustment Rules”) require annual adjustments in the basis of stock of each member of a group filing consolidated federal income tax returns. The objective of these rules is to eliminate the duplicate reporting of items of income and deduction of the group. In this manner the consolidated return regulations implement a theme that is sounded consistently throughout the consolidated return regulations: that members of an affiliated corporate group filing consolidated returns should pay a single corporate tax in respect of income of the group.[**]

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[*] This report was coordinated by Mikel M. Rollyson and Irving Salem, co-chairs of the Committee on Consolidated Returns. Significant contributions were made by Richard D. Belford, Bryan Bloom, C. Cabell Chinnis, Jr., Richard M. Fabbro and Leslie J. Hoffman Altus. Helpful comments were received from William L. Burke, Herbert L. Camp, Peter C. Canellos, Richard C. Cohen, John A. Corry and Michael Schler.

[**] See the Preamble to TD 8188, dealing with a revision of §1.1502-32(g): “The effect of the investment adjustment rules is to ensure that the income and loss of members of a consolidated group are taken into account only once in computing the taxable income of the group”.

In the Tax Reform Act of 1986 Congress repealed the General Utilities doctrine and generally imposed a corporate tax upon transactions in which appreciated assets are distributed out of corporate solution. Congress took this action in response to its belief that "the General Utilities rule tended to undermine the corporate income tax" because in permitting assets to leave corporate solution with stepped-up bases, "the effect of the rule was to grant a permanent exemption from the corporate income tax." General Explanation of the Tax Reform Act of 1986, Prepared By the Joint Committee on Taxation, (H.R. 3838, 99th Cong.; P.L. 99-514) pp. 336-37. In addition, the repeal of General Utilities reflected Congress' concern that the rule "could be at least partly responsible for the dramatic increase in corporate mergers and acquisitions in recent years." Id. at 336.

As currently in effect, the Investment Adjustment Rules can permit built-in gains to go untaxed at the corporate level. In the classic "son-of-mirrors" transaction, for instance, a purchasing corporation (hereafter referred to as the "Purchasing

Corporation” or “P”) causes its recently acquired subsidiary (hereafter referred to as the “Target” or “T”) to distribute built-in gain property to it and then sells the Target’s stock. Immediately prior to the sale, the Target’s stock basis is increased by the amount of the deferred Section 311(b) gain resulting from the distribution. The built-in gain already should have been reflected in the purchasing corporation’s basis in its Target stock, however. The effect of the upward basis adjustment in respect of the Section 311(b) gain is to create a loss on the sale of the Target that will offset the gain recognized on the distribution of the built-in gain asset, yielding no net corporate tax on the built-in gain.* The same result can be obtained if the Target sells, rather than distributes, the built-in- gain property. This avoidance of corporate tax results because although the purchasing corporation begins with a

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* The analysis above assumes that all federal income tax liability resulting from the distribution and sale is ultimately borne by the purchasing corporation, regardless of how such liability is allocated for purposes of computing earnings and profits. Mechanically, pursuant to normal consolidated return principles, tax on the gain recognized by the selling subsidiary should be allocated for this purpose to the selling subsidiary. The new regulations should result in no investment basis adjustment for either the built-in gain recognized or the taxes paid with respect to such gain. If, however, the parent pays the tax properly attributable to the selling subsidiary, it should be permitted to add the amount of tax paid to its basis in the stock of the subsidiary.

basis in the Target's stock that already reflects the value of these "built-in gain" items, the Investment Adjustment Rules call for adjustments which will duplicate that basis when the items of built-in gain are recognized.

The effect of these rules is to defeat both of Congress' goals in repealing General Utilities: corporate tax is permanently eliminated, and mergers and acquisitions are encouraged because it is only an acquiring corporation, whose purchase price basis already reflects the value of the built- in gain, that can effect this transaction without triggering a corporate tax.

In Notice 87-14, 1987-1 C.B. 445, the Internal Revenue Service announced its intention to change the Investment Adjustment Rules in cases in which acquired subsidiaries hold built-in gain assets. Notice 87-14 states that future regulations will provide that:

> the adjustment to stock basis will not reflect built-in gains that are recognized by target on sales of, or by reasons of distributions of, its assets. Thus, in cases where a target's stock is sold, the regulations will prevent recognition of losses that are attributable to the subsidiary's recognition of built-in gains.

This report first considers the extent to which the Investment Adjustment Rules are inconsistent with the objectives of General Utilities repeal. It then considers five proposals for accomplishing the goals announced in Notice 87-14. In Very brief terms, the proposals can be summarized as follows:

1. Mark to Market (“MTM”): The Investment Adjustment Rules would be modified to provide that, solely for purposes of computing the amount of earnings and profits to be taken into account in computing adjustments to the basis of stock of consolidated subsidiaries, each asset of an acquired corporation would be assigned an earnings and profits basis equal to its fair market value.

2. Presumptive Limitation on Investment Adjustments (“PLIA”): The Investment Adjustment Rules would be modified to establish a rebuttable presumption that all gain recognized by an acquired corporation with respect to the sale or exchange of a capital asset constitutes built-in gain to the extent of unrealized built-in gain. Unless the presumption were rebutted, no positive investment adjustment would arise from post-acquisition gains realized to the extent of such unrealized built-in gain.

3. Modified Conforming Basis (“MCB”): The Investment Adjustment Rules would be replaced with a rule providing that a subsidiary’s stock basis is equal to the greater of inside net asset basis or “adjusted cost basis” (purchase price plus actual contributions, less actual distributions) in the stock.[*]

4. Loss Disallowance Rule (“LDR”): The Investment Adjustment Rules would remain in place, but no loss would be recognized upon the sale or other disposition of stock of another member of an affiliated group.

[*] Certain Subchapter C reform studies have considered conforming stock basis of subsidiaries to their inside asset basis. See Committee Print 99-47, THE SUBCHAPTER C REVISION ACT of 1985, 99th Cong. 1st Sess. (1985). While that approach would also address the son-of-mirrors problem, it is not considered in detail by this report. Much of what is said in this Report about a modified conforming basis rule would also apply to a straight conforming basis mile.

5. Loss Limitation Rule (“LLR”): The Investment Adjustment Rules would remain in place, but loss upon a sale or other disposition of the stock of another member of an affiliated group would be denied to the extent attributable to gains realized by the subsidiary from the disposition of assets to the extent such gains are taken into account in computing basis adjustments under Treas. Reg. § 1502-32.

These simplified statements of the alternatives highlight the mechanical differences between the alternatives and provide a foundation for the discussion that follows. If any of these alternatives are adopted, however, the formulation of the rule will likely have to be refined to reflect the administrative, technical and policy concerns discussed later in this report. The rule ultimately implemented is certain to be more complicated than the simplified formulations set out above.

II. Summary of Conclusions.

We have identified no perfect or near perfect method for implementing the objectives of Notice 87-14. Nor is there a clearly preferable choice. Each of the proposals discussed herein would serve to overtax or under-tax taxpayers in some circumstances, and each would involve some measure of additional complexity. As discussed below, our recommendation is that MTM, MCB and LDR should be rejected, and in a close call, we recommend that PLIA be selected over LLR, but that the PLIA rule operate for only a limited number of years following an acquisition, and be backstopped with an LLR rule.

In all but the simplest of cases, MTM would not necessarily produce results that are demonstrably more accurate than the other approaches. It would, however, impose significant burdens on purchasing corporations by requiring appraisals in all acquisitions and the maintenance of an additional set of earnings and profits records for all assets of the Target. In addition, in order for MTM to fully address some of the technical problems described infra, the rule would require the Purchasing Corporation to determine the income produced by each of Target's built-in gain assets. These burdens would be imposed without regard to whether the acquisition presents the opportunity to avoid corporate taxes, and without regard to the purchaser's intention of ever disposing of the Target or its assets. Further, inaccurate appraisals would perpetuate the permanent income elimination resulting from the son of mirrors techniques, and, perhaps most importantly, rebutting taxpayers' appraisals would impose significant burdens on the Internal Revenue Service. We believe MTM would thus impose compliance burdens on taxpayers and the I.R.S. that far outweigh its benefits.

MCB should be rejected because of its substantial technical problems and because it is not a proposal that responds to the objectives of Notice 87-14. MCB would represent a complete departure from the investment adjustment rules of current law.

Such a drastic departure from the current rules is neither necessary nor appropriate to implement the objectives of Notice 87-14. As a technical matter, MCB would in many cases inappropriately result in the double taxation of operating income, permit the double deduction of losses, and permit built-in losses to shelter built-in gains (thereby permitting the son-of-mirrors transactions to continue). Moreover, there is nothing in Notice 87-14 that can be read to have forecasted the implementation of such a regime, and it could not be made to apply retroactively to the date of Notice 87-14. Accordingly we strongly urge that the regulations not adopt this approach.

We also recommend that LDR be rejected because it is simply overreaching. By denying all losses on the sale of subsidiary stock, it would deny economic losses that are wholly unrelated to investment adjustments or to built-in gains.

The choice between LLR and PLIA is a close one, but we recommend the adoption of PLIA. We do so primarily because we believe this mile responds directly to the objectives of Notice 87-14, will be readily understood by tax-payers, and will not impose significant administrative bur-dens on taxpayers and the I.R.S.

LLR offers the administrative advantage of avoiding the need for appraisals. The potential administrative convenience of LLR, however, is also the source of LLR’s weakness. Because the LLR rule applies only to losses, there would be no limitation on adjustments attributable to the recognition of built-in gains to the extent of Target’s post-acquisition appreciation, and in those circumstances such adjustments can be used to shelter additional gains that arguably should be taxed. As a consequence, its operation is subject to the vagaries of a factor (post-acquisition asset appreciation) that is only tangentially related to the point of the regulatory concern (built-in gains).

PLIA is materially better than MTM, MCB and LDR. PLIA would impose compliance burdens on taxpayers that are greater than those imposed under LLR. Although appraisals are not required under PLIA, there would be incentives for taxpayers to undertake appraisals, and, to that extent, the approach thus invites disputes and litigation over valuation issues. Moreover, taxpayers would have to apply PLIA on all sales of subsidiary stock, while LLR need be applied only on sales that would, but for its application, produce a loss.

PLIA, backstopped by LLR, is also flawed. But the

PLIA rule does not suffer from LLR's anomaly (its application being affected by post-acquisition appreciation). And the LLR backstop permits the use of a PLIA variation (a net PLIA, discussed infra) that mitigates the need for appraisals and thus reduces pressures on tax administration. PLIA, back-stopped by LLR, also permits a taxpayer to avoid appraisals entirely if the taxpayer is willing to forego an increase in basis of the stock of an acquired subsidiary for the first gain recognized by the subsidiary up to the amount of the net built-in gain at the time of acquisition.

We also recommend that PLIA or LLR, alone or in combination, be adopted with a time-period safe harbor. Target stock sold many years after the date of affiliation should not be subject to the new rules. Such a time sensitive safe harbor would significantly reduce the administrative concerns. Although a time-period safe harbor theoretically permits son-of-mirror transactions to continue, the present value of the future benefits from the investment adjustments will be small if the period is relatively long. We believe the period should not be less than 5 years.

Finally, if PLIA or LLR, alone or in combination, is adopted it would not be unreasonable for the Treasury to apply such regulations to acquisitions made after January 6, 1987. Although strong arguments can be made attacking the validity of consolidated return regulations that are retroactive,[*] Notice 87-14 placed taxpayers on notice that a rule along the lines of the PLIA or LLR or a combination of the two might be adopted, and the Congressional authority delegated under section 337(d) is quite broad.[**]

III. Background.

A. Evolution of the Investment Adjustment Rules.

The Investment Adjustment Rules have evolved to their present form in response to issues that in certain respects are not conceptually unlike the built-in gain issues addressed in this report. An overview of these rules and their historical evolution is helpful in analyzing the present issue.

The notion that an affiliated group of corporations should be permitted to file a consolidated tax return was

[*] Levin & Ginsburg, The Code Limits Retroactive Application of the Forthcoming Consolidated Return Investment Adjustment Regulation, 46 TAX NOTES No. 3 p. 317.

[**] These rules as prescribed can be overreaching in certain circumstances (discussed *infra*) and under each rule it is up to the taxpayer to prove that a particular investment adjustment was not attributable to the realization of a built-in gain. A good case can be made for providing taxpayers with some measure of relief from this burden of proof during the interim period between issuance of Notice 87-14 and ultimate issuance of the regulations because during this period taxpayers were not on notice as to the mechanics of the proposed rules and hence effectively have been denied the opportunity of rebutting the built-in gain presumptions.

initially introduced into the tax law by way of regulations in 1917 and was statutorily incorporated in 1918. The initial regulations had no provisions dealing with basis adjustments.

The absence of investment adjustment provisions created an immediate inconsistency between the mechanics and theory of a consolidated tax regime, and the issue made its way quickly to the courts. If a parent and subsidiary were to pay tax upon earnings as an economic unit, the parent should not be required to pay tax upon the subsidiary’s earnings again when it sold its stock. Courts addressed this problem (in what amounts to the precursor of the positive investment adjustment rules) by holding that a second tax should not be imposed upon a subsidiary’s earnings when the stock of that subsidiary is sold:

> The taxable group, if the Commissioner’s theory were followed, would have to account twice for the same profit or would be allowed a double deduction of the same loss. We do not believe that the provision for a consolidated return intends any such result. * * * The effect of consolidation... is to treat that as an economic unit which really is an economic unit. [Appeal of H.S. Crocker Co., 5 B.T.A. 537 (1926), nonacq. VII - 1 C.B. 36 (1928).]

Similarly, the Supreme Court established the predicate for the negative investment adjustment rules by holding that a second deduction with respect to losses of a subsidiary should not be permitted upon the disposition of subsidiary stock because:

> [i] f allowed, this would be the practical equivalent of a double deduction. In the absence of a provision . . . definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. [Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934).]

Congress reacted to this problem in 1928 by providing the Commissioner with regulatory authority to prescribe "[t]he extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group or upon the dissolution (whether partial or complete) of a member of the group". S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

The regulations that were ultimately issued pursuant to this directive were targeted specifically at preventing the double deduction of losses within affiliated groups and did not address the problem of double taxation of gains, thereby ignoring the Crocker case. The concern addressed was that a group would enjoy the benefit of a loss experienced by a member first when the loss reduced the group's consolidated taxable income, and again when the stock of the member was sold at a loss. To prevent this result, the pre-1966 regulations required a reduction in the basis of a member subsidiary's stock to reflect the subsidiary's losses if those losses were used by the group and if they could not otherwise have been used by the subsidiary if it had filed separate returns. See Treas. Reg. §1.1502-34(A)(b)(2)(i).

The 1966 consolidated return regulations extended this principle to cover the double taxation of gains as well as the double deduction of losses. They therefore provide for increases in subsidiary common stock basis to reflect:

> (i) undistributed subsidiary earnings and profits,
>
> (ii) the subsidiary's portion of unused consolidated net operating or net capital losses, and
>
> (iii) positive adjustments in respect of lower tier subsidiaries,

and for decreases in subsidiary stock basis to reflect:

> (i) the subsidiary's deficit in earnings and profits for the year,
>
> (ii) any losses sustained by the subsidiary in earlier years that are carried forward and used in the current year,
>
> (iii) distributions made out of pre-affiliation earnings and profits, and
>
> (iv) negative adjustments resulting from lower tier subsidiaries.*

The current investment adjustment regulations operate so as to ensure that a purchasing corporation receives credit,

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* Treas. Reg. § 1.1502-32(b)

by way of appropriate basis adjustments, for the realization of built-in gains. These rules operate in the son-of-mirrors transactions to exact only a tentative tax on the realization of built-in gains; the tax will be reversed on the subsequent disposition of the Target stock. This result is appropriate when viewed from the purchaser's perspective alone (the purchaser has paid for the Target with after-tax dollars and has not realized economic gain when the built-in gain is recognized), and in a pre-General Utilities repeal regime this assumption was consistent with the general rules for taxing corporate liquidations and acquisitions. The result is clearly outmoded today, however, because it permits appreciated assets to leave corporate solution with stepped-up bases without imposition of a corporate tax.

Although one might have expected the Investment Adjustment Rules to be keyed to a subsidiary's taxable income in order to implement the goal of preventing double taxation of income and double deduction of losses, the authors of the regulations chose to cause stock basis adjustments to be made in respect of changes in each member's "earnings and profits". One reason for this decision was to avoid indirect taxation of tax-exempt income (without a basis adjustment, a parent that sold subsidiary stock would pay tax on appreciation reflecting tax-exempt income earned by the subsidiary) and to prevent indirect deductions in respect of non-deductible expenditures.[*]

Interestingly enough, the Investment Adjustment Rules do address a concern that otherwise would have permitted an acquiring corporation to use those rules to generate a loss in the absence of any economic loss. The concern related to earnings that had been recognized by the acquired subsidiary before it was purchased. The acquiring corporation could acquire a subsidiary with accumulated earnings and profits (and hence acquire a cost basis in the stock that reflected the accumulated earnings), cause the subsidiary to distribute the earnings as a dividend (which would be eliminated in a consolidated return year), sell the stock for its remaining value and claim a “loss” equal to the difference between the purchase price basis and the remaining value. The remedy adopted by the regulations was to reduce stock basis by the amount of any distribution out of pre-affiliation

[*] Before enactment of the Deficit Reduction Act of 1987, the Investment Adjustment Rules had come under some fire because of discrepancies between the subsidiary’s “inside” basis (i.e., its basis in its assets) and its “outside” basis (i.e., its parent’s basis in its stock). See Woods Investment Co. v. Commissioner, 85 T.C. 274(1985). These distortions arose because the Investment Adjustment Rules, by their tie to a subsidiary’s “earnings and profits”, permitted a subsidiary to claim accelerated depreciation on its assets while its parent reduced its basis in its stock on the slower straight line method required to be made to earnings and profits by Section 312(k) of the Internal Revenue Code (enacted after the 1966 consolidated return regulations were issued). Congress reacted by adopting Section 1503(e), which provides that for purposes of determining gain or loss on disposition of stock of a member of a consolidated group, reductions to earnings and profits in respect of depreciation shall mirror deductions allowed with respect to the depreciable asset. Section 1503(e)(3)(A) gives the Treasury the authority to make “proper adjustment” for the difference between tax basis and section 312(k> earnings and profits basis of property held by an acquired corporation. This is the so-called “section 312(k) detriment”. The treatment of this item (and its coordination with Notice 87-14) could have a significant impact on the total corporate level tax to be extracted from the corporate tax system. It is but one of a number of similar policy issues which will test the Treasury’s attitude toward multiple levels of corporate taxation. (Another example now being considered by the Treasury is whether to tax both the inside and outside gain of a subsidiary held by a parent electing section 338 treatment).

earnings and profits. Treas. Reg. § 1.1502-32(b)(2)(iii).* The current basis adjustment rules thus already embrace a kind of investment adjustment or loss limitation concept where a loss produced by a mechanical application of the basis adjustment rules is inappropriate.

B. The Purpose and Scope of Notice 87-14.

Notice 87-14 is aimed at a similar malfunctioning of the Investment Adjustment Rules and is largely attributable to the repeal of General Utilities. This problem can be illustrated with a simple example:

> Example 1. (Basic Son of Mirrors). P purchases the stock of T for $100. T has a collection of assets with an aggregate fair market value ("FMV") of $100 and an aggregate basis of zero. T sells its assets to a third party for $100. T pays corporate tax on its gain of $100 ($100 received minus $0 basis). P's basis in T's stock will increase by $100 (T's gain recognized) from $100 to $200 under Treas. Reg. § 1.1502-32(b)(1)(i). When P sells T's stock for $100 (the cash left in T), P will recognize a $100 loss.**

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* This issue was also addressed by the pre-1966 regulation. See § 1.1502-36A(a)(2).

** All examples assume no other corporate activities and, for ease of illustration, ignore corporate taxes paid.

The result is not inappropriate from P’s perspective; it has not recognized any economic gain on the transaction. No net tax has been paid on the $100 built-in gain on the T asset, however, and yet the asset basis has been stepped up to fair market value. This result is clearly contrary to the concepts underlying the repeal of the General Utilities doctrine.

It is important, however, to define the limits of this problem. The regulations will have to determine the types of events which constitute the realization of built-in gains. Should the regulations address only built-in gains realized by asset dispositions, or should they also address cases in which a subsidiary “consumes” through operations a wasting asset which has a built-in gain? This is a threshold issue that cuts across each of the alternative modifications discussed in this report, and this and other similar issues will be taken up first.

1. Realization of Built-in Gains Through Asset Consumption.

The classic son-of-mirrors transaction illustrated by Example 1 involves taking advantage of the investment adjustments that arise from disposition of a built-in gain asset. Operating income produced by a built-in gain asset also gives rise to an investment adjustment, however, and in the case of wasting assets this can lead to a result over time that is similar, but not identical, to that of the son-of-mirrors transaction.

> Example 2. (Income From Wasting Built-In Gain Assets). P acquires T for $100 at a time when T holds assets with a basis, for tax and earnings and profits purposes, of $0 and value of $100, and over the following ten years the assets produce $100 of income and decline in value to $0. P’s basis in the T stock will increase from $100 to $200 as a result of the earnings and will not decrease in respect of the economic decline in value, setting the stage for a $100 capital loss when P sells T for $100. As a result, the corporate-level income recognition will be offset (ignoring capital loss limitations), albeit at a much later point in time, by a loss upon the sale of the stock.

This result is similar to the son-of-mirrors transaction in that corporate taxation of an item of built-in gain has been offset by a loss on a stock sale. The result is-not identical, however, since the built-in gain asset has not left corporate solution with a stepped-up basis. But allowing the Purchasing Corporation to offset the operating income with the subsequent loss effectively eliminates the corporate tax on the built-in gain.

It should be noted that the offsetting loss arises only if and to the extent that the asset declines in value. This example is probably more theoretical than real, there-fore, except in a few isolated situations. In the first place, in most cases income earned on assets does not necessarily correlate with a decline in the value of those assets. To the extent not correlative, a denial of a positive adjustment for such income would be tantamount to a rejection of the single entity theory of consolidation adopted in Crocker and Ilfeld and the § 1.1502-32 regulations. Stated another way, the correlation of income and decline in value should not lightly be assumed since, if wrong, the result will be a double tax on corporate earnings -- exactly what § 1.1502-32 was designed to avoid.

Moreover, any such consumption would typically take place over many years, thus reducing significantly the benefit of the offsetting investment adjustments. And finally, the loss on the sale of the stock will be a capital loss subject to various loss limitation provisions -- unlike the son-of-mirrors case, there is no ready capital gain to offset.

There may be instances, however, in which the problem is very real -- e.g., where the only assets held by the subsidiary are leasehold interests or similar identifiable wasting assets. The regulations should not permit such potentially abusive problems to escape their net, but the general approach taken by the regulations should not be driven by theoretical concerns over wasting built-in gain assets.* The effectiveness of each of the alternatives in dealing with this issue is discussed further in the sections of this report that describe those alternatives in more detail.

2. Effective Date Issues.

Notice 87-14 was released on January 6, 1987, and the regulations implementing the concepts expressed in that Notice presumably will be issued in 1990. The delay in promulgation of the regulations raises effective date issues beyond the statutory limitations contained in section 1503(a). To the extent the new rules are not inconsistent with the Notice and do not require taxpayers to take actions that they could not reasonably have anticipated under the terms of the Notice, it would not be unreasonable for Treasury to apply such regulations to acquisitions made after the effective date set forth in the Notice. However, strong arguments can be made that such a retroactive effective date violates the provisions of

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* Similar problems are inherent in Sections 384 and 1374, but are not currently addressed by the statutory scheme.

section 1503(a).[*] Moreover, as will be discussed in detail below, each proposal imparts adverse consequences that extend beyond the scope of the problems they are intended to address, and a good case can be made that relief from the effect of the new rules should be provided in such cases for transactions that took place during the transition period after Notice 87-14 was issued and before the regulations are promulgated.[**] Under certain of the proposals discussed, it would be necessary to apply a different set of rules for the transition period and to apply the permanent rules only prospectively. Effective date issues arising under each of the proposals are discussed in more detail in that context.

The general effective date set forth in Notice 87-14 raises a question about how the new rules ought to apply to a consolidated group acquired after January 6, 1987, that contains a subsidiary that acquired yet a lower-tier subsidiary prior to

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[*] See, Levin & Ginsburg, supra.

[**] Literally, the Notice may be read to apply only to limit subsequent losses attributable to built-in gains realized by Target and not to losses derived from gains recognized by other members of the affiliated group (such as lower tier subsidiaries of the Target), even where such gain is attributable to built-in gain assets held on the date of the acquisition. The effective date of the new rules, however, should not be deferred to accommodate such a literal reading when the intent of the Notice is unambiguous.

that date. For example, P acquired T in 1990 for $100. T has a basis of $90 in the stock of S (fair market value of $90) that was acquired by T prior to January 6, 1987. S has an asset with a fair market value of $90 and a basis of $60. If S sells the asset for $90, should T's basis in the S stock receive an upward adjustment, setting the stage for an offsetting loss on a later sale of the S stock?[*] In other words, should the acquisition of S by T be permanently grandfathered or should the grandfathering expire when T is acquired by P. We recommend that T's acquisition be permanently grandfathered. To do otherwise would result in certain assets being more valuable to their current holder than to a Purchasing Corporation, and thus creating an uneven playing field.

3. Issues Not Covered.

It is presumed for purposes of this report that the regime ultimately adopted will apply to all subsidiaries that become members of a consolidated group after the effective date. It may be possible, however, to limit application of the rules to instances in which the subsidiary becomes a member of the group pursuant to certain defined transactions, such as acquisitions by purchase over a fixed time period. While this is a significant issue, this report does not address such alternatives.

[*] In no event, of course, should the adjustment flow up to the basis of the T stock in the hands of P.

Moreover, this report does not address a number of technical consolidated return issues that the regulations must cover. These issues include treatment of intercompany sales and distributions, tiering adjustments, deconsolidation and the effect of other transactions (such as tax-free reorganizations) on the basis of subsidiary stock. Nor does it address the question of whether the purchaser should be given credit for any tax imposed on the corporate seller.*

4. Administrative Considerations.

The present Investment Adjustment Rules are complex but they have existed more or less in their present form since 1966. Other provisions in the code (particularly sections 382, 704(b), 752, and 1271-1275) have been addressed with enormously complex regulations within the past five years. In an effort to achieve fairness and to prevent abuse, these regulations have sacrificed the goal of administrative simplicity. As will become apparent in the following discussion, some of the proposals considered here could lead to similar complexities without entirely achieving the goal of fairness or abuse prevention. Other proposals could be implemented with relative ease. In evaluating these proposals the importance of adopting rules that can be administered with relative ease should not be minimized.

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* The adoption of Section 1503(e) may, over time, reduce the relevance of the credit issue as it will reduce the disparity in tax consequences between asset sales and stock sales and thus lead to more Section 338 elections. Indeed, enactment of that provision will serve to increase the amount of corporate gains collected on the sale of subsidiary stock generally, thereby reducing the importance of the new regulations. Of course, there will remain many instances in which the disparity between inside and outside basis arises for other reasons.

IV. Potential Solutions.

A. Mark-to-Market.

1. Description of the rule.

The general concept of MTM is that the Investment Adjustment Rules would be modified to provide that, solely for purposes of computing the amount of earnings and profits to be taken into account in computing adjustments to the basis of stock of consolidated subsidiaries, each asset held by Target would be assigned an earnings and profits basis equal to its fair market value on the date of affiliation. MTM would theoretically permit precise identification of the built-in gain inherent in Target's assets on the date of affiliation, and a precise identification of the extent to which subsequent investment adjustments to Target's stock are attributable to such built-in gains. Such precise tracing would permit appropriate limitations on investment adjustments to be made on the subsequent disposition of built-in gain assets. Thus, subsequent positive adjustments on the disposition of an asset could be limited to post-acquisition appreciation. Further, if the built-in gain asset were a depreciable asset, the stepped-up earnings and profits basis would give rise to increased basis reductions in respect of its depreciation.

Example 3. (Basic MTM Example). Assume that P purchases for $200 all of the stock of T, which owns two assets, a machine with earnings and profits and tax basis of $0 and fair market value of $100, and land with basis and value of $100. If T subsequently were to sell the land for $125, P would be permitted an investment adjustment of $25 because the gain recognized would be characterized as post-acquisition gain, not built-in gain. If, on the other hand, T were to sell the machine for $100, no adjustment in the basis of the S stock would be permitted.

2. Administrative Issues.

The theoretical accuracy of a perfect MTM system is unfortunately not possible to achieve in the real world. Assigning fair market values to individual assets of Target at the time of Target's acquisition would require detailed and costly appraisals for every acquisition. Although it would be possible to develop rules for simplifying the appraisal process, such as by grouping assets, any such procedures would undercut the technical precision that is the foundation of the rule.*

Even if a detailed appraisal of each asset of T on the date of its acquisition were available, those values would not necessarily represent the proper earnings and profits value to be assigned to T's assets. For example, if the Purchasing Corporation acquires Target stock in three tranches over five years, MTM would not be triggered until the moment of consolidation, but the Purchasing Corporation's cumulative basis in the Target stock would have little relationship to the appraised value of Target's assets. If the goal is to avoid duplicative stock basis adjustments, then MTM should adjust asset earnings and profits basis in respect of T's stock basis rather

* Because MTM applies to individual assets, it generally does not present the problems discussed infra that arise under other proposals when Target has built-in losses that offset built-in gains. Grouping assets, however, would permit assets in the group with built-in losses to shelter assets in the group with built-in gains, thus permitting the son-of- mirrors problem to continue with respect to those assets.

than T’s fair market value at the time of T’s acquisition. A similar problem arises in the case of stock acquisitions after affiliation. Only in the simplest case of a one-time purchase of 100% of Target’s stock by a consolidated group will the stock basis correlate to fair market value at the time of consolidation. Thus, in all but the simplest of cases, the alleged conceptual accuracy of the mark-to-market system is illusory.*

Given the difficulty of devising any more detailed procedure, MTM presumably would rely upon one appraisal at the time of affiliation. Pursuant to this appraisal, assets could be assigned an earnings and profits basis equal to their fair market value, or by reference to P’s basis in the T stock grossed-up for T liabilities. As is demonstrated in the following example, however, opting for the former approach will produce distortions.

> Example 4. (MTM Allocation Example). P acquired 50% of T stock in year 1 for $100. At that time T’s only asset was land with a $200 basis and $200 value. P acquires the remaining 50% of T’s stock in year 5 for $150. At that time T held the same land with a basis of $200 and a value of $300. T sells the land for $300 in year 6. If the land is assigned an earnings and profits basis equal to its fair market value at the date of affiliation ($300), there would be no investment adjustment as a result of the sale. T, however, would be taxed on $100 of gain on the sale of the land, and P would be taxed on a subsequent sale of the T stock by reference to its $250 basis in T. P would be denied an investment adjustment for its share of appreciation in the land that occurred while it owned 50% of the stock ($50) even though that $50 was not built-in gain and was not reflected in its basis in T.

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* The conceptual accuracy referred to in the text is the precise measurement of the extent to which built-in gain items are reflected in the basis of T’s stock, and the proper allocation of that amount to T’s assets.

Assigning each asset a fair market value basis at the date of affiliation thus would serve to deny investment adjustments for amounts that are not reflected in the Purchasing Corporation's basis and thus do not create the potential for avoidance of corporate tax.*

Assigning earnings and profits basis by reference to P's cost basis (grossed-up for T liabilities) in the T stock would solve the problem of over taxation illustrated by Example 4 on its narrow facts. The earnings and profits basis of the land would be $250, and on the sale of the land a $50 investment adjustment would arise.

Using grossed-up basis as the reference point, however, would also require an allocation convention such as that used in Section 1060 and Section 338(b)(5). These provisions operate on a residual method allocation. They would yield inappropriate results where the total amount to be allocated is greater or less than the aggregate fair market value of the assets. For instance, if the Target's value had increased significantly during the period after the date on which Purchaser first acquired some of Target's stock, Purchaser's aggregate basis would be much lower than the aggregate value of Target's assets on the date of affiliation. A Section 1060 allocation procedure would

* In effect, under this approach investment adjustments are permitted only for gains that accrue during the time P and T are consolidated.

result in an inappropriately large amount (perhaps all) of the stock-basis being allocated to cash, marketable securities, and the like, and an inappropriately low allocation to the assets that actually have built-in gains. An inappropriately low allocation to the built-in gain assets would permit investment adjustments to arise on a later sale of the built-in gain assets, thereby preserving son-of-mirror benefits. . .

In addition to the administrative burden the appraisal requirement would create, appraisals can invite abuse. Taxpayers would have an incentive to assign low date-of-acquisition values to those assets slated for early sale thereby creating post-acquisition gain that would create a positive investment adjustment. It would undoubtedly tax the resources of the Internal Revenue Service to provide effective policing of the appraisal process which, if not effective, could allow the son-of-mirrors technique to thrive.[*]

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[*] In dealing with valuation issues, the accounting profession has adopted a unique one-year presumption. That is, regardless of the original values attributed to an acquired subsidiary, if the subsidiary is sold within one year such value is, in general, revised to reflect the followings “(a) operations of Subsidiary S from the date of acquisition until the date of sale (the holding period - not to exceed one year), (b) interest on incremental debt incurred during the holding period to finance the purchase of Subsidiary S, and (c) proceeds from the sale”. Emerging Issues Task Force

Regardless of the allocation approach settled upon, MTM would require appraisals to determine relative values critical to any allocation procedure and likely would require the creation of new allocation procedures that would give rise to complexity and technical imprecision. MTM would also require the Purchasing Corporation to keep yet another set of records to track the new earnings and profits basis of Target's assets for purposes of computing its investment adjustments.

3. Technical and Policy Issues.

(a) Selling Corporation and Purchasing Corporation Both Permitted To Recognize a Single Built-in Loss.

MTM would aggravate the problem of current law which permits different affiliated groups to duplicate losses.

> Example 5. (MTM Duplicates Losses). X holds the stock of T with a basis of $100 and a value of $50, and T's assets have a basis of $100 and value of $50. X would recognize a $50 loss if it sold T's stock to P for $50. Under MTM, P would take a $50 earnings and profits basis in the T assets. If T then sold its assets for $50, it would recognize a second $50 loss. Unlike the situation under current law, however, the loss would not result in a reduction in P's basis in the T stock (since the loss would not produce a reduction in earnings and* profits) thereby

* #87-11 (12/17/87). This presumption could be viewed as an admission that the original valuations are not considered reliable.

setting the stage for a double use of the loss by P.*

In evaluating the significance of this issue, one must consider whether the capital loss limitations applicable to P and the section 382, 269 and SRLY limitations applicable to T provide adequate protection. Indeed, on the facts of this example, the SRLY limitations would apply to limit P's use of the loss on the sale of T's assets.

(b) Denial of Losses Due To Decline In Value of Built-In Gain Assets.

MTM would result in investment losses attributable to declines in value of a built-in gain asset being denied to the extent of the built-in gain.

> Example 6. (MTM Denial of Economic Losses). P purchases T for $100, and T has one asset, a Widget with a fair market value of $100 and a basis of $0. The Widget subsequently declines in value to 0 and is sold for $0; P then sells T for $0. Under MTM, as under current law, T does not recognize a loss on its sale of the Widget because its basis in the Widget was $0 at the time of the sale. Under current law P's stock basis in T would remain at $100 because T did not recognize a loss for tax purposes. However, under MTM, P's basis in its T stock would be reduced from $100 to $0 because, for purposes of computing T's outside basis, T would be deemed to have a basis of $100 in Widget and would be deemed to have realized a $100 loss when it sells Widget. P would therefore be denied a loss upon its sale of T stock even though it has obviously suffered a $100 economic loss and even though this loss denial is not necessary to prevent an item of built-in gain from escaping the corporate tax.

* This doubling of the built-in loss is also available with proper tax-planning under current law. Although under the current basis adjustment rules T's loss recognition would trigger an offsetting downward adjustment in P*s basis in the T stock, thus setting the stage for an offsetting $50 gain on the sale of the stock, that income recognition can easily be avoided (by not selling T or by liquidating T under section 332).

This example demonstrates that where there is no duplicative positive investment adjustment (because there is no sale at a gain), there is no reason to take account of the marked-to-market earnings and profits basis. Doing so merely results in disallowance of an economic loss.*

This problem with MTM could be resolved by modifying the approach so that it would apply only to deny increases in stock basis and not to require decreases beyond those which the -32 regulations presently require. Applying such a rule to Example 6, the sale of the Widget would not cause a negative investment adjustment, and P would recognize a $100 loss on the sale of T stock. This modification would recreate the wasting asset problem discussed below, however. In addition, this modification could enable taxpayers to recreate the son-of-mirrors transaction in cases involving recognized post-acquisition losses followed by recognized post-acquisition gains. In Example 6, for instance, if

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* The problem may be no more than a trap for the unwary since the loss could be recognized by selling T rather than the Widget; in some circumstances, however, it may not be possible to sell the T stock.

Widget 1 were sold and MTM did not require a downward basis adjustment, then any gains recognized subsequently on the reinvested sales proceeds would increase P's basis in T even to the extent that such gains did not represent value in excess of the original $100 basis.

4. MTM Addresses the Wasting Asset Problem.

By stepping up the earnings and profits basis of built-in gain assets, the mark-to-market system mechanically addresses to some extent the concerns regarding wasting assets. Referring back to Example 3, during the period T holds the machine, earnings and profits depreciation would be computed in respect of a $50 basis, the value of the machine on the date of acquisition. Assuming that the machine generated earnings that matched its economic decline, the negative adjustments to earnings and profits attributable to the machine's depreciation would exactly offset the positive adjustments attributable to its earnings, and P would not recognize any loss when it sold its T stock.

As noted above, however, MTM can result in the denial of economic losses, and it was therefore suggested *supra* that MTM might be modified to deny increases, but not to require decreases in stock basis beyond those required under current law. This suggestion would recreate the wasting asset problem, however, and thus it seems that the wasting asset problem would have to be addressed in another way. The only precise way to deal with the issue is to measure the income produced post acquisition by each built-in gain asset and to deny positive adjustments for such income to the extent they are matched by a decline in value of the built-in gain asset. Such precise tracing of income and values of built-in gain assets is obviously impracticable. Alternative approaches to the wasting asset problem are discussed infra.

5. Effect on Merger and Acquisition Activity.

A theoretically correct MTM rule would not create any strong incentives or disincentives for merger and acquisition activity. Such a rule would require the Purchasing Corporation to pay tax with respect to the same built-in gains on which the Selling Corporation would have paid tax had the Selling Corporation sold those assets. As noted above, however, if MTM were adopted it would inevitably deviate to some extent from the theoretically perfect rule. Such deviations, some of which are discussed supra, could provide corresponding incentives or disincentives for acquisition activity.

6. Effective Date Issues.

Adoption of MTM would involve difficult effective date issues. It is arguable that such a system could be effective as of January 6, 1987, on the grounds that Notice 87-14 put taxpayers on notice that for acquisitions after that date they would have to be able to identify built-in gains on the date of the acquisition. As a practical matter, however, it is doubtful that Purchasing Corporations have made the appraisals necessary to comply with a MTM rule. This fact, together with the complexity any MTM rule would likely entail, virtually dictates that any MTM rule be prospective only. A more limited rule would thus have to be applied to transition cases.

B. Presumptive Limitation on Investment Adjustments ("PLIA").

1. Description of the Rule.

This approach would modify the present basis adjustment rules to establish a rebuttable presumption that all gain recognized by an acquired corporation with respect to a sale or exchange of a capital asset constitutes built-in gain to the extent of unrealized built-in gain as of the date of affiliation. Unless the presumption were rebutted, no positive investment adjustment would arise from post-acquisition gains realized to the extent of such unrealized built-in gain.

> Example 7. (Basic PLIA Example). Assume P acquires T when it holds two assets, land (basis and value of $50) and a machine (basis $0 and value $50). If T were to sell the land subsequently for $75, the $25 gain would be presumed to constitute built-in gain, and an increase in P's stock basis in T would be denied, unless P were able to rebut the presumption. P could rebut the presumption with evidence of the value of the land at the time P acquired T, or by showing that T did not own the land at the time of the acquisition.

This proposal could take a variety of forms depending upon how the goal of administrative simplicity is balanced against the goal of fairness. For example, as discussed below, the PLIA rule applied on a net basis (comparing the outside stock basis to the net inside asset basis and applying the presumption only to this differential) could allow the gain realized on the sale of built-in gain assets to be offset by an investment adjustment in contravention of the goal of the regulations. (See Example 8 below.) The PLIA rule could be modified to limit this potential abuse with one or a combination of the following: (i) the PLIA rule could be applied to all gains subsequent to an acquisition to the extent of gross rather than net built-in gains and (ii) the Loss Limitation Rule could be applied in conjunction with the PLIA rule. These modifications are discussed below.

Administrative burdens could be eased by including a time limitation (i.e., by providing that the presumption would not apply to gains realized after an appropriate period of time subsequent to affiliation) which could be added to any version of the PLIA rule.

2. Administrative Issues.

The PLIA approach offers potentially significant administrative appeal when compared to MTM because under some permutations of the rule (e.g., applying it only to subsidiaries with net built-in gains, with appropriate time limitations) there often would be no reason to conduct an appraisal, while MTM requires an appraisal for every acquisition. Achieving this objective, however, would require implementation of a PLIA rule which turns on the presence of net unrealized built-in gain, i.e., the rule would apply only if the outside basis of the subsidiary’s stock, adjusted to reflect liabilities of the subsidiary, exceeded the inside asset basis. Adoption of such a rule would mean that acquisitions in which no net built-in gain exists would simply continue to be governed by current law. Taxpayers making acquisitions with substantial net built-in gains would find it necessary to conduct appraisals at acquisition only if they planned asset dispositions within the relevant time frame.

The time limitation could provide that the basis adjustment limitations would apply only with respect to gains realized for a limited number of years following the acquisition. An application of the PLIA rule for a limited time period would generally result in the rule applying to “bust-up” acquisitions while not burdening other acquisitions. Thus, as a practical matter, under such a rule only acquisitions involving planned dispositions would warrant conducting appraisals in order to avoid paying a double tax in respect of post-acquisition dispositions.

Achieving the level of simplification outlined above, however, comes at a price. Most significantly, as illustrated below, applying the PLIA rule only in cases in which there is net unrealized built-in gains leaves significant opportunities for manipulating the rule and avoiding its intended effects. Thus, as discussed below, a net PLIA rule should be backstopped by a loss limitation rule.

3. Technical and Policy Issues.

(a) A Net PLIA Rule permits built-in gains to be sheltered to the extent of built-in losses.

In cases in which a Purchasing Corporation holds both built-in loss assets and built-in gain assets, the PLIA rule would permit the built-in gains to be sheltered to the extent of the built-in losses if the PLIA rule applied only to those cases in which the acquired corporation has a net built-in gain, *i.e.*, to the extent that the grossed-up basis of Target stock exceeded the inside asset basis.

> Example 8. (Built-in Losses Shelter Built-in Gains Under Net PLIA). Assume P purchases T for $100 and T has two assets, Widget 1 with a basis of $0 and a fair market value of $100, and Widget 2, with a basis of $100 and a fair market value of $0. T could sell Widget 1 for $100, recognizing a $100 gain and producing a $100 increase in the outside basis of T. The increase would be permitted because at the time of the acquisition T had no net built-in gain. Subsequently, P could sell T for $100 and recognize a $100 loss.

There is no limitation on upward basis adjustments in this example because there is no net unrealized appreciation; at the time of the acquisition net inside basis equals stock basis. In this circumstance, the gain on the sale of Widget 1 effectively goes untaxed, Widget 1 takes a stepped- up basis in the hands of the third party, and the high basis of Widget 2 is preserved. This opportunity generally would not have been available to T's prior owners, who would have had to sell Widget 2 in order to shelter the gain on Widget 1. A PLIA rule tied to net built-in gains thus leaves fertile grounds for manipulation and would tend to render unlevel the playing field on which acquirors and existing owners and managers compete.[*]

This problem could be addressed in at least two ways:

(i) Apply PLIA on a Gross Basis.

PLIA could provide that all gains recognized following the affiliation would be deemed to have been generated by built-in gains at the time of affiliation, unless the taxpayer can demonstrate otherwise. In Example 8 above, notwithstanding the fact that T had no net built-in gain, the gain generated on the sale of Widget 1 would be presumed to be built-in gain for which a basis adjustment would be denied.

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[*] Although net built-in gain or loss is the standard for determining the application of Sections 382 and 384, those sections address only a timing issue -- the utilization rate of net operating losses. Son-of-mirrors transactions result in permanent avoidance of corporate tax, and thus warrant a stricter standard.

If PLIA were applied in this manner, a Purchasing Corporation would in many cases find it necessary to conduct appraisals in order to determine the amount of gross built-in gains. Taxpayers who decline to conduct such appraisals would be subjected to an unlimited denial of investment adjustments, even in cases in which no built-in gain existed at the time of the acquisition.[*] Such a rule creates the possibility that large adjustments would be denied even when they arise many years after affiliation, in transactions wholly unrelated to the realization of built-in gains. Under such a rule it would seem especially desirable for the rule to be limited in application to a fixed period after affiliation.

Under a gross PLIA rule P would retain the ability to rebut the presumption by performing appraisals, and the administrative burden on P would continue to be less significant than under MTM, for P could decide to forego an appraisal or decide to appraise only selected assets. For example, if T in Example 8 also owned Widget 3, which had a basis and fair market value of $200, P could have Widget 3 appraised and if T subsequently sold Widget 3 for $300 a basis adjustment could be permitted on the strength of such appraisal.

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[*] A cap on the adjustment limitations measured by the original purchase price of the subsidiary (grossed-up for liabilities of the subsidiary) would provide some outside limit on the amount of investment adjustments denied to the Purchasing Corporation. As the son-of-mirrors problem is generally limited to any asset appreciation reflected in the purchase price of T, this cap seems reasonable.

(ii) <u>Supplement the Net PLIA Rule with the Loss Limitation Rule</u>.

The Loss Limitation Rule is described <u>infra</u>. Under that rule, the positive investment adjustment for gains realized would be permitted, but no loss would be permitted on the sale of the T stock to the extent that such loss is attributable to such positive investment adjustments. The benefit of using the LLR as a backstop to the net PLIA (as opposed to using only the net PLIA) is that the taxpayer would not be permitted to recognize the loss described in Example 8.

Thus, the LLR could backstop the net PLIA approach; <u>i.e.</u>, LLR would apply in those cases in which Target does not have a net built-in gain. Using the LLR approach to backstop the net PLIA rule in this manner would permit inappropriate adjustments attributable to built-in gains to the extent Target has built-in loss assets, but an overall net built-in gain. While this sort of LLR backstop may not be perfect, its less than complete protection can be viewed as a compromise for simplification.

A more complete backstopping could be accomplished by applying LLR in tandem with the net PLIA rule; i.e., even if Target has a net built-in gain (and PLIA therefore applies to limit adjustments to the extent of that net amount) LLR also applies to prevent any loss recognition by P that is attributable to positive investment adjustments arising from the sale of assets. If this more complete backstopping combination of the two rules were adopted, however, it should be made clear that if the taxpayer successfully rebuts the PLIA presumption and proves that gain recognized were not built-in gains, then the investment adjustments attributable to those gains are permitted even if they cause a loss to be recognized by P on the sale of the Target stock. While a combination of any two approaches is certain to heighten the complexity of the regulations as compared to the use of only one of those two approaches, the combined scheme may still be substantially more manageable and more equitable than other alternatives.

(b) In cases in which taxpayers do not meet their burden of disproving the PLIA presumption, PLIA subjects certain items of income to double taxation.

The underlying principle of Notice 87-14 is that the consolidated return regulations should not be used to undermine the repeal of General Utilities. At the same time, any regulations promulgated pursuant to Notice 87-14 should not be more onerous than the tax consequence of the General Utilities repeal which is that a single corporate level tax should be imposed upon corporate income and gains.

A necessary consequence of the PLIA rule is the double taxation of gains of Target in cases in which the presumption is not rebutted, but, in fact, the post-acquisition gain is not attributable to built-in gain.

> Example 9. (Double Taxation of Post-Acquisition Appreciation) P purchases T for $200. T owns two assets: Widget 1, which has a basis of $50 and a fair market value of $100, and Widget 2, which has a basis and fair market value of $100. Widget 2 increases in value to $125 and is sold, and then P sells T for $225.
>
> Without rebutting the PLIA presumption, P could not increase its basis in T with respect to the $25 gain. If no basis increase is permitted, then P’s sale of T for $225 would result in the “double taxation” of T’s post-acquisition gain (first when earned by T and again when T is sold). Moreover, a purchaser of T would inherit the same potential for double taxation, by purchasing stock in a corporation with the same $50 of built-in gain.

Example 9 illustrates the potential under PLIA for the double taxation of gains that are not attributable to built-in gains.

(c) PLIA Stuffing problems.

If PLIA were applied on the basis of net built-in gains, consideration would also have to be given to providing an anti-stuffing rule similar to that set forth in Section 382(1). Unless this problem were addressed, the PLIA limitation could be avoided as follows:

Example 10. (Stuffing Example). Corporation X owns 100% of the stock of Corporation T. T owns the following assets:

	basis	fair market value
building	$ 50	$100
land	$100	$100

X also owns oil wells with a basis of 100 and a fair market value of 50. P wants to purchase T to acquire ownership of the building, and corporation Z wants to own the land. X could contribute the oil wells to T and enter into a lease of such wells with T. X could then sell T to P for $250, and under the PLIA rules T would have a net built-in gain of zero. T would then distribute the building to P, and P would sell the T stock to Z for $150, its fair market value. P would have a $200 stock basis ($250 minus the $100 distribution and plus the $50 gain) and thus a $50 loss to offset the $50 deferred gain. Z would own the land and X would have use of the oil wells.

Application of a Section 382(1) anti-stuffing concept would ignore the oil wells for purpose of calculating the PLIA limitation. Thus P would be purchasing a corporation with a $50 built-in gain and would not be allowed to increase its basis in the T stock on the distribution. There would be no need for an anti-stuffing rule, however, if PLIA applied to gross built-in gains.

4. Effect on Merger and Acquisition Activity.

The problem described in Example 8 above associated with a net PLIA rule could foster merger and acquisition activity. The ability to shelter built-in gains to the extent of built-in losses while preserving the built-in loss would reside only with an acquiring corporation whose purchase price basis in the stock of a target already reflects the value of the built-in gain. This opportunity generally would not be available to the target's prior owners, who would have had to sell Widget 2 in order to shelter the gain on Widget 1. If a PLIA rule were adopted, the operation of the presumption and the cost of appraisals to rebut the presumption would add a disincentive to acquisition activity to the extent not mitigated by the addition of a time limitation.

On the other hand, a PLIA rule can result in multiple taxation of corporate gains, and thus in that regard would tend to discourage acquisition activity. This result is illustrated *infra* in connection with Example 21.

5. Wasting Assets.

If the basis limitations under PLIA apply only to gains from the sale or disposition of assets, as opposed to all positive adjustments, a concern arises with respect to wasting assets. If the PLIA rule applied to all positive adjustments, however, it would result in double taxation of post-acquisition operating income in any case in which P could not rebut the presumption that such income was attributable to built-in gains. We believe the concerns regarding such potential double taxation makes this approach inadvisable, and recommend that if the wasting asset issue is to be addressed, it be addressed more narrowly by denying adjustments due to income recognized only in respect of certain defined assets. This concept is discussed further under LLR.

6. Effective Date Issues

PLIA could be applied retroactively to acquisitions after January 6, 1987, although this would produce harsh and unfair results with respect to taxpayers who would have been able to rebut the presumption had they obtained an appraisal at the date of acquisition. If the PLIA rule were backstopped by LLR, it might be more equitable to apply only LLR to acquisitions occurring after January 6, 1987, but before the promulgation of the regulations.

C. Modified Conforming Basis ("MCB").

1. Description of the Rule.

The MCB approach would replace the Investment Adjustment Rules with a rule providing that stock basis is equal to the greater of "inside net asset basis" ("NAB") or "adjusted cost basis" ("ACB") in the stock. Generally, a Target's NAB would be equal to the gross basis of its assets reduced by the Target's non-contingent liabilities, and a Target's ACB would equal the cost basis of the Target stock increased by the amount of any contributions to capital and decreased by the amount of any distributions. In contrast to adjusted cost basis under existing law, ACB would not be adjusted upward (or downward) to reflect increases (or decreases) in Target's earnings and profits.

Example 11. (Basic MCB Example). Assume that P purchases for $100 all of the stock of T, which has no liabilities and owns two assets: a machine with a fair market value of $75 and a tax basis of $25, and land with a fair market value and tax basis of $25. Assume further that T sells the machine for $75. Subsequently, P sells T for $100. Under existing law, the sale of the machine results in a $50 step-up in P's basis in T stock which enables P to realize an offsetting $50 loss on the sale of T. In contrast, under the MCB, P's basis in T stock would remain at $100, (the greater of its NAB ($100) and its ACB ($100), with the result that there would be no opportunity to realize an offsetting loss.

MCB would thus be similar in effect to MTM and PLIA in that it would disallow increases in the outside basis of Target stock in respect of built-in gains, but it would differ from the other approaches in that it would adopt an irrebuttable presumption that all of an acquired subsidiary's post-acquisition income constitutes a built-in gain until it exceeds the subsidiary's net built-in gain.

2. Administrative Issues.

This approach would avoid the need for asset-by-asset appraisals. It presumes all income earned is attributable to built-in gains at least to the extent of the difference between cost basis and net asset basis. Unlike the PLIA approach, however, the taxpayer would have no opportunity to rebut the presumption.

Also, unlike the other proposals discussed in this report, MCB replaces the Investment Adjustment Rules in their entirety with a new regime. It should be presumed that so radical a departure from current law will pose a significant administrative burden upon taxpayers and the I.R.S. This wholesale replacement of the current rules would probably warrant a prospective effective date as well, for MCB goes far beyond the proclamation of Notice 87-14. It also raises the unpleasant spectre of consolidated groups being forced to operate in perpetuity under two unrelated regimes: the Investment Adjustment Rules for subsidiaries acquired prior to the effective date of the new regulations, and MCB for subsidiaries acquired thereafter.

3. Technical and Policy Issues.

(a) MCB Can Allow Double Recognition of Loss By A Single Consolidated Group.

This problem is similar to the problem addressed in the Ilfeld case 55 years ago, and it is not limited to cases in which built-in loss exists at the time of an acquisition (although the problem exists equally in such cases).

> Example 12. (MCB Permits Multiple Losses). T is acquired by P at a time when T holds only cash of $200. T uses the $200 to buy Widget 1. Widget 1 declines in value to $100 and is sold, so that T recognizes a $100 loss. T's ACB remains at $200 and thus is greater than its NAB after the sale of $100. P therefore recognizes a further loss of $100 when it sells T. The P-T group has thus enjoyed a $200 tax loss in respect of a $100 economic loss, and the problem that led to promulgation of the Investment Adjustment Rules in the first place has been recreated.

For this reason, it has been suggested that MCB be supplemented with a loss disallowance rule such as the LDR discussed infra, i.e., losses on sales of subsidiary stock be flatly disallowed. This proposal is not satisfactory for two reasons: first, as will be explained below, a loss disallowance rule extends far beyond that which is necessary to address the concerns that underlie Notice 87-14. Second, the MCB not only permits double deduction of losses, but it also imposes double taxation of income, thereby recreating to a significant degree the two problems that the Investment Adjustment Rules were enacted to confront. This latter point is described in the following example.

(b) MCB Taxes Operating Income Twice Within A Single Consolidated Group.

> Example 13. (MCB Overtaxes Operating Income). P purchases T for $100. T has one asset, Widget 1, which has a basis of zero and value of $100. Next year Widget 1 generates $100 of operating income and Widget 1 maintains its $100 value. P sells the T stock for $200. Under MCB, the $100 of operating income does not increase P’s basis in T (basis is greater of ACB ($100) or NAB ($100). P is thus taxed again on the $100 gain on the sale of the T stock even though this gain represents post-acquisition earnings on which the P-T group has already been taxed.

MCB thus effectively presumes (irrebuttably) that all post-acquisition recognition events constitute the recognition of built-in gains. This produces the result described above: operating income, or for that matter post-acquisition gains, can be taxed twice to the extent of net built-in gains. Moreover, even after P has been required to pay tax twice on the operating income, the problem would carry over to the next purchaser. The proposal thus raises the possibility of a continuous cycle of recognition of a single corporate gain.*

(c) MCB Allows Built-In Losses To Shelter Built-In Gains And Hence Permits The Son-of-Mirrors Transaction To Occur Under Certain Circumstances.

> Example 14. (MCB Permits Built-in Losses to Shelter Built-in Gains). P purchases T for $100. T holds two assets: Widget 1 with a value of $100 and a basis of $0, and Widget 2 with a value of $0 and a basis of $100. Both NAB and ACB in this case are equal to $100. T sells Widget 1 for $100, and then P sells T for $100. The sale of Widget 1 causes NAB to increase to $200, and as NAB exceeds ACB, P's basis in T will be equal to $200, and P will be entitled to a $100 loss on the sale of the T stock.

This is the same problem that exists under the net

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* There are obviously ways to mitigate the effects of this double taxation. For example, the NAB of Target could be adjusted upward, solely for purposes of determining outside basis, by the acquisition date fair market value of certain of its non-depreciable assets, such as land and goodwill. Such assets would be appraised as of the acquisition date in order to establish their fair market value and built-in gain. Upon any taxable disposition of any such asset, the positive NAB adjustment attributable to the asset would be reversed. This reversing entry would ensure that no positive adjustment to outside stock basis would result from the subsequent recognition of the built-in gain. Alternatively, ACB could be adjusted to reflect certain items of income which are clearly not attributable to recognition of built-in gain. Such items could include income attributable to assets acquired by Target after the acquisition date and certain items of ordinary income attributable to non-amortizable assets (i.e., rentals with respect to a ground lease). Other alternatives would also be possible, but each would make MCB more complex and would give rise to administrative problems similar to those inherent in MTM.

PLIA approach described above, and would likewise permit son-of-mirror transactions to continue. As discussed in connection with Example 12, it has been proposed that MCB be supplemented with a loss disallowance rule, which would address this netting problem. A loss disallowance rule is undesirable, however, for reasons discussed infra. This example also illustrates that in the absence of such a loss disallowance rule the MCB approach would also require anti stuffing rules such as those discussed supra with respect to the net PLIA approach.*

4. Treatment of Wasting Assets.

The MCB approach attempts to deal with the concern over wasting built-in gain assets by denying any investment adjustments for income of Target. In general, because under MCB there is never an adjustment to ACB and NAB is adjusted only as inside basis increases, wasting assets would not be a major concern.

* Consider, for example, a case in which an historic parent formed T by contributing $50 to it. T used the cash to buy one tract of land that appreciates in value to $100. P also holds Tract 2, which it bought for $50 and has depreciated in value to $0. P now contributes Tract 2 to T. T’s ACB and NAB are both equal to $100. If T were to sell Tract 1 for $100, its NAB would increase to $150. P could then sell T for its $100 value and realize a $50 loss.

5. Effect on Merger and Acquisition Activity.

The problem described in Example 12 (double deduction of losses) seems to apply equally in the case of subsidiaries owned by their historic parents and newly acquired subsidiaries. The problem described in Example 13 (double taxation of income) puts acquiring groups at a disadvantage. The problem described in Example 14 (built-in losses shelter built-in gains and permit son-of-mirrors transactions) permits abuse both in the cases of historic subsidiaries and newly acquired subsidiaries. Overall MCB should have a negative effect on acquisitions because of the potential for double taxation of operating income.

6. Effective Date Issues.

MCB would replace current law in its entirety with a new regime. As noted in the examples above, it imposes detrimental consequences upon situations unrelated to the son-of-mirrors problem and upon situations that do not raise theoretical problems under current law. We believe that an MCB regime could not be imposed legitimately on a retroactive basis. Thus, some other regime would have to be adopted for transition cases.

D. Loss Disallowance and Loss Limitation Rules (“LDR” and “LLR”).

1. Description of the Rules.

LDR is easily stated: No loss shall be recognized upon the sale or other disposition of stock of another member of the affiliated group. Such a rule would serve two purposes. It would address the built-in gain problem described in Notice 87-14 via an irrebuttable presumption — that is, if stock of a member is sold at a loss, such loss is irrebuttably presumed attributable to an investment adjustment which is in turn attributable to a built-in gain that duplicates an amount already reflected in stock basis. In addition, such a rule would eliminate the opportunity, presently available under current law, for different corporate groups to duplicate the same economic loss. The rule accomplishes these purposes, however, by reaching far beyond the concerns expressed in Notice 87-14. A variation of this approach, a loss limitation rule, however, has much to commend it.

LLR would provide that solely for purposes of computing any loss upon P’s sale of the stock of T, P’s loss is limited to the excess of that loss over the aggregate amount of Target’s gains from the sale or exchange of assets that were taken into account in computing positive adjustments under Treas. Reg. § 1.1502-32(b)(1)(i). LLR would be conceptually similar to LDR but would more directly address the concerns underlying Notice

87-14 by keying off of positive investment adjustments under § 1.1502-32 for gains that are potentially duplicative and hence may create the potential for a loss. If a loss is otherwise to be reported, LLR would back out the positive investment adjustment for gains realized to ensure that there is no duplication of amounts already reflected in basis. Thus, it presumes the positive adjustments resulting from such gains are attributable to built-in gains.

2. Administrative Issues.

Either of these rules would be simple to understand and administer. There would be no valuation issues to debate. Exceptions and special rules may be needed, however, to deal with the technical problems discussed below.

3. Technical and Policy Issues.

We believe that LDR should be rejected because in many cases it needlessly would deny the utilization of recognized economic losses. The rule would also not come into play to the extent there is post-acquisition appreciation in the value of Targets assets so that no loss is recognized upon the sale of Target. This latter point is described and discussed in detail in connection with the LLR discussion. The overreaching effects of LDR is illustrated by the following examples.

(a) LDR Denies an Economic Loss Realized Upon a Sale of a Subsidiary That Held No Built-In Gain Assets When It Was Acquired.

Example 15. (LDR Denies Economic Losses Without Regard to Built-in Gains). P forms-T with $100 in cash. T purchases a non-depreciable Widget for $100. At the end of the year, the Widget is worth $10 and P sells T for $10, realizing a $90 economic loss. LDR would disallow P's loss.

This result cannot be justified. To deprive P of its economic loss (available if separate returns had been filed) would unduly penalize those filing consolidated returns.[*] Such a rule seems driven more by concerns over the potential duplication of losses within the corporate tax system that exists under current law, than by the concerns addressed by Notice 87-14. By denying losses on sales of stock, LDR would put an end to the doubling of losses that can arise under current law when P contributes a built-in loss asset to T. While this problem is perhaps one that should be addressed, it would take a major effort to work out a satisfactory solution. We believe the

[*] Of course, P could recognize the loss merely by selling the Widget or by selling the stock of T and electing section 338(h)(10). There will be circumstances, however, in which a contemplated stock sale will not meet the requirements of section 338 (e.g. absence of "qualified stock purchase"). Moreover, it would be particularly onerous to force P to sell assets when P wishes to sell only a portion of its interest in T. Finally, we do not believe the consolidated return rules should deny the taxpayer the choice of selling stock or assets provided by current law.

current regulations project should focus more directly on the issues presented by Notice 87-14, and should not take on this more general problem which would undoubtedly delay guidance with respect to the implementation of Notice 87-14.

(b) LDR Can Deny an Economic Loss Where Target's Assets Decline in Value.

> Example 16. (LDR Denies Economic Losses Attributable to Decline in Value of Built-in-Gain Assets). P purchases T for $100. T owns land with a basis of $0 and a value of $100. The land declines in value during the year and P sells T for $0. Under LDR, P's economic loss of $100 is disallowed. And since T's inside basis is $0, the acquiror of T cannot recognize a loss by selling the land, with the result that nobody will benefit from the loss.

This example demonstrates that the denial of an economic loss under an LDR can arise when a corporation suffers post-acquisition losses following the purchase of a corporation with built-in gains. In this case, as in Example 15, the investment basis adjustments permitted under present law would not have operated to create an artificial loss, and LDR would disallow an economic loss that has been realized by P.

(c) LDR Denies Investment Loss Where Realized Loss by Target Cannot be Offset Against Purchaser's Income.

Example 17. (LDR Denies Economic Losses Where T's Recognized Loss Cannot Be Utilized). P purchases T for $100. T owns land worth $100 and with a basis of $100. The land declines in value during the year and is sold for $0. T's loss cannot be absorbed by the P group. P sells T for $0. Under LDR, P's economic loss would be disallowed.

Again, as in Examples (15) and (16), P's economic loss would be disallowed, even though the investment adjustment rules played no part in the result and the loss would be available if separate returns were filed.[*]

4. The Loss Limitation Rule.

LLR would achieve many of the benefits of LDR, such as ease of administration and understanding, and although its reach is also wider than its aim it would in large part avoid the overreaching nature of the LDR. By disallowing losses only to the extent of certain investment adjustments, the rule is more directly targeted to the issues presented in Notice 87-14. LLR in essence presumes that to the extent of losses on T stock, investment adjustments from gains on the sale or exchange of property are attributable to the realization of built-in gains.

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[*] One way to minimize this result would be to provide P with an election to retain the loss notwithstanding that T is sold. That is, allow P the ability to elect to reverse the rules under § 1.1502-79, so that P would be in a position to obtain a tax benefit from its economic loss. Note the retention of the loss by P was the consolidated rule until the precursor of § 1.1502-79 was adopted in 1943.

The rule applies only to the extent of losses, however, and thus would have no application where a subsidiary is sold at gain, even if such a sale is subsequent to a sale of built-in gain assets by the subsidiary. For example, if Target recognizes built-in gains and has unrecognized post-acquisition gains in an amount equal to the recognized built-in gains. The effect of LLR in these circumstances is to treat the investment adjustments that arose from the sale of the built-in gain assets as attributable to post-acquisition gains, and thus to permit an investment adjustment with respect to the recognized built-in gains. The effects of LLR are illustrated by the examples that follow.

(a) Under LLR, to the Extent of Losses, All Post-Acquisition Realized Gains Are Deemed Attributable to Built-in Gains And Can Result in Over-taxation.

Example 18. (LLR Presumes Gains Are Built-in Gains). P acquires T which holds $100 cash. T buys land for $100 and after 10 years, T sells the land for $500. The $500 is reinvested in Widgets, which decline in value to $0 in year 11. P sells T for $0. P’s basis in T is $500 ($100 plus $400 positive investment adjustment). P’s recognized loss is limited to $100, because in computing such loss, the $400 positive investment adjustment is backed out of P’s basis in T.

Example 18 illustrates that LLR is overreaching whenever the gains realized that give rise to investment adjustments exceed the built-in gain present at the time of acquisition and there is not post-acquisition appreciation to offset such adjustments. In Example 18 P is inappropriately denied an economic loss of $400 because of the LLR presumption that all gains realized are attributable to the realization of built-in gains. This over-taxation is similar to that presented by the LDR approach, but is more limited because it arises only to the extent the loss is created by positive investment adjustments.

This overreaching aspect of the proposal could be ameliorated in several ways. One approach would be to limit the disallowed loss to the amount of P’s initial grossed-up basis in T prior to any investment adjustments. Thus, in Example 18 P would recognize a loss of $400, the loss realized of $500 less the original basis of $100. The rationale for such a limitation is that there can only be a duplication of basis that is caused by investment adjustments to the extent such built-in gain was reflected in P’s original purchase price.* The original purchase price thus sets the maximum amount of built-in gain that could

* It is possible that other circumstances could trigger basis adjustments that do not reflect increases in value, for example, when excess loss accounts in lower tier subsidiaries are triggered. Treasury may wish to address such other

possibly exist in T. On the facts of Example 18 P is still denied $100 of an economic loss that is not attributable to a built-in gain, but at least the problem has been limited in scope.

It is possible to go further in reducing this potential for over-taxation by permitting the Purchasing Corporation to rebut the LLR presumption by demonstrating that the adjustments were not attributable to assets held on the date of acquisition. That would be a step in the direction of a PLIA rule. Alternatively, a time period limitation could also be provided. Thus, for example, only gains realized within some time period following affiliation would be deemed attributable to built-in gains, or only losses on the sale of T stock realized within some such time period would be disallowed.

(b) Under LLR Built-in Losses Do Not Shelter Built-in Gains.

It was noted that under PLIA (if applied on a net basis, but not if applied on a gross basis) and under MCB, built-in losses on assets held by T could shelter built-in gains on other T assets, and that this could perpetuate the son-of-mirrors problem. The following example shows that this does not occur under LLR.*

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* circumstances in regulations.

Example 19. (Under LLR Built-in Losses Do not Shelter Built-in Gains). P purchases T for $100 and T has two assets, Widget 1 with a value of $100 and a basis of $0, and Widget 2 with a value of $0 and a basis of $100. T sells Widget 1 for $100 and then P sells T for $100. Under LLR P would have a $100 positive investment adjustment from the sale of Widget 1, but that adjustment would be reversed for purposes of computing a loss on the sale by P of the T stock. Thus, P would have no gain or loss on the sale of the T stock.

Example 19 illustrates that so long as LLR is applied on a gross basis, that is, to all gains that are taken into account in computing all positive adjustments (and not merely to positive adjustments in excess of negative adjustments), LLR will not permit built-in losses to shelter built-in gains.

(c) Post-Acquisition Appreciation in Value Serves Under LLR to Shelter Tax on Gain Realized on the Disposition of Target.

As noted above, LLR also would permit P to shelter its investment gain on the sale of T to the extent there is post-acquisition appreciation in T’s assets. This result is illustrated by the following example.

Example 20. (Under LLR Built-in Gains Can Shelter Post-Acquisition Gains). P purchases T for $100. T has two assets. Widget 1 has a basis of $0 and a value of $100. Widget 2 has a basis of $100 and a value of $0. T sells Widget 1 for $100. Widget 2 has appreciated in value to $100 at that time. P sells its stock in T for $200 (the value of the $100 sales proceeds and the $100 value of-Widget 2). T recognizes $100 of gain upon its sale of the built-in gain asset, Widget 1. This gain causes a positive adjustment in the basis of P’s stock in T from $100 to $200. Upon the sale of T, for $200, P recognizes no gain or loss ($200 amount realized minus $200 basis) even though P’s investment in T has increased in value from $100 to $200 as a result of the post-acquisition appreciation of Widget 2. The investment adjustment attributable to the $100 of built-in gain on Widget 1 has effectively served to shelter taxation of this gain.

In effect, under the LLR rule, gains are presumed to be post-acquisition gains to the extent there has been post-acquisition gain. As a result, LLR arguably does not fully reflect the stated intention of Notice 87-14 that "the adjustment to stock basis will not reflect built-in gains that are recognized by target on sales of, or by reasons of distributions of [the target's assets]." In Example 20, the $100 basis adjustment that reduces gain by P on the sale of T stock is attributed to recognition of the built-in gain. The results of this adjustment can be viewed in different ways, depending upon one's perspective. It can be argued that the adjustment is not inappropriate because T's built-in gain has been taxed to T and the adjustment has not resulted in a loss which offsets that gain. Moreover, the failure to tax P separately on its investment gain of $100 with respect to T can be defended on the grounds that the P-T group has paid tax on its economic gain of $100 and the appreciation in value of Widget 2 (which gives rise to the investment gain) remains in corporate solution, to be taxed when that asset is disposed of. From this perspective, the LLR rule can be viewed as merely providing a deferral of tax on the built-in gain on Widget 2.

On the other hand, however, Notice 87-14 can be read to say that no investment adjustment should ever be made for recognized built-in gains, and that the P-T group in the above example should pay tax on the $100 of built-in gain and pay tax on the $100 of investment gain as well (attributable to the appreciation in Widget 2). Viewed from this perspective the LLR rule permits P to avoid permanently tax that should be paid on $100 of investment gain.*

A strict policy of denying adjustments for built-in gains, however, requires an appraisal to determine whether all or a portion of the gain on Widget 1 resulted from a built-in gain rather than a post-acquisition gain. That is, Widget 2 may have had a value of $100 when P purchased T and Widget 1 may have had no built-in gain. If that had been the case, a $100 positive investment adjustment* would be appropriate since under a tracing rule the gain on Widget 1 that was realized was not built-in and thus not already reflected in basis.

LLR thus represents a trade-off. It offers the significant administrative efficiency (for both taxpayer and the Internal Revenue Service) of avoiding the need to deal with appraisals, but at the cost of imposing additional tax in the case of some losses and failing to impose tax on some investment gains that arguably should be taxed.

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* A different way of looking at the issue is that LLR is effectively a deferral of the tax on T's inside gain and not an elimination of gain on the sale of T. This is because if P were subject to a tax on the sale of T (because the basis step-up on the sale of Widget 1 is denied), P would presumably either have T sell its assets or would sell T and elect section 338(h)(10). Although this would cause the P group to pay an immediate tax on the appreciation on Widget 2, no second tax would be paid when the purchaser sells Widget 2 because the basis of Widget 2 would have been stepped up. Accordingly, it may be more accurate to state the post-acquisition issue as permitting deferral, not elimination, of tax.

(d) <u>Treatment of Wasting Assets</u>.

Under LLR as described above, wasting built-in gain assets will not trigger application of the rule, because the rule reverses only those investment adjustments arising from the sale or exchange of assets. Failure to apply the rule to all positive adjustments could thus lead to an inappropriate loss on the sale of T stock. If this is thought to be of significant concern, the LLR could be expanded to deny adjustments attributable to income from wasting assets. Defining such assets with specificity, however, would be a difficult task, and would inevitably lead to complex regulations. It would be preferable perhaps for the regulations merely to state the concept of a wasting asset, give several examples of wasting assets, and then give the IRS the authority to deny investment adjustments in potentially abusive cases, such as where it can be shown that more than, say, 15% of T’s value is attributable to wasting built-in gain assets.

(e) <u>Effect on Merger and Acquisition Activity</u>.

LLR may have some effect on acquisition activity, but any effect would be limited. As Examples 19 and 20 illustrate, LLR denies a Purchasing Corporation the son-of- mirrors benefit, but it permits deferral or elimination (depending upon one’s perspective) of investment gains up to the amount of built-in gains to the extent there are post-acquisition gains.

> Example 21. (Deferral of Post-Acquisition Unrealized Gains Under LLR). Assume T owns Widget 1 with a value of $100 and a basis of $0, and Widget 2 with a value of $0 and a basis of $0. P buys T for $100 and sells Widget 1 to purchaser A for $100. Widget 2 appreciates in value to $100, and P sells T to purchaser B for $200. The $100 of built-in gain on Widget 1 is taxed. The $100 positive adjustment gives P a basis in T of $200, and is not reversed because the sale of T to purchaser B for $200 does not produce a loss. P is taxed on the $100 of built-in gain on Widget 1, but P's gain on Widget 2 is deferred, effectively being sheltered by the adjustment that arose from the sale of a built-in gain asset.

If the owner of T in Example 21 were a corporation with a basis in the T stock equal to the inside basis of the T assets ($0), and that corporate owner caused T to sell Widget 1 to one purchaser and then sold the T stock to another purchaser, the selling corporation would bear the economic burden of tax on $200 of gain ($100 on the sale of Widget 1 and $100 on the sale of T). Moreover, unless the purchaser of T made a Section 338 election, the built-in gain on Widget 2 would continue and would be taxed again if Widget 2 were sold directly.

It can be argued therefore that LLR has a pro-acquisition effect in that it eliminates this potential for multiple taxation of the built-in gain. But this effect would arise only if (and after) the purchaser held the stock of T long enough for net post-acquisition appreciation in the assets of T to occur. Moreover, even if post-acquisition appreciation has arisen, the same corporate level tax deferral can be achieved under any of the other alternatives in those cases where shareholders of P are individuals or public shareholders that wish to reduce their investment to cash. In that case, T could sell Widget 1, and the shareholders of P could then sell the stock of P. The shareholders of P are taxed on the sale of their P stock, but no additional shareholder tax arises, and corporate tax on the appreciation in Widget 2 is deferred. In such case, LLR offers the purchaser of the P stock no relative advantage or disadvantage because a sale by P of the T stock gives rise to the same corporate level tax consequence whether occurring before or after the sale of the stock of P. The effect of LLR on merger and acquisition activity thus should be limited at most.* As discussed above, under Example 20, this deferral of the built-in gain on Widget 2 is not necessarily inappropriate because Widget 2 has not received a stepped-up basis. Moreover, this deferral opportunity is also available to the prior individual or public owners of T. The prior owners could cause T to sell Widget 1 and continue to hold. Widget 2; a subsequent sale of T, when Widget 2 had appreciated to $100 in value, would not trigger a corporate level tax on the built-in gain on Widget 2.

It should be noted, however, that under MTM or PLIA, P’s gain in Example 21 would not be sheltered. Under either rule, P would be denied an investment adjustment for the $100 gain on the sale of

* As noted in the discussion of the PLIA approach, supra at page 46, PLIA can result in multiple corporate tax being imposed on a single corporate gain. Under PLIA, P’s gain in Example 21 would not be sheltered. P would be denied an investment adjustment for the $100 gain on the sale Widget 1, and on the sale of T for $200, P would recognize $100 of additional gain that is attributable to the built-in gain in Widget 2; that built-in gain would also carry over to the purchaser of T. Thus, PLIA can result in a single corporate gain being taxed more than once. Arguably, therefore, PLIA would thus appear to make assets more valuable in the hands of current owners than purchasers, which would tend to reduce acquisition activity.

(f) Stuffing Problems.

The potential for deferral under LLR noted in the examples above also presents a potential for abuse. A parent corporation might, for example, have a subsidiary with a large amount of built-in gains and simultaneously hold a large amount of appreciated assets outside the subsidiary. If the subsidiary subsequently sold those built-in gain assets while the parent corporation simultaneously “stuffed” that subsidiary with the other appreciated assets, the parent would effectively defer taxation with respect to those appreciated assets if the subsidiary stock were then sold. Accordingly, if LLR were adopted it would be appropriate to develop an anti-stuffing rule.

(g) Effective Date Issues.

Because of the assumption in LLR that gains realized are attributable to built-in gains, the rule can deny economic losses that, in fact, are not the result of investment adjustments attributable to built-in gains. In this respect the rule is overreaching, and it would be unfair to apply such a rule retroactively without some potential relief from the assumption. Consideration should be given to permitting taxpayers who made acquisitions during the transition period (after January 6, 1987 and before promulgation of the regulations) to rebut the presumption that inheres in LLR.

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