REPORT #863

TAX SECTION

New York State Bar Association

Report on Temporary and Proposed Regulations on Transactions Involving Stock of the Common Parent of a Consolidated Group

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TAX SECTION

New York State Bar Association

January 30, 1996

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Re: Proposed and Temporary Regulations
Section 1.1502-13T(f)(6)

Dear Secretary Samuels and Commissioner Richardson:

Enclosed please find our report commenting on Temporary and Proposed Regulations §1.1502-13T(f)(6) (the "Regulations") relating to the income tax treatment of transactions involving the stock of the common parent of a consolidated group. The principal author of the report is Ann-Elizabeth Purintun, Co-Chair of our Committee on Consolidated Returns.

The report recognizes that the problem to which the Regulations are addressed is a classic whipsaw problem stemming from the ability of members of a consolidated group to trigger losses but avoid gains by holding parent stock in a consolidated subsidiary -- if the stock depreciates it can be sold by the subsidiary to produce deductible loss, whereas if the stock appreciates it can be held by the subsidiary indefinitely, postponing or (in the case of a §332 liquidation) even eliminating altogether the tax on the gain. By contrast, if the parent dealt in its stock directly it would recognize neither gain nor loss on the stock.

As stated in the report, we support the promulgation of regulations that put an immediate end to abusive transactions in parent stock that produce artificial losses. We generally endorse the loss disallowance and basis reduction rules (or concepts) provided in the Regulations. There are, however, certain aspects of the Regulations that are of concern to us.

First, the issuance of the Regulations as Temporary regulations with an immediate effective date constituted a significant change in the law, of which taxpayers had no notice. We suggest that consideration be given to providing some transitional relief, for example for depreciated stock owned by formerly unaffiliated corporations that became members of the parent's group before July 12, 1995; and to allowing losses on “positions” entered into before July 12, 1995.

The report also expresses our dissatisfaction with the Regulations' asymmetrical treatment of gains and losses. It is both unfair and theoretically unsound to promulgate Regulations that deny losses on parent stock yet require the recognition of gains. And it is not correct to assume that taxpayers will always be able to avoid the mismatching of recognized gains and disallowed losses that results under the Regulations either by limiting their group's dealings in parent stock to the parent itself, or by holding appreciated stock and positions in stock indefinitely. There will be transactions undertaken for legitimate business reasons for which the inevitable result under the Regulations is that gains are recognized while losses are disallowed. This is not an appropriate or balanced tax result, and we urge that Treasury not impose this mismatch by finalizing the Regulations in their current form.

We recognize that you share our concerns about the asymmetrical treatment of gains and losses. We also agree that the imposition of “single-entity” treatment for gains as well as losses does raise a number of very complex questions. We do not underestimate the challenge presented by creating a comprehensive system to achieve nonrecognition of gains as well as losses on transactions by group members involving parent stock.

We believe, however, that progress has already been made in identifying and resolving a number of the issues this presents. We also believe that the complexity of the issues should not overwhelm the importance of dealing equitably with both gains and losses. The promulgation of Regulations addressing the loss side of the equation makes it particularly important to address the gain side of the equation as well. This report refers to prior reports we have issued on analogous issues, and suggests some approaches for achieving parity in the treatment of gains and losses. We also discuss certain possible measures that would achieve greater neutrality while involving less comprehensive changes.

As a technical matter, we believe that the scope of the Regulations should be conformed to that of section 1032, so that the Regulations do not operate to preclude (through loss disallowance) subsidiaries from engaging in transactions to which section 1032 would not apply. In a similar vein, we suggest certain netting rules, and we suggest an exception for transactions entered into in the ordinary course of a subsidiary's trade or business as a securities dealer. Finally, believing the “zero basis” issue to be an unfortunate virus against which the well-advised are generally inoculated while the unwary blunder forward, we urge that this opportunity be taken to expand the Regulations to deal more effectively with the zero basis problem.

Please do not hesitate to contact us if we can be of assistance to you in revising and finalizing the Regulations, particularly in dealing with the issues presented by achieving equivalent nonrecognition treatment for gains and losses.

Very truly yours,

Carolyn Joy Lee
Chair

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON CONSOLIDATED RETURNS

Report on Temporary and Proposed Regulations on Transactions Involving Stock of the Common Parent of a Consolidated Group[1]

January 22, 1996

This report comments on Temporary Treasury Regulations §1.1502-13T(f)(6), issued on July 12,1995, and entitled “Transactions Involving Stock of the Common Parent of a Consolidated Group”(T.D. 8598)(the “Regulations”).The text of the Regulations also served as a notice of proposed rulemaking(CO-24-95).

Description of the Regulations. The Regulations provide that any loss Recognized by a member of a consolidated group with respect to P stock is permanently disallowed. For this purpose, P stock is any stock of the common parent(P)held by another member(S),[2] or any stock of a member that was the common parent if the stock was held by another member while the issuer was the common parent. The disallowed loss does not reduce earnings and profits. Under the investment adjustment rules, however, the

[1] This report was prepared by Ann-Elizabeth Purintun, Co-Chair of the Committee on Consolidated Returns, with substantial assistance from Michael L. Schler and Patrick C. Gallagher. Helpful comments were also received from Peter C. Canellos, Wm. Lesse Castleberry, David P. Hariton, Carolyn Joy Lee, Richard O. Loengard, Jr., Richard L. Reinhold, and Steven C. Todrys.

[2] Although the Regulations use “M” to refer to the member holding the P stock, this report uses the more common designation “S” to refer to any member of the consolidated group other than P.

basis of S’s stock is reduced (Treas. Reg. § 1.1502-32(b)(3)(iii)(A)). If P stock owned by S has a basis in excess of fair market value immediately before it becomes owned by a nonmember, then, to the extent the loss disallowance rule does not apply, S’s basis in the stock is reduced to fair market value immediately before the stock is owned by the nonmember. The loss disallowance and basis reduction rules also apply to options, warrants, forward contracts, and other positions with respect to P stock.

The Regulations prevent S from recognizing gain on a “qualified disposition” of P stock. This provision is not concerned with transactions involving P stock that has appreciated in value. It is directed solely at preventing recognition of gain due to the “zero basis” problem[3] and is very narrowly drawn. The gain nonrecognition rule applies only to certain transactions in which S acquires P stock from P in a contribution to capital or a section 351 transaction (or, if necessary, through a series of such transactions involving only members of the group) and immediately transfers the stock to an unrelated nonmember in a taxable transaction. Gain recognition is prevented by treating the P stock as purchased from P for fair market value with cash contributed to S by P (or, if necessary, through any intermediate members), thereby giving S a fair market

[3] The zero basis problem arises because S is viewed as taking a zero basis in P stock contributed by P or acquired from P in a section 351 exchange. See Rev. Rul. 74-503, 1974-2 C.B. 117.

value basis in the stock. This treatment also results in an increase in the basis of the stock of S (and of any intermediate members).

Reason for the Regulations. The preamble to the Regulations states that taxpayers could use circular ownership structures to claim "artificial" losses,[4] and that the Regulations are necessary "to provide greater single entity treatment for losses by preventing groups from inappropriately claiming losses on the sale of stock of the common parent." Since the Regulations disallow all losses with respect to P stock, the conclusion that loss recognition by S is inappropriate appears to derive from the fact that no loss would be allowed to P if P engaged in the same transaction. And, while P would recognize no gain if it sold its own stock, the Regulations also assume that the group can avoid recognizing gains with respect to P stock, and that there is therefore no need for a corresponding gain nonrecognition rule.

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[4] While the preamble provides no examples of such artificial losses with respect to P stock, it has been reported that a major reason for the promulgation of the Regulations was to deal with a particular transaction designed to generate an artificial capital loss. The transaction reportedly involved the purchase of publicly traded P stock by S, followed by the redemption of 95% of the purchased stock in exchange for cash and warrants and, later, the sale of the retained shares back to the public. The desired result was a dividend to S under section 302(d), elimination of the dividend in determining consolidated taxable income, the addition of the basis of the redeemed shares to the P shares retained by S, and a capital loss on the sale of the retained shares. See Letter from Lawrence M. Axelrod to Glen Kohl, Tax Legislative Counsel, reprinted in Highlights & Documents, Sept. 22, 1995, at 4415, 95 TNT 185-59 (Sept. 21, 1995).

We agree that corporations, whether or not they are members of a consolidated group, should not be able to generate artificial capital losses. We believe, however, that this particular transaction (assuming section 1059 would not apply) is better addressed by proscribing the basis shifting that generates the artificial loss, rather than by promulgating a wholesale loss disallowance rule for consolidated groups.

Thus, the problem addressed by the Regulations is a classic whipsaw problem -- the ability of a consolidated group to recognize losses on P stock selectively while avoiding recognition of gains. For example, S can purchase P stock from P. If the value of the P stock has gone down at a time when the group wants to issue P stock, S will sell the P stock at a loss. If the value of the P stock has gone up, P will issue new stock. S can hold the appreciated P stock indefinitely.[5]

Issuance of the Regulations in temporary form. We have no quarrel with putting an immediate end to any abusive transactions that produce artificial losses. But, quite apart from the question of the Regulations' validity, we are concerned about the issuance of an immediately effective rule disallowing all losses on P stock (and on positions with respect to P stock) -- losses that prior law unquestionably allowed. We therefore suggest that consideration be given to amending the Regulations to permit the recognition of some losses on P stock acquired before July 12, 1995. While we would not recommend broad transitional relief extending to all but specifically targeted abusive transactions, we believe that a more narrowly targeted transitional rule would be appropriate. Such a rule could, for example, apply only to built-in losses with respect to P stock held by a nonmember that became a member before July 12, 1995. In addition, we would urge that consideration be given to providing transitional relief for positions with respect to P stock (not

[5] As long as dividends on P stock are eliminated from S's income (as they were under Treas. Reg. § 1.1502-14(a)(l)), or are eligible for the 100% dividends received deduction (as they typically will be under section 243(a)(3) except during the year S acquires the P stock, see Treas. Reg. §§ 1.1502-13(f)(2)(ii) and 1.1502-26(b)), there will be no federal income tax disincentive to holding the P stock indefinitely. And, while it will no longer be possible to avoid recognition of gain on a distribution of P stock to P or on a redemption of P stock under the final intercompany transaction regulations (Treas. Reg. § 1.1502-13(0(4)), S will still be able to merge into P without recognition of gain.

including actual ownership of P stock) acquired from, or entered into with, an unrelated party before July 12, 1995. For example, a member that purchased an option on P stock from an unrelated party before July 12, 1995, should be allowed a loss upon lapse of the option. And, assuming that an equity swap is considered a position with respect to P stock, a member that entered into such a swap with an unrelated party before July 12, 1995 (and perhaps had already recognized income with respect to the swap), should not have its losses with respect to the swap disallowed. We recommend that the appropriate treatment of positions with respect to P stock be considered separately from the treatment of actual P stock because, as discussed below, in many instances S will not have the ability to avoid gain recognition by simply holding the position indefinitely.

Extend single entity treatment to gains as well as losses. We support greater single entity treatment for transactions in P stock, and we are disturbed by the asymmetrical treatment of losses and gains in the Regulations. The Regulations address the current whipsaw problem by reversing it -- now taxpayers will be required to recognize gains (where they cannot achieve self help), while their losses are disallowed.

The asymmetrical approach taken by the Regulations is on its face unfair and theoretically unsound. Indeed, the preamble offers no theoretical justification for it. The sole justification, discussed at some length in the hearing notice relating to the proposed intercompany transaction regulations (Notice 94-49, 1994-1 C.B. 358) and the preamble to the final intercompany transaction regulations (T.D. 8597, 1995-32 I.R.B. 6), is the complexity entailed by single entity treatment.

Weighing the competing considerations of fairness and simplicity is seldom easy. In this case, we believe the balance was tipped in favor of simplicity because the resulting unfairness was viewed as more apparent than real. The Regulations are explicitly premised on the assumption that recognition of gain with respect to P stock can generally be easily avoided. While this may often be the case, it is not true in all cases. There will therefore be instances in which members recognize gain on P stock while losses are disallowed. It may also be that another, unexpressed, assumption underlying the Regulations' approach is that transactions in P stock by other members of the group are probably tax-motivated, and that once the Regulations take away the motivation for transactions in P stock, taxpayers will not, in fact, be whipsawed. Again, there is some validity to this assumption, but it is not the case that all such transactions are tax-motivated. Consequently, the approach of the Regulations will result in the asymmetrical treatment of gains and losses derived from transactions that have real business purposes.

There are legitimate business transactions in which stock of the common parent moves in or out of the group as it is used, or repurchased, for such purposes as to support acquisitions, raise or reduce capital, or pay compensation. Under the Regulations, substantial differences in taxation will turn on whether such stock is used or repurchased by P itself or by another member. For example, if S wanted to use previously acquired P stock to compensate its employees, Rev. Rul. 80-76, 1980-1 C.B. 15, might not protect S from recognizing gain. Thus, the Regulations will force consolidated groups to structure transactions in P stock with a view to tax consequences -- this time to avoid potential mismatches of gain and loss -- instead of leaving them the flexibility to base structuring decisions solely on business considerations.

There also are legitimate business reasons for a consolidated group to engage in transactions involving positions with respect to P stock. For example, issuing debt convertible into P stock (or investment units of debt and warrants) can reduce the group's cost of borrowing. Alternatively, a group may want to hedge against increases in the cost of P stock where P has a stock buyback program in place. There may also be good business reasons why a subsidiary, rather than the common parent, engages in such transactions, for example, where the subsidiary has superior creditworthiness, or the parent is subject to regulatory or contractual restrictions.

The Regulations' loss disallowance rule will eliminate tax-motivated transactions in P stock. We believe that it will also affect legitimate business transactions. One could attempt to ameliorate the inequitable treatment that stems from the Regulations by identifying non-abusive transactions that would be exempt from the loss disallowance rule. On balance, however, we believe that the better approach, based on considerations of fairness and sound policy, would be to extend single entity treatment to gains as well as losses.

In Notice 94-49, 1994-1 C.B. 358, the Internal Revenue Service (the "Service") specifically rejected single entity treatment for transactions in P stock because treating S and P as a single entity would have far-reaching effects. However, eliminating both gains and losses with respect to P stock need not involve actually treating S and P as a single entity and need not affect the tax consequences of a transaction to nonmembers of the group.

Notice 94-49 also observed that the elimination of S's gain or loss on P stock would require a definition of the disposition to which the elimination applied (including indirect dispositions such as S becoming a nonmember), and rules concerning the effects of the elimination on basis and earnings and profits, the treatment of intermediate members, the treatment of stock equivalents, and the resolution of transitional problems. To some extent, the Regulations' loss disallowance/basis reduction rules have already begun to address these issues.

The preamble to the final intercompany transaction regulations (T.D. 8597, 1995-32 I.R.B. 6) also notes that adoption of single entity treatment for P stock would require additional guidance dealing with the effects of such treatment on other provisions of the Code (e.g., the reorganization provisions) and with a variety of collateral consequences. We do not underestimate the complexity of these issues. We believe, however, that progress can be made toward resolving these issues, and that the complexity of the issues should not overwhelm the importance of moving in this direction.

In our prior report on the proposed intercompany transaction regulations,[6] we suggested that a significant extension of single entity principles could be achieved at a reasonable administrative cost if an approach modeled on the rules addressing intercompany obligations (Treas. Reg. § 1.1502-13(g)) were followed in the context of transactions involving stock of the common parent. Under this approach, P stock (which

[6] NYSBA Tax Section, Report on Proposed Intercompany Transaction Consolidated Return Regulations, reprinted in Highlights & Documents, Dec. 22, 1994, at 3696, 94 TNT 249-63 (Dec. 21, 1994).

could include positions with respect to P stock) held by another member of the group ("intercompany stock") would be treated as redeemed and reissued immediately before it was acquired by a nonmember or the member holding it became a nonmember. Similarly, P stock held by a nonmember ("nonintercompany stock") would be treated as redeemed and reissued immediately after it was acquired by a member or the nonmember holding it became a member. Neither gain nor loss would be recognized when intercompany stock became nonintercompany stock. Separate entity treatment would apply, however, to gain or loss recognized when nonintercompany stock became intercompany stock in order to preserve taxation of gain or loss accruing while the stock was held outside the consolidated group. Thus, if a nonmember holding P stock became a member, gain or loss would be recognized on the deemed redemption. The practical effect of these rules would be to treat P stock held anywhere within the group as quasi-treasury stock and to extend section 1032 nonrecognition treatment to any member selling P stock.

In our prior report we dealt with two issues. One issue is whether any appreciation in the value of P stock should be taxed when such stock enters the consolidated group in a non-taxable transaction (i.e., when S becomes a member while owning P stock or acquires P stock in a carryover basis transaction). This issue involves the scope of General Utilities repeal and the degree to which circular ownership structures should permit the elimination of corporate-level tax on appreciated stock. It is thus related to issues dealt with in Prop. Treas. Reg. §1.337(d)-3 (partnership transactions involving stock of a partner), Notice 94-93, 1994-2 C.B. 563 (inversion transactions), and Rev. Proc.

94-76, 1994-2 C.B. 825 (downstream reorganizations). (We also commented on these related issues in three other reports.[7])

We also dealt with the basic policy determination of the extent to which dealings in P stock should create taxable gain or loss to the consolidated group. The Regulations deal with this issue by disallowing all losses with respect to P stock while theoretically taxing even gains that arise entirely while P stock is held by the group. The Regulations do not address the General Utilities issue at all.

The question of whether built-in gain in P stock should be taxed when such stock enters the group is separate and distinct from the question of how P stock should be taxed while it is held by the group. Therefore, it is possible -- and, we believe, appropriate - to adopt a self-contained system for taxing P stock within the group while deferring resolution of the General Utilities issue, which we believe is best addressed in a broader context.[8] Accordingly, in place of the Regulations' asymmetrical treatment of losses and gains, we urge further consideration of a regime in which neither loss nor gain would be recognized by any member of the consolidated group as a result of dealings in P stock (or positions with respect to P stock).

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[7] NYSBA Tax Section, Report on Notice 89-37, reprinted in Tax Notes, Jan. 1, 1990, at 99, 89 TNT 240-5 (Nov. 30, 1989); Report on Proposed Regulations Implementing Notice 89-37, reprinted in Highlights & Documents, May 3, 1993, at 691, 93 TNT 101-81 (May 11, 1993); Report on Notice 94-93 ("Inversion Transactions") and Rev. Proc. 94-76 ("Downstream Reorganizations"), reprinted in Highlights & Documents, Feb. 16, 1995, at 2703, 95 TNT 31-26 (Feb. 15, 1995).

[8] Thus, we disagree with the preamble to the final intercompany transaction regulations (T.D. 8597, 1995-32 I.R.B. 6), which suggests that requiring recognition of gain or loss when a nonmember owning P stock became a member would be a necessary corollary of extending section 1032 treatment to all members of the group. We would note, moreover, that the General Utilities issue also arises if P acquires P stock from a nonmember in a tax-free reorganization.

We recognize that, depending upon the ultimate resolution of the General Utilities issue,[9] a regulation extending nonrecognition treatment to gain on P stock might have to be subsequently modified, but we do not believe that a possible future change in law should impede the current adoption of a regulation providing symmetrical treatment of gains and losses. If, for example, the Service determined that P stock should be valued at the time it entered the group, with built-in gain deferred until disposition, the regulation could be modified to deny nonrecognition treatment for that deferred gain. On the other hand, if the Service determined that the built-in gain should be triggered at the time the P stock entered the group, the regulation would not have to be modified, since the basis of the P stock would then equal its fair market value.

Possible changes to the scope of the Regulations. It is possible that, should single entity treatment for P stock not be adopted, greater neutrality could be achieved by narrowing the loss disallowance rule and/or expanding the gain nonrecognition rule. One suggestion we considered was not applying the loss disallowance/basis reduction rules to P stock held by a nonmember that became a member. This would ensure that a loss accruing while the stock was held outside the group would not be inappropriately disallowed. However, a loss attributable to a decline in the value of the P stock occurring after the nonmember became a member would also be allowed, and the problem of selective realization of losses would remain. The problem of disallowing an economic loss that accrued while the stock was

[9] The Service, in Notice 96-6, I.R.B. 1996-5, announced its decision not to currently issue guidance under section 337(d) on corporate combining transactions in light of General Utilities repeal and, in Rev. Proc. 96-22, I.R.B. 1996-5, adopted a no ruling policy on these issues. Thus, the issues raised by Rev. Proc. 94-76 are not likely to be resolved in the near future.

held outside the group could be solved by marking the P stock to market whenever a nonmember holding P stock became a member of the group. However, such a rule would require recognition of gains as well as losses. As discussed above, such a rule might be appropriate if the Regulations provided symmetrical treatment of gains and losses with respect to P stock, but we do not believe it would be appropriate in the context of the Regulations' asymmetrical approach.

We also considered whether gain nonrecognition should be extended to some, but not all, cases in which P stock held by a member has appreciated in value. In general, we do not believe that the Regulations can be significantly improved by such a selective expansion of the scope of the gain nonrecognition rule. However, we do believe that consideration should be given to extending gain nonrecognition to dispositions of P stock that has never been held by a nonmember.[10] This would represent a significant extension of single entity principles at the cost of a relatively modest increase in complexity. For example, the General Utilities issue discussed above would not be implicated.

Comments on the loss disallowance/basis reduction rules. Because we believe that selective recognition of losses with respect to P stock is unacceptable as a policy matter, we generally endorse the loss disallowance and basis reduction rules. However, those rules apply not only to P stock but also to "options, warrants, forward contracts, or other positions with respect to P stock (including, for example, cash-settled positions)."

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[10] Cf. Letter from Michael H. Frankel to Christina Vasquez of the Internal Revenue Service, reprinted in Highlights & Documents, Dec. 15, 1995, at 4395, 95 TNT 243-19 (Dec. 14, 1995).

It is unclear to what extent (if any) section 1032 extends beyond stock and options. For example, an equity swap is presumably a “position with respect to P stock” within the meaning of the Regulations. If section 1032 does not apply to equity swaps, the Regulations could result in the disallowance of a loss to S when P itself would recognize a loss on the same transaction. Given the rationale of the loss disallowance rule, it seems clear that that rule should be no broader in scope than section 1032. We therefore suggest that the Regulations be clarified to limit their scope to positions with respect to which P would recognize no gain or loss by virtue of section 1032. Although such a change would introduce additional uncertainty as to the precise scope of the Regulations, the same uncertainty now exists with respect to P’s own transactions. Where the applicability of section 1032 is truly uncertain, members other than P would probably not be willing to take the risk that losses would be disallowed while gains would be recognized. Nevertheless, we believe it is inappropriate for the Regulations to effectively preclude members other than P from engaging in transactions to which section 1032 would not apply.

We recommend that consideration also be given to identifying cases in which the whipsaw potential at which the Regulations are directed (i.e., selective recognition of losses and avoidance of gains) is not present. For example, where S writes options on P stock, the selective recognition of losses that is possible where S actually owns P stock may no longer be available: Unless S is liquidated into P before the option lapses, gain recognition by S on the option cannot be avoided. We believe it is inappropriate for application of the loss disallowance/gain recognition rules to preclude members from engaging in transactions that present no significant potential for whipsaw, if such transactions can be identified.

We also recommend adoption of a netting rule Cf. Treas. Reg. § 1.1502- 20(a)(4) and (b)(4)) permitting a member’s loss with respect to P stock to offset member gains on other P stock taken into account as part of the same transaction. Although such a rule would probably have very limited application, we believe it would be an appropriate relief provision. We also believe that a loss on an intercompany sale of P stock should offset any gain subsequently recognized by the buying member (Cf. Treas. Reg. § 1.1502-20(c)(4), Example 9(iii)).

Finally, we urge that an exception to the loss disallowance rule be provided for members that are securities dealers. Such an exception is already provided in the case of obligations of members. Under Treas. Reg. § 1.1502 13(g)(3)(i)(B)(1) and (4)(i)(B)(1), deemed satisfaction/reissuance treatment does not apply to obligations that became or become intercompany obligations in an acquisition by a securities dealer described in Treas. Reg. § 1.108-2(e)(2). We recommend adoption of a similar rule for transactions by a member that acquires and disposes of P stock (or positions with respect to P stock) in the ordinary course of its business of dealing in securities.

Comments on the gain nonrecognition rule. The Regulations’ gain nonrecognition rule is a step in the right direction, but we believe that the rule should be expanded to deal more effectively with the zero basis problem.[11]

The zero basis problem arises whenever S uses P stock acquired from P as a capital contribution or in a section 351 exchange to pay for property or services. In particular, the zero basis problem often arises in taxable acquisitions in which S acquires the stock or assets of a target in exchange for cash and some P stock.[12]

Well advised taxpayers can generally avert the zero basis problem in taxable acquisitions of property by: (i) structuring the transaction as a sale to P rather than to S, followed by a dropdown of the property to S; (ii) as a

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[11] And apart from this particular context, we generally endorse a comprehensive effort to eliminate zero basis issues. As long ago as 1969, in commenting on the tax treatment of subsidiaries dealing in their parents' stock, we termed the zero basis approach "unsound on both technical and economic grounds." Committee on Corporate Taxation, NYSBA Tax Section, Sale or Exchange by a Subsidiary Corporation of Its Parent Corporation's Stock, 47 Taxes 146, 158 (1969). We believe that the zero basis problem exists primarily as a trap for the unwary. We recognize that a comprehensive reappraisal of the zero basis issue is beyond the scope of the Regulations. Zero basis issues do, however, continue to create unnecessary complexities and needless traps. (See NYSBA Tax Section, Report on Proposed Regulations under Sections 358. 1032 and 1502 Concerning Stock Basis Adjustments in Triangular Reorganizations (CO-993-71), reprinted in Highlights & Documents, Sept. 22, 1995, at 4405, 95 TNT 185-36 (Sept. 21, 1995).) We urge the Service and the Treasury Department to undertake a complete analysis of this area, and to uncomplicate the tax law by ridding it of the zero basis problem. For example, we believe that instead of the result prescribed in Rev. Rul. 74-503, 1974-2 C.B. 117, the Service and the Treasury should instead consider adopting the view that whenever X receives Y stock from Y as a contribution to capital or in a section 351 exchange (whether or not X and Y file consolidated returns and whether or not Y is in control of X), X takes a fair market value basis in the Y stock and Y increases its basis in its X stock by a corresponding amount (or takes a corresponding basis in the X stock received in the exchange), as if Y had instead transferred cash to X and X had used that cash to purchase Y stock from Y.

[12] The zero basis problem arises not only in acquisitions that are taxable by design, but also in triangular acquisitions that inadvertently fail to qualify under section 368, unless the acquirer takes one of the technical "precautions" described below.

shortcut for the two steps described in (i), having P contract to purchase the property but direct delivery of the property to S;[13] or (iii) having P sell the P stock to S immediately before the purchase (often for a note that may eventually be forgiven by P as a contribution to S's capital), thus giving S a fair market value basis in the P stock.[14]

We believe that S should not recognize gain as a result of delivering zero basis P stock in a taxable property acquisition, for the same policy reason that supports extending section 1032 nonrecognition treatment to S on its use of P stock in triangular reorganizations (Treas. Reg. § 1.1032-2(b)): Sound tax policy is furthered by treating economically comparable acquisitions similarly. There is no good reason to distinguish for tax purposes between (i) a taxable property acquisition in which P contributes its stock to S and S delivers that stock to the seller and (ii) a taxable acquisition in which P delivers its stock to the seller and then drops the property down to S.[15]

The zero basis risk inherent in S's use of P stock as a medium of exchange, whether for property or services, is a trap for the unwary. Taxpayers should not be compelled to implement formalistic solutions of the type described above to avoid the problem. Accordingly, we applaud the Regulations' attempt

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13 Cf. Rev. Rul. 70-224, 1970-1 C.B. 79.

14 If P and S are willing to run the risk that a circular cash flow will be disregarded, or if they can plan far enough ahead, S may purchase the P stock with cash contributed by P.

15 In triangular acquisitions where P issues its stock directly to the seller (rather than first transferring it to S), S can be taxed on the delivery of the P stock to the seller only if the acquisition is recharacterized as a contribution of the P stock to S followed by the delivery of the stock by S to the seller. The creation of these fictional steps is no more compelling than the application of an "over-the-top" model in which P is deemed to have acquired the property and then dropped it down to S.

to ameliorate the zero basis problem. However, we believe that the definition of a “qualified disposition” of P stock is so narrow that the Regulations will frequently fail to achieve their goal. In our view, there is little, if any, potential for abuse when stock acquired through a contribution to capital or a section 351 transaction (or a series of such transactions) is immediately transferred pursuant to a plan in a taxable transaction. Accordingly, we suggest that the definition of “qualified disposition” be expanded.

For example, § 1.1502-13T(f)(6)(ii)(F) of the Regulations provides that there can be no qualified disposition if S becomes or ceases to be a member as part of, or in ' contemplation of, the plan or disposition. While we do not believe that this is intended to include newly formed corporations, it might be so interpreted. In that case, a taxable triangular acquisition would be excluded from the gain nonrecognition rule whenever S was newly formed in connection with the acquisition, as it typically would be. (Similarly, § 1.1502-13T(f)(6)(ii)(E) might be interpreted as precluding gain nonrecognition treatment where P was newly formed in connection with the acquisition.) We therefore urge that the Regulations clarify that P and/or S may “become a member” if such corporation is newly formed as part of the overall plan.

We also recommend deletion of the requirement that the P stock be transferred by S to an unrelated nonmember. In a taxable triangular acquisition, for example, we believe it is inappropriate to require S to recognize gain merely because a portion of the target stock is owned by a member or a related nonmember. In any property acquisition, P could always acquire the property itself by issuing its stock.

We also suggest that the Regulations be modified so that even though S would not “otherwise recognize gain” on a qualified disposition of P stock governed by section 83 (Rev. Rul. 80-76, 1980-1 C.B. 15),[16] S would be treated as purchasing the P stock for fair market value with cash contributed by P. This change is necessary to give P (and any intermediate members) the increase in stock basis to which they would be entitled in the absence of Rev. Rul. 80-76.

Finally, we believe that consideration should be given to expanding the gain nonrecognition rule to qualified dispositions of warrants and other positions with respect to P stock that are subject to the loss disallowance rule.

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16 Rev. Rul. 80-76 holds that S does not recognize gain or loss when stock is transferred to an employee of S in a transaction governed by section 83. Rev. Rul. 80-76 involved a transfer of P stock to S's employee by a shareholder of P and therefore did not raise the zero basis problem.

GCM 38176 (November 26, 1979), which discussed Rev. Rul. 80-76, rejected a series of deemed transactions in which the shareholder would contribute his stock to the capital of P, P would sell the stock to S at fair market value, and S would distribute the stock to its employee. The GCM expressed concern that the deemed sale by P to S at fair market value could have serious repercussions in an unrelated area of the Code (sections 351 and 368) pending resolution of the zero basis problem. Concern was also expressed that if S were given a cost basis in the stock and the stock were transferred subject to a restriction, the amount ultimately deductible by S and the cost basis of the stock could be different. Gain or loss would then have to be recognized to the extent of that difference. Therefore, the GCM concluded that the ruling should simply treat the transaction as not producing a recognizable gain.