REPORT #657

TAX SECTION

New York State Bar Association

Outline of Presentation by Tax Section of
New York State Bar Association
re Treasury Regulation 1.1502-20T

Table of Contents

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June 7, 1990

Internal Revenue Service
Attention: CC:CORP:T:R, Room 4429
(CC:CO-78-87)
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Gentlemen:

Pursuant to Announcement 90-58, we respectfully request the opportunity to speak at the hearing concerning Reg. §§ 1.332(d)-IT and 1.1502-20T, on June 26 or 27, 1990. An outline of our statement is enclosed.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

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New York State Bar Association
re Treasury Regulation 1.1502-20T

1. While we believe it important that the integrity of General Utilities repeal be protected, the right of a taxpayer who recognizes an economic loss in a business transaction to a corresponding deduction is of equal dignity and importance in the tax system.

It is, therefore, wrong to solve the son-of-mirrors problem -- essentially a mechanical problem arising out of the workings of Reg. § 1.1502-32 -- by totally denying deductions for economic losses. The problem should instead be resolved by some sensible balancing of equities, recognizing that any compromise is likely to leave some cases where General Utilities repeal is not perfectly implemented and others where taxpayers will not enjoy deductions fully reflecting their economic losses.

2. We strongly disagree with the Treasury's assessment that Reg. § 1.1502-20T will disallow true economic losses only in rare and unusual cases. As practitioners regularly dealing with these matters, we believe such economic losses have been and will continue to be quite common. That is the principal reason we believe it important to strike a balance different than that struck by the Treasury on the issue. See also our report (#645) entitled "Report on Built-In Gains and the Investment Adjustment Rules in the Consolidated Return Regulations" dated January 17, 1990.

3. We continue to be of the view, expressed in our letter of April 17, 1990 to Assistant Secretary Gideon, that the Treasury should announce promptly that Reg. § 1.1502-20T is to be regarded as published in proposed form, that any replacement for that provision will be published in proposed, not temporary, form, and that Reg. § 1.337(d)-IT will remain in effect until adoption of a final regulations.

As a practical matter, Notice 87-14 and particularly Reg. § 1.337(d)-IT have put an end to son-of-mirrors transactions. Although that regulation has the undesirable aspect of relying on valuation and tracing, it does achieve that purpose. Thus, there is no reason why any substitute for Reg. § 1.1502-20T cannot be published in proposed form.

It should also be announced that any new version of Reg. § 1.1520-20T will be effective only for the first taxable year of every affiliated group beginning after promulgation of the regulation in final form, if the regulation retains the loss disallowance approach of Reg. § 1.1502-20T or is otherwise designed to achieve aims beyond dealing with the son-of-mirrors problem. Groups filing consolidated returns should be given the option for such year of revoking their elections to file consolidated returns without suffering any adverse consequence such as loss of basis for subsidiaries as provided in Reg. § 1.1502-20T(b).

4. We are mindful that there is no perfect solution to the son-of-mirrors problem, but would propose the following approach in place of the current Treasury proposal:

A. Except as set forth in B below, there would be no change in the consolidated return regulation investment adjustments.

B. A parent company’s basis for shares of a subsidiary, for purposes of determining both gain and loss, would be calculated by disregarding any gain recognized by the subsidiary (i) within ten years of the acquisition date of the subsidiary, (ii) but only with respect to any asset held by the subsidiary on the acquisition date and (iii) only to the extent that the aggregate of such gains does not exceed the subsidiary’s net unrealized built-in gain as of the acquisition date.

C. The acquisition date of the subsidiary would be the first day it joins in the filing of the acquiring corporation’s consolidated return. Net unrealized built-in gain would be defined as the parent’s aggregate basis for the subsidiary’s stock plus the subsidiary’s liabilities less the subsidiary’s aggregate basis for its assets, all as of the acquisition date.

D. We are satisfied that the foregoing rules adequately deal with son-of-mirrors transactions without disallowing true economic losses, without the need of appraisals or anti-stuffing rules and with only minimal tracing. We recognize that Treasury may have concerns regarding the application of this rule to acquisitions in which the target holds both built-in gain and built-in loss property. We believe, however, that the simplification benefits gained from using a net built-in gain approach far outweigh those concerns. Moreover, as indicated, we support applying the rule described in paragraph B to determine both gain and loss. This provides further simplification benefits and would eliminate the need for any anti-breakup rule. However, we would strongly oppose applying an investment adjustment limitation rule to determine gain to the extent that adjustments are to be disallowed in an amount exceeding actual net built-in gain at the acquisition date.

5. We believe the Treasury’s rather extraordinary attention to the wasting asset “problem” is unwarranted. That situation -- particularly with respect to depreciation or amortization of tangible property used in the normal operations of the acquired business -- is neither a serious threat to revenues nor a significant area of abuse. Time value factors quickly erode the value of any tax benefit from wasting asset income simply because the taxpayer must pay tax first and benefit from the corresponding loss later.

This fact makes this a classic case where the desire for simplification should outweigh the urge to create a theoretically perfect solution. The wasting asset "problem" should not lead either to highly complex solutions or to a broad loss disallowance rule, which will apply to many cases where the acquired subsidiary has no wasting assets, or wasting assets of relatively small value.

If, nevertheless, concern about this issue remains, we would cooperate with the Treasury in an effort to draft more narrowly focused anti-abuse provisions such as those in the current Section 3 38 regulations. Cf. Treas. Reg. § 1.338(b)-3T(g).

6. Under our proposal, the current rule requiring a stock basis step down upon de-consolidation would no longer be necessary; also there would be no need for a successor rule.

7. We do not agree that there is any serious "loss duplication" issue that requires a regulation change by the Treasury. The basic concept has been part of the Tax Law since its inception in both consolidated return and non-consolidated return contexts and most of the problems are adequately dealt with by the existing investment adjustment rules. In addition, significant revenue protection is afforded in this area by, among other principles and provisions, SRLY, the built-in loss rules, Sections 382 and 383(b) and the limited ability of corporations to use capital losses. Here again, the impact of time value factors dramatically reduces the real value of any duplicated loss in almost all cases.

It should also be noted that “loss duplication” is the corollary of double taxation of shareholder and corporate gain after General Utilities repeal. When the stock of a corporation is acquired in a transaction where a Section 3 38 election is not made, gain recognized by the target’s shareholders is duplicative of gain which will be later incurred if the target’s assets are sold. In today’s world there are many cases where Section 338 elections are not made, for example, in cases where the selling parent corporation’s stock basis exceeds the target’s inside asset basis. Thus, any loss duplication that may arise when corporate stock is sold at a loss, followed by a sale of corporate assets at a loss, is not on its face inherently abusive.

Even if the loss duplication issue looms large in the Treasury’s eyes, we still think it a mistake to try to solve the problem in the context of an amendment aimed at the son-of-mirrors problem. It is the effort to solve several different policy concerns in one regulation that has led to the overreaching nature of Reg. § 1.1502-20T.

However, if the Treasury still believes this perceived problem must be remedied, a solution could be engrafted upon the proposal outlined in paragraph 4, again without disallowing all economic loss. For example, losses realized (with basis calculated under the method suggested above) by a parent when it sells stock of a subsidiary could be disallowed: (i) to the extent that the subsidiary’s aggregate inside asset basis exceeds the selling price (grossed up by the subsidiary’s liabilities); and (ii) to the extent of any unused net operating losses of the subsidiary. Alternatively, the parent should be allowed to elect to use its loss in full if the subsidiary’s inside asset basis is reduced to the level of the amount realized by the parent on the sale and its net operating loss carryovers are appropriately adjusted. This provision need not be complex, nor should it require tracing or appraisals.

June 7, 1990