REPORT #770

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED SECTION 1502 REGULATIONS

CONCERNING CONSOLIDATED RETURN BASIS ADJUSTMENTS

AND RELATED MATTERS (CO-30-92)

August 31, 1993

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TAX SECTION
New York State Bar Association

M E M O R E N D U M

September 2, 1993

TO: Harry L. Gutman
Margaret Richardson
Leslie B. Samuels

FROM: Peter C. Canellos

Enclosed is the report of the New York State Bar Association Tax Section dealing with Proposed Regulations on consolidated return investment adjustments and related matters.

The Proposed Regulations are a long awaited and most welcome harmonization of the existing jumble of rules relating to investment adjustments, basis in affiliate stock, earnings and profits, and associated issues. As noted in the Report, the existing rules relating to these issues have evolved over time, through an accretion process, into a virtually incomprehensible and unmanageable system. We believe that the Proposed Regulations are a well conceptualized and, for the most part, highly consistent new codification which takes into account the various statutory changes which have taken place since 1965. The Report applauds the purpose and overall scheme of the Proposed Regulations, and finds particularly useful the express enunciation and explication of purposes set forth in the preamble to the Proposed Regulations.

The Report makes a number of specific recommendations for changes and clarifications in the Proposed Regulations. These are summarized on pages 3-6 of the report. While our comments are extensive, in keeping with the length and detail of the Proposed Regulations, they are for the most part clarifications, and our disputes with the Proposed Regulations are rather narrow. Our objective has been, for the most part, to make improvements in what we believe to be the sound scheme contained in the Proposed Regulations.

We would be happy to discuss our comments at your convenience.

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Tax Report # 770

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON CONSOLIDATED RETURNS

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON CONSOLIDATED RETURNS

REPORT ON PROPOSED SECTION 1502 REGULATIONS CONCERNING CONSOLIDATED RETURN BASIS ADJUSTMENTS AND RELATED MATTERS (CO-30-92)[1]

I. INTRODUCTION

The proposed revision of the consolidated return investment adjustment regulations, and related provisions, are complex and comprehensive.[2] Adding to the urgency of a thorough review is the retroactive aspect of the regulation—thus, the basis of a subsidiary disposed of after the date the final regulations are promulgated will be calculated under the new rules (with minor modifications) as if such rules were in place from the first year consolidation was permitted (theoretically, 1919).

Between the repeal of General Utilities (effective for liquidations after July 31, 1986) and November 12, 1992, Congress and Treasury took turns trying to patch perceived abuses arising

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[1] The principal authors of this report are Jonathan S. Brenner, Patrick C. Gallagher, and Irving Salem. Significant contributions were made by Martin B. Amdur, Bryan Bloom, Richard M. Fabbro, Robert C. Holmes, Jonathan Kushner, Erika W. Nijenhuis and Yaron Z. Reich. Other helpful comments were received from Peter C. Canellos, John A. Corry, George B. Javaras, Stephen B. Land, Carolyn Joy Lee, Richard L. Reinhold, Robert H. Scarborough, Michael L. Schler, Dana Trier, Thomas Wessel, Victor Zonana.

[2] The proposed regulations were published in the Federal Register on November 12, 1992 and are identified as CO-30-92. The preamble to the Notice of Proposed Rulemaking is referred to herein as the "Preamble."

from the computation of subsidiary stock basis. In addition to the loss disallowance regulations of Treas. Reg. §1-1502-20 (the "LDR"), the patches include the following:

- Enacting anti-Woods legislation dealing with the lack of coordination of earnings and profits ("ESP") and taxable income (section 1503(e)).[3]

- Enacting Wyman-Gordon legislation dealing with a lack of coordination of debt cancellation and E&P (section 1503(e)(1)(B)).

- Enacting anti-cousin-of-mirror legislation (section 304(b)(4)) and regulations (Treas. Reg. §1.1502-80 eliminating section 304 for consolidated groups).

- Recalculating basis in the former common parent after formation of a holding company (Treas. Reg. §1.1502-31T).

- Creating E&P for a newly formed holding company (Treas. Reg. §1.1502-33T).

- Rolling back distributions declared before, but paid after, the sale of subsidiary stock (Treas. Reg. §1.1502-32T(b)).

- Ameliorating the reversal of prior positive adjustments upon deconsolidation (Treas. Reg. §1.1502-32T(a)).

[3] Unless otherwise indicated, "section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

- Eliminating the consolidated return election to reduce basis of debt (section 1503(e)(4)).

- Amending section 1059 to reduce basis for distributions with respect to pre-affiliation built-in gains.

- Promulgating anti-bump-and-strip regulations dealing with step-up in basis following distribution of appreciated stock (Treas. Reg. §1.1502-14T(c)).

After so many years of devising makeshift solutions, the Treasury and Service have wisely attempted to revise comprehensively the investment adjustment system, including related rules.

This report has three parts in which it will:

1. summarize its principal recommendations;
2. summarize the proposed regulatory changes; and
3. analyze the recommendations in detail.

II. OVERVIEW AMD SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. Overview.

We commend the Treasury for undertaking a complete revision of the basis adjustment regulations. The numerous regulatory and statutory patches, especially since the repeal of General Utilities, have resulted in an overly complex regulation which lacks a unifying theoretical underpinning. The proposed regulations do a superb job alleviating these twin concerns. Moreover, they are well written and, together with their detailed

Preamble and the liberal use of examples, principles and purposes, provide significant guidance. Nevertheless, the undertaking is massive, and we have a number of recommendations designed in large part to make the new system more equitable and understandable.

Our principal recommendations are summarized below. These are discussed in greater detail in Part IV, together with a number of relatively minor and technical comments.

B. Principal Recommendations Regarding Basis Adjustments and Related Provisions.

1. Role of general principles (see IV.A.2). Clarify that neither taxpayers nor the Service may rely on general regulatory purposes to override clear and specific regulatory guidance, except in cases of double counting and except as provided in the overriding adjustments rule of Prop. Reg. §1.1502-32(e) (subject to our comments in 4 below). Provide for an expedited ruling process for issuing retroactive guidance in cases where the regulations, applied literally, would produce a result that is "clearly inconsistent" with the stated regulatory purposes.

2. Amount and timing of adjustments to taxable income (see IV.A.3). Provide immediate guidance for a number of issues relating to the scope and timing of the key new provisions that adjust taxable income (i.e., "tax-exempt income" and "noncapital, non-deductible expenses") and that have a judicial or administrative history in the E&P area.

3. Expired losses (see IV.A.3.d). Apply prospectively only the rule that reduces basis by the amount of expired losses (i.e., apply the rule only to losses that expire in taxable years

beginning after the date final regulations are published). Eliminate the potential for a negative basis adjustment upon expiration of a SRLY loss, unless S's stock was acquired with a carryover basis. Add examples illustrating the application of the regulations to expired losses.

4. Overriding adjustments (see IV.A.5). If the recommendation in paragraph 1 above to limit the scope of the “general principles” rule is accepted, change the standard that triggers application of the adjustments in Prop. Reg. §1.1502-32(e) from “a” principal purpose to “the” principal purpose, and revise the examples to target clear abuses. Otherwise, either eliminate this provision or replace it with a much briefer statement of policy supported by selected examples.

5. Distributions from affiliated, nonconsolidated years (see IV.A.7). Provide an automatic basis adjustment upon consolidation for undistributed E&P accumulated in affiliated, nonconsolidated years. Alternatively, retain existing law but reduce basis for distributions from affiliated, nonconsolidated years only if they violate the policies expressed by Congress under section 1059.

6. Annual reporting (see IV.A.9). Eliminate the annual reporting requirement.

7. Election out of retroactivity (see IV.A.10). Permit taxpayers to elect out of the retroactive determination of subsidiary basis with respect to all subsidiaries sold within a specified period after the date final regulations are published Grant blanket permission for groups to discontinue filing consolidated returns as of the first day of the taxable year of the group during which final regulations are promulgated.

8. Elective offset of stock basis against ELA (see IV.C.3). Retain election (with clarification) to offset ELA against the basis of certain other stock, including preferred stock.

9. Reduce scope of group structure changes (see IV.F). Exclude taxable acquisitions from the definition of group structure changes for basis (but not E&P) purposes.

C. Principal Recommendations Regarding Income for Short Years.

1. Allocating items between consolidated and separate returns (see IV.G). Provide (i) rules to insure that extraordinary transactions occurring after the transfer of S are borne by the buyer, (ii) additional guidance for short taxable years that require a closing of books, (iii) a hybrid, ratable allocation method in which only the month in which the change occurs is subject to proration, and (iv) that additions to the list of extraordinary items by the Service will be prospective.

2. 30-day rules (see IV.G.5). Retain existing law, either for all purposes or for limited purposes (e.g., for counting taxable years for attribute carryover and for section 481 purposes, and for determining several liability under Treas. Reg. §1-1502-6).

III. SUMMARY OF CHANGES

A. Basis Adjustments

1. The Four Basis Adjustment Categories. The parent's adjustment to its stock basis in its subsidiary (hereinafter “P” and “S”) is governed by a “modified taxable income approach” and is tied to the net amount of four specified items of S:

a. Taxable income or loss as reflected in consolidated taxable income (thereby taking into account the deferred intercompany gain or loss rules, etc.). All losses (including passive losses and at-risk losses) reduce basis only when “absorbed” (or upon expiration, as discussed in clause c below).

b. “Tax-exempt income,” defined broadly to include income permanently offset by a deduction that does not represent a basis recovery or an expenditure of money. The term thus includes income eliminated through section 103, the dividends received deduction (“DRD”) and cancellation of indebtedness provisions (limited, however, to the extent applied to reduce losses and basis, but not credits). There also is a narrow area referred to in the Preamble as “Basis Pops” (example is a basis increase under section 50(a)(1)).

c. “Noncapital, nondeductible expenses” that are permanently disallowed, such as Federal income taxes. This category also includes permanent decreases to asset basis such as pursuant to section 1017) and, apparently, the expiration (but not the "absorption") of a loss carryforward.

d. All section 301 distributions, including deemed section 305 distributions. However, the deemed dividend election under Treas. Reg. §1.1502-32(f)(2) is eliminated, as is the exception from the negative adjustment rules for E&P accumulated in separate return, affiliated years.

The regulations recognize that some issues are not covered by the above four paragraphs. Therefore, Prop. Reg. §1.1502-32(a) expands the scope by providing that, "in the absence of specific guidance," adjustments must reflect (i) all the facts and circumstances, (ii) the underlying economic arrangements, (iii) applicable federal tax accounting principles, and (iv) the stated regulatory purposes (i.e., avoiding duplication and treating P and S as a single entity).

2. Allocation of Adjustments to Common and Preferred Stock; Redeterminations Thereof.

a. Distributions. Allocated to the shares entitled to the distribution (common or preferred), even if held by a nonmember (in which case such allocated amount will have no impact on stock basis).

b. Met positive adjustments (exclusive of distributions). Allocated first to any preferred stock to the extent required (when aggregated with prior preferred stock allocations during consolidation of P and S) to cover current and prior amounts arising during consolidation. Again, if allocable to stock currently (or previously) held by a nonmember, such adjustment is effectively disregarded.

Any unallocated positive amount is then allocated to common stock. Allocations are made first to reduce an excess loss account (“ELA”). If there are different classes of common, the “overall economic arrangement” will control.

c. Met negative amount (exclusive of distributions). Only allocable to common stock (and first to shares of a class that have basis, before adding to an ELA of other shares of that class).

d. Cumulative redeterminations. All the above adjustments must be reexamined when the basis becomes relevant i.e., a stock sale or a deconsolidation – unless the original allocation “has been used.” Thus, a basis increase allocable to common stock in year 1 can be reallocated in year 2 if necessary to cover preferred stock arrearages accruing in year 2.

e. Definition of preferred stock. For any preferred stock not described in section 1504(a)(4), the allocation rules for common stock may apply if less than 80% of S's common stock is owned by members of the consolidated group.

3. Other important rules. There are six other rules worth noting:

a. Record date controls date of distribution. Dividends are deemed distributed when the shareholder “becomes entitled” to the distribution (i.e., the record date, not the payment date). This eliminates the need for Treas. Reg. §1.1502 32T(b), which treated certain distributions paid after P's sale of S as made prior to deconsolidation to ensure a basis reduction.

b. Tiering up; taking into account varying interests. The net adjustment to the basis of S's stock, taking into account the varying interest during the year (and not merely the year-end interest as under the current regulations), tiers directly upward if S is a lower tier subsidiary.

c. Deemed share of Federal taxes. Federal tax liability is deemed to be allocated among members of the group as if there were an obligation of immediate payment of 100% of the liability to (or from) S. If not paid, an appropriate adjustment (i.e., capital contribution or dividend distribution) will be required. This method may differ from that used for E&P.

d. Circular basis. Existing “circular basis” rules are continued, clarified and expanded to prevent the useless absorption of S's NOL upon a sale of S. As under current law, no relief is provided if brother-sister corporations are disposed of in the same year.

e. Annual reporting. Annual statement of stock basis adjustments (including redeterminations) is required to be filed with the group's return. However, no penalty is prescribed, and no calculation as of the effective date of the proposed regulations is required.

f. Overriding adjustments to prevent avoidance. Despite the specific rules, and some general principles, there are "overriding" adjustments intended to carry out the purposes of the regulations. Thus, if a person acts with "a principal purpose" of avoiding these rules, or uses these rules to avoid other provisions, adjustments to carry out the purposes of the regulations will be made. The regulations provide five examples of perceived abuse of the system that will cause a redetermination.

4. Retroactive effective date. Stock basis determinations after the proposed regulations are finalized must, with few exceptions, be determined as if the proposed rules had been in effect for <u>all</u> consolidated return years of the group. Thus, for example, positive adjustments for modified taxable income will automatically be made for all consolidated return years (not just post-1966 years). Grandfather rules include any deemed dividend elections and distributions of affiliated, nonconsolidated E&P. The new rules will not apply (except as to lower tiers of S) if P disposes of S stock before the regulations are finalized.

B. Earnings and Profits.

1. E&P Delinked from Basis. E&P will continue to tier up, but (consistent with section 1503(e)) will no longer be tied to or implicate stock basis. Thus, a deficit in S's E&P will currently be reflected in P's E&P, even though S's NOL is not absorbed. Conversely, if S's NOL is larger than the deficit (<u>e.g.</u>, because of S's tax exempt income or accelerated depreciation), P will not be charged with phantom E&P as under existing law.

2. Tiering Up. E&P of S is tiered up directly to P's E&P under the principles stated above for basis adjustments.

3. Separate Tax and E&P Adjustments to Stock Basis. Separate stock bases are required to be maintained for E&P purposes.

4. Eliminating E&P Upon Deconsolidation. To reflect the single entity theory of consolidation and to eliminate the complex basis reduction account rules of Treas. Reg. §1.1502-32T(a), S's E&P arising during consolidation and reflected in P's basis will generally be eliminated immediately before S becomes a nonmember. Exceptions are provided (i) if the group is acquired, (ii) if a subsidiary is distributed under section 355, (iii) to test distributions from thrift institutions, (iv) to test amounts received by insurance companies, and (v) other cases to be identified in an IRB.

5. Tax Sharing Rules Retained. The elective allocation methods (Treas. Reg. §1.1502-33(d)) are retained, but rewritten to improve comprehension.

6. E&P Following Group Structure Change. If the group remains in existence (as a result of a group structure change), the E&P of the former common parent is replicated in the E&P of the new parent (to the extent of the new parent's ownership of old P). The expansion of the definition of a group structure change is also reflected here.

7. Effective Date. Generally the same as the basis adjustment rules.

C. Excess Loss Accounts.

An ELA resulting from the above basis adjustments will be viewed as negative basis, to be triggered into income (or deferred) generally under the normal rules dealing with the disposition of property with built-in gain. Thus, a deferred gain will result from a section 311 distribution, but not from an internal section 355 spin-off.

As under existing law, there is no trigger if the group is acquired by another group that files a consolidated return, but there is a trigger if S otherwise ceases to be a member. Other triggers for an ELA/negative basis are (i) worthlessness of S (provided substantially all of S's assets are treated as disposed of, abandoned or destroyed under section 165) and (ii) debt discharge which exceeds all of S's tax attributes. Both of these triggers occur at a later time than under existing law and are designed to avoid the elimination of the economic loss that can arise by a combination of the LDR, other consolidated return provisions and the bankruptcy laws.

Two special rules worth noting are:

1. Treas. Reg. §1.1502-19(a)(6) is eliminated, so that an investment in preferred stock can no longer be reduced electively by an ELA.

2. Section 357(c) (dealing with liabilities in excess of basis) is virtually written out of the Code for consolidated groups, thereby converting what was a deferred intercompany gain to a negative basis adjustment.

D. Deferral of Section 165(g) Deduction.

Prop. Reg. §1.1502-80(c) provides that stock or securities may not be treated as worthless unless so treated under the deferred trigger rules of Prop. Reg. §1.1502-19(c)(1)(iii) (See III.C above).

E. Impact on the LDR.

In addition to a few conforming changes, the scope of the LDR may (inadvertently) have been enlarged:

1. Since <u>all</u> prior positive adjustments (not just post-1966 adjustments) will increase basis automatically pursuant to the retroactive transition rule, such adjustments automatically will be added to the maximum disallowed loss under Treas. Reg. §1.1502-20(c)(1)(ii). This may enlarge the scope of the LDR if a deemed dividend election had been made.

2. A general principle declaring that “an adjustment must not have the effect of duplicating an item in S's stock basis” could be read broadly to exclude all realized built-in gains. Prop. Reg. §1.1502 -32(a)(2).

3. The “overriding adjustments” rule would reduce basis with respect to built-in gains arising in connection with a transfer of appreciated assets, if the transfer is for “a principal purpose” of increasing stock basis. See Example 3 of Prop. Reg. §1.1502-32(e)(1).

F. Group Structure Changes.

If the common parent changes, but the group remains in existence (for example, as a result of a reverse acquisition ("RA") under Treas. Reg. §1.1502-75(d)(3)), special rules provide that the basis of the stock of the former common parent will reflect the net inside basis of the former common parent's assets. Two important extensions of the current rules (Treas. Reg. §1.1502-31T) were added: no longer will the RA have to (1) be the product of a tax free transaction or (2) meet an 80% continuity of ownership test (the normal 50% RA test will be sufficient).

G. Allocation of Items Between Consolidated and Separate Returns; 30-Day Rules.

1. Alternative Allocation Rules. To provide greater certainty and prevent inconsistent allocations:

a. S's taxable year is treated as ending as of the close of the day it becomes or ceases to be a member of the group, eliminating the so-called "lunch" rule.

b. To avoid the necessity of a mid-year closing (including a taking of inventory), S may elect irrevocably to allocate its items of income and loss ratably, except for eleven specified extraordinary items (including sales of capital assets, credits, section 481(a) adjustments, and cancellation of indebtedness income). The ratable election is not available if the Code otherwise requires S to change its annual accounting period (e.g., S is sold to a group with a different fiscal year).

2. P Always Files One Return. P always files one tax return per year, even though P does not own at least 80% of a subsidiary for a portion of its year.

3. Income from Pass Through Entities. Special rules allocate income of a partnership in which S has an interest, as of the time S is deemed to leave/join the group.

4. Elimination of 30-Day Rules. The 30-day rules of Treas. Reg. §1.1502-76(b)(5) are eliminated for deconsolidation occurring on or after February 15, 1993.

IV. DISCUSSION

A. Stock Basis Adjustments (Prop. Reg. §1.1502-32).

1. In General: Delinking Basis Adjustments from E&P Adjustments.

a. Drawbacks of linkage under current system. The Committee agrees with the general conclusion that the existing investment adjustment system, in which basis adjustments depend on E&P, is flawed. The existing system is flawed in at least two important ways. First, it is overly complex and confusing. The existing regulations contain separate rules for distributions out of E&P arising in different years[4] and addbacks of certain

[4] Treas. Reg. §1.1502-33(b)(2) provides for a negative investment adjustment for distributions out of E&P accumulated in prior consolidated return years beginning after December 31, 1965, in preaffiliation years of S if the distribution occurs on or before August 9, 1979 or in separate return limitation years of S if the distribution occurs after August 9, 1979, but does not provide for such an adjustment out of E&P accumulated in consolidated return years beginning before January 1, 1966 or in affiliated but unconsolidated years.

unused tax attributes but perhaps not others.[5] Many regulatory provisions are overridden by temporary regulations[6] or by later enacted Code provisions not yet reflected in regulations.[7] Moreover, there are differences of opinion regarding the E&P treatment of many items and transactions under the current regulations.[8] Hence adjusting stock basis according to E&P leaves many unanswered questions. The need for simplicity and clarity alone would justify a major revision of the system.

Second, linking basis with E&P is flawed conceptually. The existing system, in which increases and decreases in E&P generally produce identical changes (both in amount and timing) in basis, often produces either the wrong basis result or the wrong E&P result when judged by the role that each of these calculations should play in the consolidated return regulations. In general, P's basis in S's stock should be adjusted to reflect any increase or reduction in P's investment in S to the extent necessary to prevent (i) items recognized by S from being duplicated in the gain or loss recognized by P on the sale of its S stock and (ii) tax-exempt income and nondeductible, noncapital expenses (and similar items of S) from resulting in gain or loss on the sale of S's stock. In contrast, P's E&P should be adjusted

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[5] Treas. Reg. §1.1502-32(b)(1)(ii) provides a positive investment adjustment for the portion of an unabsorbed consolidated net operating loss or consolidated net capital loss attributable to S, but arguably no such adjustment for unabsorbed passive losses, charitable contributions or losses limited by the at-risk rules. See Temp. Reg. §5.1502-45(d).

[6] See Temp. Reg. §1.1502-32T (overriding Treas. Reg. §1.1502-32(g) where S ceases to be a member of a group during a taxable year of the group ending after November 30, 1987).

[7] See section 1503(e)(4) (limiting Treas. Reg. §1.1502-19(a)(6) for dispositions after July 10, 1989).

[8] For example, (i) whether S's passive losses, which reduced E&P when they were incurred, are added back to E&P if not absorbed, (ii) how S's current E&P or current E&P deficit is treated upon S's midyear liquidation, and (iii) whether P's E&P is reduced for S's unabsorbed NOL upon S's liquidation.

when P's dividend-paying capacity has been enhanced or diminished as a result of S's earnings or losses.[9]

For example, Treas. Reg. §1.1502-32(b)(1)(ii) provides a positive basis adjustment for S's portion of an unabsorbed consolidated net operating loss or net capital loss. This adjustment correctly avoids reducing P's basis in S until P has had the benefit of S's loss. Because of basis-E&P linkage, however, it also produces a form of “phantom” E&P; that is, P's E&P are not reduced until the loss is absorbed, even though P's ability to pay dividends has been impaired currently by the loss.

Conversely, the correct E&P result may produce an incorrect basis result. For example, where the Code limits the deductibility of items other than net operating losses or net capital losses (e.g., the passive loss and at-risk limitation rules), E&P are reduced immediately (and correctly so), but basis apparently is reduced as well due to the lack of an express addback provision.[10] Thus, if P sells its S stock before S is permitted to take the deduction, P may recognize gain or loss on the sale determined by reference to a decreased basis without having received a tax benefit from S's loss.

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[9] See, e.g., Luckman v. Comm'r, 418 F.2d 381, 383 (7th Cir. 1969):

> The crucial issue [in determining E&P adjustments] is whether a given transaction has a real effect upon the portion of corporate net worth which is not representative of contributed capital and which results from its conduct of business. In order to make this determination it is necessary to scrutinize the economic effects of the particular transaction as well as its character and relation to the corporate business.

[10] See Temp. Reg. §5.1502-45(d).

Some of the problems created by linking basis with E&P have been addressed piecemeal over the years by statute or regulation. For example, sections 1503(e)(1) and (3) address certain inside/outside basis differences, and Temp. Reg. §1.1502-32T addresses the treatment of straddle dividends (i.e., dividends declared before S leaves P's consolidated group, but paid thereafter). Unfortunately, such provisions have complicated matters without entirely fixing the problems. As the Preamble (¶D.2) acknowledges, for example, section 1503(e)(3) creates "substantial complexity and burdens" and reflects conflicting and ambiguous concerns, many of which have been addressed by the loss disallowance rules of Treas. Reg. §1502-20 (the "LDR"). Many of the most important problems, such as phantom E&P or premature basis decreases, have never been corrected.

b. Proposed regulations: need for further guidance. The Committee commends the use of taxable income rather than E&P as the benchmark for making investment adjustments under the proposed regulations.[11] Taxable income has the significant benefit of correcting timing mismatches that plague the current system (because of basis-E&P linkage) without the need to adopt special rules. If an item of income or deduction attributable to S has not yet been taken into account in determining the tax

[11] The Preamble (¶D.1) indicates that in drafting the proposed regulations the Treasury considered, but rejected, a conforming basis regime, in which P basis in S's stock would conform to S's net asset basis. We agree that such a system would raise serious policy and fairness concerns. Strictly applied, a conforming basis regime would carry the single entity notion too far by ignoring the independent significance of stock purchases, for example. That is, presumably P would have a basis in S's stock equal to S's net asset value without regard to whether P paid a premium or a discount for S's stock. By rejecting the fundamental equivalence of basis and purchase price, such a system would result in a taxable gain or loss upon the future sale of the S stock without regard to P's economic gain or loss.

liability of the group, either because the group's ability to use an item of deduction is limited (such as the inability to use net capital losses due to a lack of net capital gains) or because the Code postpones the time of inclusion or deduction (under the passive loss or at-risk rules, for example), it is automatically excluded from the basis computation. Thus, if P sells S before the item affects the group's tax liability, P's gain or loss on sale is correctly unaffected by such item.

Although the taxable income approach of the proposed regime may be the best approach, one should not be overly optimistic as to its operational simplicity and certainty. Taxable income is only the starting point for investment adjustments under the proposed regulations, just as it is for E&P under section 312. Hence it is subject to some of the same uncertainties that complicate the E&P approach in connection with so-called “tax-exempt income” and “noncapital, nondeductible expenses.” The new system, while offering many improvements, may indeed be less certain than the old in some respects if the judicial and administrative patina of the E&P rules for these crucial categories is swept away. As discussed in IV.A.3 below, guidance will be required in many areas to replace precedent relating to E&P.

The role of sections 705 and 1367 should also be fleshed out. The Preamble (¶D.1) indicates that the selection of taxable income as the foundation for investment adjustments was motivated in part by the simplification advantage of “adopting, to the extent feasible, the existing principles for adjusting the basis of partnership interests (section 705) and stock in s corporations (section 1367).” All three systems have the common purpose of adjusting the basis of an owner's investment in an entity to reflect the entity's operations and, to that extent, treating the entity and its owner as one. Patterning the proposed regulations on the partnership and subchapter S rules raises two concerns, however. First, the principles of sections 705 and 1367 have not been developed beyond regulations that are much less detailed than the proposed consolidated return regulations.[12] Second, the reference in the Preamble to sections 705 and 1367 as a model can be read to suggest that taxpayers actually may apply section 705 and 1367 precedent in connection with investment adjustment issues. It would be helpful if the final regulations clarified the role of section 705 and 1367 precedent.

2. Articulation and Role of General Purposes. Prop. Reg. §1.1502-32(a)(1) identifies the fundamental purposes of the basis adjustment rules. Prop. Reg. §1.1502-32(a)(2) provides that "[t]he rules of this section ... must be applied in a manner that is consistent with and reasonably carries out [such] purposes," and it requires that, "[i]n the absence of specific guidance, adjustments must be made in a manner that reflects all the facts and circumstances, the underlying economic arrangement, applicable federal tax accounting principles, and the [specified] purposes."

The Committee strongly supports the regulatory statement of purpose and the general requirement that the regulations be applied consistent with that purpose and other relevant factors,

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[12] Treas. Reg. §1-705-1(a)(2) adjusts a partner's basis in a partnership interest for taxable income, tax-exempt income, the excess of depletion deductions over basis, partnership losses and nondeductible, noncapital expenditures of the partnership. No further guidance is provided. Prop. Reg. §1.1367-1, regarding shareholder basis in S corporation stock, is somewhat more illuminating in that it includes several examples of noncapital, nondeductible expenses.

subject to the following comments.[13]

a. The first and third sentences of Prop. Reg. §1.1502-32(a)(2), both quoted in relevant part above, seem contradictory. The first states, without qualification, that the specific rules "must be applied" in a manner "consistent" with regulatory purposes, and it continues with the specific example of avoiding duplication of an item in S's stock basis.[14] In contrast, the third sentence states that regulatory purpose and other specified factors control only "in the absence of specific guidance." The final regulations should reconcile these two statements. In particular, the final regulations should clarify which provision takes precedence when the mechanical rules lead to an adjustment that is clearly inconsistent with a regulatory purpose (because an item is duplicated in basis or otherwise).

There are three situations in which an investment adjustment might be governed by regulatory purposes rather than mechanical rules. First are "interstitial" cases which the specific rules simply do not address. Whether Prop. Reg. §1.1502-32(a)(2) is read broadly or narrowly, it properly directs both the Service and taxpayers to reflect regulatory purpose to

[13] An important ancillary benefit of requiring consistency with stated purposes in the consolidated return regulations is that interpretive issues could be resolved without resort to amending the regulations, thereby alleviating the section 1503(a) problem of having to amend the regulations before the due date of the return for issues that are not adequately addressed by the literal rules. Retroactive amendments (often to help the taxpayer) have been adopted only a few times. See, e.g., T.D. 7631, approved on June 26, 1979, which amended Treas. Reg. §1.1502-26, retroactive to years ending on or after August 30, 1975, in order to soften the harsh dividend received deduction rules previously adopted for such prior years.

[14] Cf. Treas. Reg. §1.1502-20(e)(1): "The [LDR] must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments must be made as necessary to carry out their purposes."

determine adjustments in circumstances where “specific guidance” is lacking. Second are cases of taxpayer abuse. Prop. Reg. §1.1502-32(e), which the Committee generally supports in principle but would limit in a number of ways (see IV.A.5 below), would permit the Service to override the specific rules in tax avoidance cases.

The third and most troublesome category, and an area in which past problems have arisen, are cases, not necessarily involving taxpayer manipulation or abuse, for which the regulations do provide specific guidance, but that guidance simply produces an irrational result when applied to a specific situation, as in the Woods Investment case.[15] These are the cases for which the scope of Prop. Reg. §1.1502-32(a)(2) becomes critical. In such a case, to what extent, if any, may the taxpayer and/or the Service disregard the mechanical rules and rely on regulatory purpose to arrive at a rational investment adjustment? The first sentence of Prop. Reg. §1.1502-32(a)(2) suggests that either may do so (though perhaps, based on the second sentence, only in the case of a duplicated item). The third sentence suggests that neither may (subject to the Service's discretion under Prop. Reg. §1.1502-32(e)).

Given the section 1503(a) retroactivity problem and Woods Investment-type problems, we believe it is important to provide a fair and administrable procedure to deal with such cases. While it was a close question, the Committee concluded that (i) the general rule in Prop. Reg. §1.1502-32(a)(2) that “an adjustment must not have the effect of duplicating an item in S's

[15] Woods Investment Company, 85 T.C. 274 (1985).

stock basis" should always control, despite specific regulatory guidance to the contrary, (ii) in all other cases, taxpayers should not be able to use general purposes to override clear and specific regulatory guidance, even if the result is apparently inconsistent with regulatory purpose, and (iii) in all other cases, the Service should be able to use general purposes to override specific regulatory guidance only under the authority of Prop. Reg. §1.1502-32(e) in cases of clear taxpayer abuse. Accordingly, we recommend amending Prop. Reg. §1.1502-32(a)(2) to clarify that, except in cases of double counting, the first sentence is not intended to expand the scope of the third.

At the same time, because the thrust of the regulations is to provide a conceptual foundation to resolve issues, we also recommend that the final regulations provide for an expedited process, available to both taxpayers and the Service, for issuing guidance (which may be retroactive in appropriate cases) where the regulations, applied literally, would produce a result that is "clearly inconsistent" with the stated regulatory purposes.[16]

b. Consideration should be given to establishing priorities or otherwise clarifying the relationship among the factors that Prop. Reg. §1.1502-32(a)(2) specifies should be reflected in investment adjustments where specific guidance is

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[16] Cf. Treas. Reg. §1.704-2(f)(4) (granting the Service the "discretion" to waive the minimum gain chargeback requirement if it is demonstrated that the requirement would "distort the partners' economic arrangement") and (f)(5) (providing that the Service "may" by revenue ruling create exceptions to the minimum gain chargeback requirement).

For a possible example of a mechanical flaw in the proposed regulations that might be addressed by such a ruling process, see S. Matthias, "Dividend Equivalent Redemption Problematic After New Regs.," The M&A Tax Report, p. l, May 1993 (suggesting that the rule for reducing basis for all dividend distributions produced the wrong economic result for a stock redemption that the Code treats as a dividend-equivalent).

absent. For example, “federal tax accounting principles” may suggest a different result than “the underlying economic arrangement” or the express regulatory purpose would.

c. As further discussed in IV.E.2 below, the final regulations should clarify (by example or otherwise) what is meant by the language “an adjustment must not have the effect of duplicating an item in S's stock basis” to prevent its application in a manner that is inconsistent with the policies underlying the LDR.

3. Guidance As to Amount and Timing of Adjustments to Taxable Income.

a. “Tax-exempt income” and “noncapital, nondeductible expenses.” Prop. Reg. §1.1502-32(b)(4)(ii) and (iii) adjust basis for “tax-exempt income” and “noncapital, nondeductible expenses.” While these provisions are appropriate in concept, the final regulations should clarify their scope and operation.

Regarding scope, a number of significant issues appear to fall through the cracks. Given the retroactive nature of the regulations to, theoretically, a group which began filing consolidated returns in 1919, it is important for the regulations to be clear and precise. For example, the following issues should be addressed:

(1) Whether the exercise of incentive stock options or qualified options (or their pre-statutory predecessors) decreases basis, as under existing E&P precedents.[17]

(2) Whether the payment of nondeductible insurance premiums under section 265 is offset by the buildup of cash value, as under existing E&P precedents.[18]

(3) Whether the E&P characterization of certain estimated tax payments of an insurance company prescribed by section 847(a)(9) would control the basis result under the proposed regulations.

Furthermore, the final regulations should address the timing of adjustments for tax-exempt income and noncapital, nondeductible expenses. Under Prop. Reg. §1.1502-32(b)(4)(i), adjustments for items of income or deduction that affect taxable income are made in the year of the effect on taxable income. No timing rule is provided for items that will never affect taxable income. In contrast, there is E&P precedent in this area. Rev. Rul. 64-146, 1964-1 C.B. 129, holds that a tax refund with respect to an NOL carryback increases E&P for an accrual basis taxpayer for the year in which the refund right arises (i.e., the year of the loss and not the years to which the loss is carried back). Rev. Rul. 70-269, 1970-2 C.B. 78, allows a cash basis taxpayer to reduce E&P only for taxes actually paid, although the courts have disagreed and allow the taxpayer to accrue taxes.[19]

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[17] See Devine v. Commissioner, 500 F.2d 1041 (2d Cir. 1974) (holding that E&P are reduced by the bargain element of qualified options).

[18] See Edelsein, Earnings and Profits — General Principals and Treatment of Specific Items, Tax Mgmt Portfolio No. 175-3d (1982), A-20; Sidney Stark, 29 T.C. 122 (1957).

[19] See, e.g., Demmon v. U.S., 321 F.2d 303 (7th Cir. 1963).

Presumably these and similar authorities, which by their terms apply only for E&P purposes, cannot be relied upon for purposes of the proposed basis adjustment rules. The final regulations should provide guidance regarding the timing of adjustments of this type.

b. Adjusting basis for items from closed years. One additional important timing issue — clear under E&P rules — should be clarified in the final regulations. E&P (and hence, under the current regulations, basis) is subject to audit based upon the statute of limitations for the taxable year in which E&P or basis is relevant in determining the tax liability of a taxpayer. Apparently this is so even though the statute of limitations for the year in which the item first affected E&P or basis is closed for purposes of assessing tax liability.

We recommend that the final regulations clarify the application of statutes of limitations under the new basis adjustment computations. For example, if S lost (or earned) $100 in 1980 (a closed year) but did not claim such loss (or include such income), P should not be able to reduce (or increase) its basis in S by the amount of such loss (or income) in 1994, the year P sells S. In this connection, it seems clear under present law, for example, that if P did not report income earned by S in a prior year (that year now being closed), P cannot now claim an upward adjustment in its basis in S's stock due to such income. Cases have reached this result based on the theory of a taxpayer duty of consistency or quasi-estoppel.[20] Moreover, the mitigation

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[20] See Treas. Reg. §1.1016-6; Coldiron v. Commissioner. T.C.M. 1987-569; Beltzer v. U.S., 495 F.2d 211 (8th Cir. 1974); Orange Securities Corp. v. Commissioner, 131 F.2d 662 (5th Cir. 1942).

provisions of sections 1311-14 presumably prevent the taxpayer and the Service from whipsawing one another.

c. Dividend distribution date. Under Prop. Reg. §1.1502-32(b)(4)(iv), a distribution from S to P reduces basis "when [P] becomes entitled to the distribution (generally on the record date)." In contrast, the current regulations generally reduce basis when the distribution is "made," with exceptions and special rules to address straddle dividends and other anomalies.[21] While the proposed accrual-type regime undercuts the fundamental Subchapter C principle of cash-method dividend inclusion,[22] the Committee considers the proposal a substantial improvement over other approaches to the straddle dividend problem. In particular, it eliminates the complexity of Temp. Reg. §1.1502-32T as well as that provision's use of an artificial earnings stacking rule (i.e., ignoring S's post-deconsolidation E&P) to achieve the correct economic result.

We have two recommendations regarding the dividend accrual rule. First, we suggest that the final regulations provide additional guidance regarding when a shareholder becomes "entitled" to receive a dividend. In particular, the general rule states that this will "generally" be the record date. If there is a record date, will another date ever be relevant? If there is no record date, what date will control? Second, as discussed in IV.B.3 below, we believe the dividend accrual rule should be limited to basis determinations and should not apply to E&P computations.

[21] Treas. Reg. §l-1502-32(b)(2)(iii), (c)(2), (k), §1.1502-32T.

[22] See, e.g., Treas. Reg. §l-301-l(b).

d. Expired loss carryovers. The current regulations do not make a negative investment adjustment upon expiration of a net operating loss or net capital loss carryover.[23] In contrast, the proposed regulations, while not entirely clear on the point, can be read to do so, on the ground that the expiration of a loss carryover is equivalent to "a decrease in a loss carryover," which itself "may be treated as a noncapital, nondeductible expense" under Prop. Reg. §1.1502-32(b)(4)(iii)(B) (emphasis added). The treatment of expired losses is all the more confusing because of the vague second sentence of Prop. Reg. §1.1502-32(b)(4)(iii)(B): "Whether a decrease is so treated is determined by taking into account both the purposes for requiring the decrease and the purposes of this section."

We recommend two changes to the treatment of expired losses under the proposed regulations:

First, we recommend that the reduction in basis for losses that expire during consolidated return years apply only to losses that expire in taxable years beginning after the date final regulations are published. Reducing basis upon the expiration of a loss represents a major and unanticipated departure from current law. Therefore, in the interest of fairness, this rule should apply prospectively only. Retroactive application could produce unreasonably harsh results for taxpayers that had significant expired losses in prior years.

[23] Like Prop. Reg. §1.1502-32(b)(4)(i)(A), Treas. Reg. §1.1502-32(b)(2)(ii) requires a negative basis adjustment for a consolidated net operating loss or net capital loss carryover in the taxable year in which the loss is "absorbed." In either case, the Committee is unaware of any authority suggesting that the expiration of an NOL or capital loss carryover constitutes an "absorption." Moreover, no provision in the current regulations is equivalent to the first sentence of Prop. Reg. §1.1502-32(b)(4)(iii)(B), which expressly provides for a basis reduction in the event of "a decrease in loss carryover," as discussed in text below.

Second, subject to the preceding paragraph, we agree that a basis reduction for S's expired loss carryovers is not inappropriate if the loss arises and expires within the same consolidated group. Such a loss represents an impairment of P's original investment in S, and a basis reduction produces the same result as if the group were a single entity. As discussed below, however, we believe that in most cases a basis reduction on the expiration of a SRLY loss is improper for reasons of policy and fairness.

> Example (1): P forms S with $100 of capital. S purchases securities for $100, which it later sells for $20. The P group cannot absorb the $80 net capital loss, which therefore does not reduce P's basis (under both the current and proposed regulations). Before S's $80 capital loss carryover expires, P sells S to corporation X for $20, incurring an $80 loss on the sale (subject to the LDR). S's loss carryover expires unused while X owns S. Under the current regulations, the expiration of S's loss carryover does not reduce X's $20 cost basis in S's stock. In contrast, the proposed regulations can be read to reduce X's basis in S's stock by the amount of the expired loss, creating a $60 ELA.

> Example (2): Same as the preceding example, except that S's $20 NOL, as a result of a prior ownership change of the P-S group, is subject to a zero section 382 limitation (e.g., because P apportioned none of its consolidated section 382 limitation from the prior ownership change to S under Prop. Reg. §l.1502-21(b)). Assume that S has no built-in gains. Hence S's $20 NOL is worthless to X. The result is the same as in the preceding example.

In the above examples, the only possible justification for reducing X's basis in S's stock by the entire amount of S's expired loss carryover would be if X paid dollar-for-dollar for the loss when it purchased S. (Otherwise, the expiration of the loss does not impair X's investment in S.) This is not the case in Example (2), where S's capital loss carryover is worthless to X. Even in Example (1), where it may be less clear whether X ascribed value to S's loss carryover, to assume that X paid dollar-for-dollar for a loss that ultimately expires unused is contrary to market economics. To begin with, X would never pay more than the maximum tax benefit, or 34% (ignoring state tax). Beyond that, in our experience purchasers typically pay far less than that for NOLs. Moreover, an acquiror will pay nothing for a loss it believes will expire unused. Thus, if X has analyzed the situation properly, any loss of S that ultimately expires will not have been reflected at all in X's cost basis in the S stock, precisely because X predicted that the loss would expire.

The Committee belieyes it is inappropriate for the regulations to assume that parties to a transaction behave irrationally. On the contrary, the treatment of expiring losses should be consistent with business reality and the conservative behavior of purchasers in this area, and hence should presume that a rational purchaser does not ascribe any material value to a loss that ultimately expires. Even if some purchasers, who overestimate the future utilization of acquired losses, pay some amount for losses that expire, those exceptions do not justify a rule that reduces basis by 100% of the expired loss amount in all cases.

The Committee therefore believes that a general rule that reduces X's basis in S's stock upon expiration of S's SRLY loss carryover is flawed in principle, because in all likelihood

X did not pay for the loss, so that the loss, in effect, has already reduced X's basis in S's stock. Hence the later expiration of the loss does not impair X's investment. Moreover, as the above examples illustrate, such a basis reduction creates significant potential hardship for purchasers, since it essentially double counts the loss. X could avoid the problem, of course, by making a section 338(h)(10) election with P. However, that would change the economic deal between the parties and merely illustrates that this potential result under the proposed regulations is a major trap for the unwary.

The above analysis of SRLY losses generally does not apply where X acquires S's stock with a carryover basis. This could occur, for example, where (i) X acquires S's stock in a “B” reorganization or (ii) X acquires the stock of S's direct or indirect corporate parent in a taxable purchase. In such a case, any NOL of S would be a SRLY NOL but, in contrast to X's taxable purchase of S's stock, the X group's initial basis in S's stock will not yet have been reduced to fair market value and hence will not yet have been impaired by S's SRLY loss.[24] In such cases, we believe it would be appropriate to reduce S's stock basis upon expiration of S's SRLY NOL. However, where X acquires S's SRLY loss in a taxable purchase of S's parent (“P”), any basis reduction of S's stock upon expiration of S's SRLY loss should not tier up to reduce X's basis in P, since X already will have a fair market value basis in the P stock.

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[24] In addition, unless the transfer of the S stock to X “deconsolidates” S for LDR purposes (which often will not be the case), the LDR will not reduce S's stock basis to fair market value in connection with the transfer to X. <u>See</u> Treas. Reg. §1.1502-20(b)(2).

For the above reasons, and because of the retroactive nature of the proposed regulations, we strongly recommend that the final regulations:

(i) clarify that there is a negative investment adjustment upon expiration of S's non-SRLY loss carryover;

(ii) eliminate the potential for such adjustment upon expiration of S's SRLY loss carryover (including a carryover arising from a built-in loss as defined in Treas. Reg. §1.1502-15), unless (A) X acquires S's stock with a carryover basis or (B) X acquires S's SRLY loss in a taxable purchase of S's parent, as noted above);

(iii) clarify the scope and operation of the second sentence of Prop. Reg. §1.1502-32(b)(4)(iii)(B) (including circumstances in which it would or would not apply in the context of both expired losses and other items); and

(iv) add examples illustrating the application of these rules to common cases of loss expiration, including specifically in connection with the X group's non-section 338 acquisition of S (a loss corporation) by (A) a taxable purchase of S's stock (in which case no downward adjustment of X's basis in S's stock would result) and (B) a taxable purchase of the stock of S's parent (in which case a downward adjustment of P's basis in S's stock would result).

4. Allocation of Adjustments, Including Cumulative Reallocations. The proposed regulations make two important changes to the allocation rules with which we agree. Under current regulations, if P is able to consolidate with S by owning convertible preferred stock of S, P is not required to adjust its

basis in such stock.[25] Thus, if S operates at a loss, P may be able to utilize the loss to reduce its consolidated taxable income and then recognize a loss on the sale of the S preferred stock, subject to the LDR.[26] Prop. Reg. §1.1502-32(c) and §1.1502-32(d)(2) require an investment adjustment to preferred stock when consolidation is achieved by virtue of its ownership. This mechanism appropriately eliminates a possible abuse.

Prop. Reg. §1.1502-32(c)(4) requires that investment adjustments be reallocated in subsequent years "whenever necessary to determine the tax liability of any person." While this provision has drawn some adverse comment, the Committee believes that such cumulative reallocations, despite their complexity, are economically sound and appropriate.

5. Overriding Adjustments. Prop. Reg. §1.1502-32(e) contains several anti-abuse principles and examples that provide for "overriding adjustments" to the normal rules where a taxpayer acts with "a principal purpose" of tax avoidance and in certain other cases.

a. In general. The Committee believes an anti-abuse provision of some sort is appropriate to address legitimate concerns of the Service. If the "general principles" rule of

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[25] See Treas. Reg. §1.1502-32(c) (applies to all stock "limited and preferred as to dividends").

[26] But see Technical Advice Memorandum 8022017 (February 22, 1980) (where P, attempting to take advantage of such a double loss, literally satisfied the section 1504(a) stock ownership requirements with respect to S through P's ownership of S voting preferred stock, the Service, citing Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934), nevertheless concluded that P could not consolidate with S "unless it can be shown that appropriate basis adjustments [to the S preferred stock] have been made so that the possibility of a double deduction is avoided").

Prop. Reg. §1.1502-32(a)(2) is generally limited to permit the application of general regulatory purposes only in "interstitial" cases where "specific guidance" is absent (as recommended in IV.A.2 above), the overriding adjustments provision (subject to the comments below) would appropriately permit the Service to address abusive cases notwithstanding specific regulatory guidance. On the other hand, if Prop. Reg. §1.1502-32(a)(2) is drafted broadly to permit the application of general purposes despite specific rules to the contrary, there would appear to be little potential for abuse of the investment adjustment provisions that could not be addressed by the general principles, the LDR or case law. In that case, we would suggest that the overriding adjustment rules add complexity and uncertainty to the regulations without necessarily strengthening them, and that consideration be given to eliminating these rules from the final regulations altogether, or perhaps replacing them with a much briefer statement of policy supported by selected examples.[27]

In addition, we believe the overriding adjustment provisions take an overly broad view of what constitutes an abuse as opposed to legitimate tax planning. Accordingly, if Prop. Reg. §1.1502-32(e) is kept, we recommend limiting it to cover cases that are more clearly abusive. As drafted, we believe the overriding adjustment provision will tend to raise issues unnecessarily on audit or otherwise undermine the ability of taxpayers to rely on the normal rules in many nonabusive

[27] By comparison to the expansive approach taken in the proposed regulations, the anti-abuse provision in Treas. Reg. §1.1502-20(e)(l) merely states: "If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments must be made as necessary to carry out their purposes."

circumstances. For example, the “a principal purpose” test in each of Prop. Reg. §1.1502-32(e)(1), (2) and (3) seems an unreasonably low threshold. It often could cause taxpayers to question their ability to take tax considerations into account at all in choosing among legitimate and nonabusive courses of action, one of which produces a superior tax result. To address this concern, we recommend changing this standard to “the principal purpose,” which should still adequately cover transactions that are truly abusive.[28] In addition, we suggest that the concept of acting with a purpose “to avoid the effect” of the consolidated return regulations (Prop. Reg. §1.1502-32(e)(1)) is vague and should be clarified. Is this merely a reference to the purpose specified in Prop. Reg. §1.1502-32(a)(1)? If so, it is unclear how it would apply. On the other hand, it is unclear what else it might refer to.

Furthermore, the relationship between the overriding adjustment rule and the LDR should be clarified as discussed in IV. E below.

b. Examples. The examples illustrating overriding adjustments are also troubling in a number of respects. In Example l, for instance, P “anticipates” that S will lose money during its first two years of operation, and thus capitalizes S with common and preferred stock. P owns 80% of S's common stock and all of S's preferred stock, which P “intends” to recapitalize into common stock at the end of year 2. The example states that “a principal purpose” for the temporary issuance of the preferred stock is so that P will avoid bearing more than 80% of the downward basis adjustments in years 1 and 2. This example would extend the step-transaction doctrine to situations of mere

[28] Cf. sections 269, 1551(a).

anticipation of events two years in the future, during which time the parties bear the economic benefits and burdens of the structure. Indeed, the example ignores that the recapitalization will be based upon the relative values of the common and preferred stock at that time. The Committee believes that, so long as the interim structure genuinely shifts economic benefits and burdens, this is legitimate tax planning. It is little different from the shareholders of a new venture electing subchapter S treatment to pass through start-up losses and then converting to subchapter C status once the enterprise is successful. The inequity of the example arises largely from the use of the “a principal purpose” standard of the proposed regulations, which would treat this transaction as abusive despite P's entering into the preferred stock arrangement for a substantial business reason — downside protection of its investment. Accordingly, the result in the example would be more reasonable if the final regulations adopted a “the principal purpose” standard, as recommended above.

In Example 2, P has a $100 basis in S's stock. P intends to sell the S stock to the X group at the end of year 1 for $300. X is a customer of S, and with a principal purpose to increase the basis of S's assets immediately before X buys S's stock, X makes a $200 prepayment to S (apparently for services). S recognizes $200 of ordinary income, which increases P's basis in S, and P recognizes no gain on the sale of S. The example concludes that, because X's prepayment was made with a principal purpose to “distort investment adjustments,” the $200 positive adjustment to S's stock basis is not made until S becomes a member of the X group. Apparently the net effect of the transaction intended by the parties (as compared to postponing the $200 payment until after S joins X's group) is that (i) P recognizes $200 of ordinary income rather than $200 of capital gain, (ii) the X group avoids having to include in its consolidated return S's income from receipt of the $200 prepayment, (iii) X obtains an early deduction for prepaying the services (assuming the payment need not be capitalized), and (iv) after the transaction, the X group has a tax basis in S's stock of $300 rather than $500.

We have several comments regarding Example 2. First, it would be extremely helpful if the final regulations clarified the targeted abuse. The example states that the transaction is for "a principal purpose to increase the basis of S's assets immediately before X buys S's stock." This suggests that the abuse is a step-up of P's stock basis in S, perhaps to reduce P's recognition of gain on the stock sale. Since the prepayment results in P's recognition of $200 of ordinary income, however, P apparently gains nothing from the transaction. Perhaps the perceived abuse is that S will not report such income after its acquisition by the X group, thereby eliminating such income from the reach of the LDR under Treas. Reg. §1.1502-20(c)(1)(ii) (positive basis adjustment). Another potential concern may be that by accelerating the expenditure for services, X will have obtained a deduction (assuming capitalization is not required) which otherwise would have been washed-out (by S's inclusion of the payment in income) if expended during consolidation. Second, the final regulations should clarify the tax treatment of the purchaser, X. The example states that the $200 positive adjustment in S's stock is not made "until S becomes a member of the X group." Thus X, rather than P, apparently obtains the benefit of the $200 basis step-up. It is unclear, however, whether X must pay a price for the step-up, since, as discussed below, the example is silent as to whether P or X must include in income the $200 prepayment income. Moreover, if the section 338 consistency rules apply (which they should if X's prepayment is for property outside the ordinary course of business, for example), they would impose either a deemed section 338 election for S (generally under the temporary regulations) or a carryover basis in the property purchased (generally under the proposed regulations).[29] It is unclear how the adjustment required by the example is intended to coordinate with the consistency rules. Perhaps it should be stipulated that the example applies only in cases where the section 338 consistency rules do not.[30] Third, by postponing the $200 positive adjustment to S's stock basis until after S joins the X group, the example denies P the investment adjustment attributable to the $200 prepayment, so that P must report $200 of capital gain on the stock sale. It is silent, however, as to whether P also must recognize the income attributable to the prepayment itself. The example would be „ draconian in its treatment of P if P were required to recognize the prepayment income, because P would be taxed twice. Penalizing P in this manner seems particularly inappropriate because the transaction as structured produces no apparent tax benefit for P (which would merely convert capital gain to ordinary income). Therefore, we recommend that Example 2 be clarified to remove any inference of P's double recognition of income. This could be accomplished by treating the $200 prepayment itself (rather than merely the corresponding investment adjustment) as having been made immediately after the stock purchase. This approach, by shifting the $200 prepayment income from P to X, also would eliminate X's deferral and support X's $200 basis stepup in S's stock. Fourth, in light of the above difficulties, consideration

[29] See section 338(e); Temp. Reg. §1.338-4T(f); Prop. Reg. §1.338-4(c). The consistency rules do not apply with respect to a sale in the ordinary course of business. Section 338(e)(2)(A); Temp. Reg. §1.338-4T(f)(3); Prop. Reg. §1.338-4(d)(2)(i).

[30] It should be noted that some members of the Committee expressed strong views that if the section 338 consistency rules do not apply (e.g., the sale is in the ordinary course of business or is for services), there is no justification for tracing and eliminating this sort of activity.

should be given to eliminating the example and relying instead on the general anti-abuse rule t address transactions of this type.

Example 4 concerns a transaction that is considered to be an abusive application of section 358(b). The Committee agrees that certain transactions that take advantage of an unintended interaction between the consolidated return regulations and Subchapter C (such as mirror and son of mirror transactions) may be abusive. In this particular case, however, we believe that the perceived abuse does not arise from the consolidated return regulations. In particular, the investment adjustments made during years 1 through 3 are not essential to the section 358(b) basis allocation issue that the example targets, because section 358(b) could produce a favorable result for the taxpayer even in the absence of investment adjustments. While the investment adjustment rules may affect the amount of the perceived basis distortion, the source of the problem is section 358(b), not the consolidated return regulations. Therefore, we believe the example inappropriately lays the problem at the doorstep of the basis adjustment rules. Moreover, we believe this transaction is adequately addressed by existing general tax principles, including the step transaction doctrine. That is, to the extent the steps described in the example are part of a prearranged plan, the dropdown of the S stock to T would be disregarded under general tax principles, and the example is unnecessary. If the steps described in the example are not part of a prearranged plan, we believe the form of the transaction should be respected and the example reaches the wrong result. Because the example seems misplaced and unnecessary, we recommend eliminating it.

If the final regulations retain Example 4, we recommend that they (i) clarify that the dropdown is part of a prearranged plan “the principal purpose” of which is to reduce P's gain on the sale of S's preferred stock and (ii) specify a date for the preferred stock sale that is relatively close to the dropdown.

6. Elimination of Deemed Dividend Election from Pre-1966 Consolidated Return Years. The proposed regulations eliminate the deemed dividend election of Treas. Reg. §1.1502-32(f)(2) for consolidated return years ending on or after the finalization of regulations.[31]

The deemed dividend election under Treas. Reg. §1.1502-32(f) effectively allows a consolidated group to capitalize its pre-1966 consolidated return (or affiliated SRY) earnings (i.e., the deemed dividend distribution does not reduce basis, whereas the deemed capital contribution increases basis). This was viewed as an especially important transition rule in 1966 since many groups were effectively prevented from filing consolidated returns because of the 2% penalty tax (eliminated in 1964).

Whereas the proposed regulations eliminate the deemed dividend election, the principle is effectively retained since P's basis in S will be increased for all income (or loss) of S for all consolidated return years. In fact, this expands the scope of the election since it eliminates two restrictions under Treas. Reg. §1.1502-32(f), i.e., (i) the requirement of 100% stock ownership, and (2) the coverage only of E&P accumulated as of the beginning of the taxable year of the election. We agree with the expansion of this principle.[32]

[31] See Prop. Reg. §1.1502-32(h)(4)(i), §1.1502-33(j)(5)(i).

[32] Another minor difference is that under the new approach the E&P of S will not be eliminated until S leaves the group.

7. Treatment of Earnings Distributed From Mon-Consolidated, Affiliated Years. The proposed regulations make a radical change in the treatment of earnings from nonconsolidated, affiliated years. Under Prop. Reg. §1-1502-32(b)(3), any distribution out of E&P from such years will cause a basis reduction, in contrast to the result under current Treas. Reg. §1.1502-32(b)(2)(iii)(b) and (c). Thus, unless distributed (through an actual or deemed dividend) before the effective date of the new regulations, a subsequent distribution of such earnings during consolidation, though not subject to a current tax, could result in Federal (and state) income tax of at least 34% when S is sold.

The Preamble (¶E.1.e) suggests three reasons for the change in policy: (1) the current rules presume the earnings are not reflected in P's basis, a presumption which “is often inaccurate”; (2) to “refine” the presumption would result in “significant complexity,” including the adoption of “special rules” to implement section 1059(e)(2)(B), relating to gain accrued before affiliation; and (3) greater distinctions have arisen in recent years between separate and consolidated returns. For these reasons, the Treasury concluded that it would be inappropriate “to extend consolidated return benefits” to E&P from separate return years.

We strongly oppose this new approach. Our reasons include the following:

a. It is not sound tax policy to extract a 34% or more corporate-level tax on earnings already taxed once and which are merely being moved within the same affiliated group.

b. The proposal would eliminate a benefit section 243(b) provides to groups filing separate returns (i.e., 100% DRD and generally no basis adjustment), not extend a consolidated return benefit. Since the basis reduction could be avoided by those groups able to pay a dividend immediately prior to consolidation, the withdrawal of this separate return benefit amounts to a penalty for groups that fail to make a timely distribution because of regulatory restrictions, lack of foresight, or other reasons.

c. A good case can be made that Congress designed sections 243 and 1502 to reach essentially the same result, and that it is therefore inappropriate for Treasury to change the current, longstanding rule:

(i) When adopted in 1964, the section 243(b) election was viewed as an alternative to filing consolidated returns for corporations that were affiliated but could not elect under the Code (i.e., life-nonlife groups) or did not want to elect for administrative reasons (i.e., P and S were on different fiscal years):

> Your committee concluded that it would be inequitable to repeal the consolidated return 2- percent tax without also providing a 100% inter corporate dividends received deduction for corporations meeting the same tests of common ownership, but which for one reason or another cannot, or do not want to, file a consolidated return and are willing to forgo multiple surtax exemptions....
>
> To be sure that no special advantage was given these corporations over those corporations which do file consolidated returns, your committee has reviewed the various provisions of the code and denied tax benefits in those cases where the separate corporations received significant advantages over a consolidated

group.[33]

(ii) Consistent with this legislative design to have distributions under sections 243 and 1502 produce essentially parallel tax results, Congress recently confirmed that it was aware of -- and approved of -- the consolidated return treatment of distributions from earnings that accrued in affiliated, separate return years:

> It is expected that the application of the provision to distributions between members of an affiliated group filing consolidated returns will be consistent with the principles of the exceptions relating to qualifying dividends and dividends with respect to stock which the distributee has held throughout the distributor's entire existence. For example, a distribution during a consolidated return year out of earnings and profits accumulated during a prior year, throughout which the distributing corporation was affiliated with the distributee but did not join the distributee's consolidated return and not attributable to gain on property that accrued prior to affiliation, would not result in a reduction in the basis of the distributee's stock in the distributing corporation.[34]

(iii) In the same Senate Report, Congress expressed its intent that the consolidated return regulations reflect the section 1059 policy with respect to the issue of pre-affiliation, accrued earnings:

> However, to the extent results produced under the consolidated return regulations are inconsistent with the purposes and principles of the extraordinary dividend provision, it is intended that a basis reduction may be required under this provision notwithstanding the fact that no reduction is mandated under the consolidated return regulations.[35]

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[33] S. Rep. No. 830, 88th Cong., 2d Sess. 75 (1964).

[34] S. Rep. No. 445, 100th Cong., 2d Sess. 45 (1988) (emphasis added).

[35] Id. (emphasis added).

(iv) The Congressional fix to the built-in gain problem under section 1059 was to require tracing under section 1059(e)(2)(B). If Congress thought it proper and doable for separate returns, Treasury should justify why the path endorsed by Congress, for what Congress perceived as an alternative filing method, is not adequate. Moreover, the legislative history suggests that Congress approved of the consolidated return rules for earnings that accrued in affiliated, separate return years, but wanted a change with respect to pre-affiliation built-in earnings along the lines prescribed under section 1059. Again, the Treasury should justify the perceived need to go beyond this mandate and change its long standing regulation.[36]

d. We do not agree that separate and consolidated filing (with the exception of the LDR) have gone in opposite directions. It appears that whenever Congress thinks of it, it now provides that a new Code provision should apply to affiliated groups (whether or not consolidated returns are filed) as if the group "were a single corporation." Consider, for example, sections 338(h)(2), 384(C)(6) and 809(h)(2).

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[36] Recently, the Tax Court spoke of the extra burden the IRS must carry in reversing long standing regulations: "If an agency reverses a prior statutory interpretation, however, its most recent expression may be accorded less deference than a consistently maintained position.... Sharp changes of agency course constitute danger signals to which a reviewing court must be alert.... An agency which changes its position must ... supply a persuasively reasoned explanation for the change." Georgia Federal Bank v. Comm'r, 98 T.C. 105 (1992).

In short, we do not believe the perceived complexity in fixing the problem warrants a bad policy result,[37] wholly at odds with the legislative history of dividends from affiliated years.

To balance out the selective nature of the deemed dividend election, and undesirable double tax on affiliated earnings, we recommend an automatic basis adjustment, as of the beginning of the first year in which S is or was included in P's consolidated return, for the undistributed E&P of S from affiliated separate return years.[38] We also believe it would then be appropriate, as contemplated by the proposed regulations, to reduce basis for all distributions made during consolidation. This approach has the advantage of eliminating the need to "trace" earnings, without sacrificing fairness since the LDR theoretically deals with the built-in gain problem.

Alternatively, we recommend retaining existing law, augmented to reflect the policies expressed by Congress under sections 1503(e) and 1059 (i.e., implement the tracing rule of section 1059(e)(2)(B), as well as the extraordinary dividend rules). In this connection, Treasury might consider tightening section 1059 (e.g., extend or eliminate the 2-year rule); this

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[37] See Gerling International Insurance v. Comm'r. 98 T.C. 640 (1992) in which Judge Tannenwald quotes the following from Judge Learned Hand: "The one sure way to do injustice ... is to allow nothing whatever upon the excuse that we cannot tell how much to allow."

[38] We believe such adjustments should be for net positive E&P years only. Negative basis adjustments for net negative E&P affiliated SRY years seem unnecessary and inappropriate. This is because the net E&P deficit for each such year generally will be accompanied by an NOL that will reduce basis automatically when the NOL ultimately is absorbed. To the extent the NOL is not absorbed before P disposes of S, any potential duplicated loss should be eliminated under the LDR. Under this approach, the result is the same as if P and S had always been consolidated.

would be far more palatable than altogether rejecting the basic relief Congress afforded distributions from affiliated separate return years.

8. Predecessors and Successors. Prop. Reg. §1.1502-32(f) extends the proposed regulations to predecessor and successor corporations "as the context may require." We would suggest either deleting this language or clarifying what it means.

9. Annual Reporting. Prop. Reg. §1.1502-32(g) requires annual reporting of investment adjustments for the year on the group's federal income tax return. The Committee is concerned that this reporting requirement places a significant burden on taxpayers without providing any corresponding benefit to either the taxpayer or the government. This is particularly so in the many cases where P owns multiple (perhaps hundreds of) subsidiaries which it has no intention of disposing of, because in those cases investment adjustments are wholly irrelevant. We question the Preamble's suggestion (IE.4) that, unlike the current E&P-based adjustments, the necessary information will be readily available from the preparation of the group's tax return. As discussed in IV.A.1.b above, the modifications to be made to taxable income in arriving at the investment adjustment are similar to the modifications made in determining E&P. Neither the tax-exempt income nor the noncapital, nondeductible expense categories are self-evident, and taxpayers and their advisors will be required to do much of the same analysis that is now done in E&P studies to arrive at the correct adjustments. Based on our experience with E&P and basis studies, we believe that it would be considerably more cost effective to perform this analysis for all relevant years when P disposes of S's stock, rather than annually for all subsidiaries (most of which will not be sold).

Since the proposed regulations do not (nor should they) require P to recalculate its basis in S under the proposed regulations as of the effective date of the proposed regulations, the utility of requiring P to report merely future adjustments is questionable. Without a starting point, if P owns S before the effective date of the proposed regulations, P will never know its basis in S's stock. In addition, the annual calculations themselves would not be determinative, since they would always be subject to cumulative redetermination under Prop. Reg. §1.1502-32(c)(4) (e.g., upon sale of S), thus further undercutting the usefulness of an annual reporting requirement.

Moreover, it is unclear why the Service would benefit from such annual reporting. The taxpayer has the burden of proving its basis when it reports gain or loss on a transaction. If the taxpayer cannot substantiate basis, the taxpayer, not the government, is at risk.

Finally, the regulations do not appear to penalize noncompliance with the annual reporting requirement. The lack of a penalty will lead inevitably to substantial noncompliance, particularly in light of the time and expense necessary to comply with this provision and the limited practical benefit of compliance.

For the above reasons, we recommend eliminating the annual reporting requirement.

10. Effective Date.

a. Disposition approach generally. The proposed investment adjustment rules generally are to apply for any determination of stock basis (e.g., a sale of S stock) on or after the date final regulations are published (the “disposition approach”).[39] At such time, basis and any ELA must be determined or redetermined as if these miles applied for all consolidated return years of the group, with limited exceptions.

The disposition approach is novel and has many advantages, not the least of which is simplicity. The existing system of different rules for different years is cumbersome and should not be exacerbated by another tranche. Therefore, the Committee generally supports the disposition approach. The Committee, however, is concerned about the fundamental fairness of eliminating decades of established principles retroactively and replacing them with revised and sometimes imprecise rules that could produce many unexpected results.

While the proposed effective date generally will not materially alter stock basis adjustments when compared with the existing regulations, they may materially alter basis adjustments for prior years in which one or more relevant provisions of the existing regulations did not apply. Retroactive consequences of this type might be defended on the ground that, viewed globally, windfalls and detriments under the proposed regulations may be offsetting, or that taxpayers should have anticipated changes designed to improve or streamline the system as a whole. While these arguments may resound on the macro level, however, on the micro level of fairness to individual taxpayers they ring somewhat hollow. (For example, the changes in the proposed regulations dealing with distributions from affiliated, separate return years or a reduction in basis for expired losses could not have been predicted.) This is particularly so given that, in

[39] Prop. Reg. §1.1502-32(h)(1).

contrast to changes in law affecting particular transactions, which a taxpayer might avoid simply by avoiding the transaction itself, generally no consolidated group may escape the consolidated return regulations except by the radical step of disaffiliating. Further, although the Treasury's and Service's understanding (expressed in the Preamble at fE.5) that few groups determine investment adjustments currently may be correct, those groups might well have planned transactions based upon advice as to the application of the existing regulations.

Finally, the retroactive effect of the proposed regulations could create administrative hardship for taxpayers that have invested the time and money to keep current records of subsidiary stock basis under the existing regulations.

b. Exceptions to retroactive application. Balancing the strong administrative need to move quickly to a single investment adjustment/E&P system applicable to all years with the need for fairness is not simple. As stated above, the Committee supports a general rule of automatic retroactively. For the above reasons of fairness, however, we recommend three exceptions to retroactivity:

First, we recommend that taxpayers be allowed to elect out of the retroactive determination of subsidiary basis with respect to all subsidiaries sold within a specified period (e.g., 3-5 years) after the date final regulations are published. Requiring the election to be made for all dispositions within the specified period would discourage taxpayer selectivity and ease administration. The election would allow taxpayers time to determine whether they would be adversely affected by the proposed regulations and to avoid such consequences by selling the affected subsidiaries (or by ceasing to file consolidated returns, if the second recommendation below is adopted). The proposed regulations are complex and their ramifications not yet entirely clear. Some clarity will be provided by future pronouncements of the Service or by commentators. We believe that taxpayers need significant time to analyze the regulations (in light of future developments) and their own facts before they can determine with reasonable certainty the impact of the proposed regulations on their particular situations. We therefore encourage the Service to be generous in setting the time period for this election. As noted above, the final regulations might provide that the election, once made, apply with respect to subsidiaries sold within three to five taxable years beginning after the date final regulations are published. The final regulations might require the election to be made by the due date (including extensions) for the return covering the year in which the first post-effective date sale of a subsidiary occurred.

This election would not apply to E&P determinations, which would be made retroactively to the extent provided in the proposed E&P effective date rules.

Second, we recommend that the Service grant blanket permission pursuant to Treas. Reg. §l.1502-75(c)(2)(i) for all groups to discontinue filing consolidated returns as of the first day of the taxable year of each group during which final regulations are promulgated. We believe the prerequisite for blanket permission to discontinue filing consolidated returns is satisfied, because the proposed regulations “could have a substantial adverse effect” on the filing of consolidated returns by all consolidated groups. While such blanket authority should apply to the taxable year of the group that includes the effective date of the proposed regulations, we encourage the Service to give taxpayers a reasonable period of time to determine whether to discontinue filing, because the complexity of the regulations will require many taxpayers to engage in considerable analysis to make an informed decision. We suggest an election deadline not sooner than the due date (including extensions) for the return covering the first taxable year beginning after the date final regulations are published (i.e., the due date for 1994 calendar year returns if the regulations are finalized in 1993). This would fairly balance the need for administrative convenience to the Service (by limiting potential amended returns to one year) against the importance to taxpayers of time to perform an adequate study.[40]

Third, as discussed in IV.A.3.d above, we recommend that the reduction in basis for expired losses apply only to losses that expire in taxable years beginning after the date final regulations are published.

B. Earnings and Profits (Prop. Reg. §1.1502-33).

1. Articulation and Role of General Principles. Prop. Reg. §1.1502-33(a) articulates and defers to general principles in a manner similar to the analogous basis adjustment provision (Prop. Reg. §1.1502-32(a)). The comments in IV.A.2 above generally apply.

2. Direct Tiering Up. Prop. Reg. §1.1502-33(b) establishes a separate system (independent of the investment adjustment rules) for adjusting P's E&P based on a direct tiering up of S's E&P. The Committee agrees that tiering up E&P directly is a major improvement over the existing “ratchet” system (in

[40] Cf. the election under section 243(b)(2) which, in general, may be made on a retroactive basis provided there is at least one year remaining in the statutory assessment period.

which P's E&P adjustments with respect to S are triggered by adjustments to P's basis in S's stock), because it eliminates anomalies arising from basis-E&P linkage (see IV.A.1.a above).

3. Dividend Distribution Date. Under Prop. Reg. §1.1502-33(c)(1)(ii), a section 301 distribution from S to P is taken into account for purposes of adjusting P's E&P when P "becomes entitled" to the distribution rather than when the distribution is made. This parallels the basis provision of Prop. Reg. §1.1502-32(b)(4)(iv) (see IV.A.3 above). This accrual-type rule for distributions, while appropriate for basis purposes, seems inappropriate for E&P purposes for the following reasons.

First, although the proposed rule facially addresses only the timing of P's E&P adjustments as a result of a distribution, it appears to reduce as well S's E&P as of the same date for purposes of characterizing distributions to nonaffiliated shareholders.[41] This in turn can affect the treatment of distributions paid to S's preferred shareholders and minority shareholders in a manner that thwarts their reasonable economic expectations.

> Example (3): P and X, both corporations, form S on January 1 of year 1, with P acquiring all of S's common stock and X acquiring S preferred stock with a $10 dividend preference. P and X expect S to be profitable, and X

[41] Prop. Reg. §l.1502-33(c)(1)(ii) is somewhat unclear on this point, since it literally applies only for determining when a section 301 distribution "is taken into account by members" (emphasis added). Unless S's E&P is reduced at the same time for purposes of characterizing distributions to nonmembers, however, the aggregate amount of S's distributions to P and to nonmember shareholders that are characterized as dividends could be different from S's aggregate E&P, which presumably is not intended. The last sentence of Prop. Reg. §1.1502-33(c)(1)(ii), which provides for "proper adjustments" where S's stock is not wholly owned by affiliates, may be intended to address this issue, but is a bit cryptic.

> hopes to receive the benefits of the dividends received deduction. S has $10 of E&P in year 1 and no E&P in year 2. At the end of year l, S declares a $10 preferred stock dividend and a $10 common stock dividend, each payable at the beginning of year 2. Under existing regulations, both P and X would look to current and accumulated E&P in year 2 to determine the nature of the distribution. Since there are only $10 of E&P to support a $20 distribution, half of each shareholder's distribution would be a dividend. Under the proposed regulations, S's distribution to P is deemed to occur in the year prior to its distribution to X and reduces accumulated E&P as of the end of year 1. Thus, X would have a $10 return of basis distribution rather than a $5 dividend and a $5 return of basis distribution.[42]

It is possible that the last sentence of Prop. Reg. §1.1502-33(c)(1)(ii) (providing for "proper adjustments," taking into account the "purposes" of this provision, where S has minority shareholders) would alter the result described in the above example. However, since the proposed regulations do not elaborate on the manner in which such adjustments are to be determined, it is difficult to know this special minority shareholder rule would apply.

Second, the purpose of the proposed dividend accrual for E&P purposes is unclear. The Committee does not believe that mere symmetry with the basis counterpart of Prop. Reg. §1.1502-32(b)(4)(iv) justifies the rule. Indeed, since the proposed regulations generally delink basis from E&P, there is no apparent

[42] A similar analysis would apply where X, rather than owning S preferred stock, is a minority shareholder of S's common stock, and S declares a $20 common stock dividend at the end of year l payable to P and X at the beginning of year 2.

obstacle to providing separate timing rules for the investment adjustment and E&P effects of dividends. Moreover, we are aware of no independent reason to “accrue” dividends for E&P purposes. In particular, this rule does not appear to address any existing abuse, and it may distort the taxation of certain back-to-back distributions by S and by P:

> Example (4): P has no current or accumulated E&P in year 1. At the end of year 1, P declares and pays a $100 dividend to its shareholders. In order to entitle its corporate shareholders to the dividends received reduction, P has S declare a $100 dividend out of S's preaffiliation E&P to S's shareholders of record at the end of year 1, payable in year 2. Under the current regulations, P's E&P would not increase until S actually pays the dividend in year 2, resulting in nondividend treatment of P's year 1 distribution to its shareholders. Under the proposed regulations, S's dividend declaration would increase P's year 1 E&P by $100 (despite S's payment of the dividend in the following year), resulting in dividend characterization of the dividend paid by P.

For the above reasons, although we recognize the complexity of using two separate rules, consideration should be given to retaining existing law by eliminating the accrual-type dividend rule of Prop. Reg. §1.1503-33(c)(1)(ii). Alternatively, the final regulations should give guidance regarding the treatment of minority shareholders that is more specific than the vague “proper adjustments” principle appearing as the last sentence of that provision.

4. Federal Income Tax Liability. Prop. Reg. §1.1502-33(d) is essentially a rewrite of existing Treas. Reg. §1.1502-33(d)(2). Both provide elective methods of allocating federal income taxes among members of a group for E&P purposes so as to reflect the compensation of group members whose losses were absorbed by income of other members. These elective methods complement the basic methods of federal income tax allocation contained in section 1552. An election under both the current and proposed regulations must be made on a group's first return and, generally, cannot be changed without the consent of the Commissioner.[43]

Under the existing regulations in which investment adjustments are linked to E&P, the income tax allocation method elected for E&P purposes automatically governs for purposes of making investment adjustments. The proposed regulations not only delink basis and E&P, but mandate that the "percentage method," also known as the immediate payment method, of Prop. Reg. §1.1502-33(d)(3) (assuming a 100% allocation) be used in making investment adjustments for all consolidated return years.[44] Thus, any group that has not already elected the percentage method under Treas. Reg. §1.1502-33(d)(2)(ii) using a 100% allocation will be required to allocate its federal income tax liability twice, using separate methods for E&P and basis purposes. This creates an unnecessary administrative burden for many groups.

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43 Treas. Reg. §1-1502-33(d)(3); Prop. Reg. §1.1502-33(d)(5).

44 Prop. Reg. §1.1502-32(b)(4)(vii). Note that this provision incorrectly cites Prop. Reg. §1.1502-33(d)(2) rather than Prop. Reg. §1.1502-33(d)(3).

The Committee suggests that the proposed regulations, or a revenue procedure issued along with the regulations, permit any group that has not elected the percentage method (with a 100% allocation) for E&P purposes to do so on its consolidated return for the first taxable year ending after the regulations are finalized.[45] As Treas. Reg. §1.1502-32(b)(4)(vii) is retroactive, the election to adopt the percentage method should be available on both a retroactive and a prospective basis.

5. Deconsolidation. Prop. Reg. §1.1502-33(e) eliminates S's E&P, “to the extent they were taken account by any [other] member” of P's group, immediately before S becomes a nonmember. In addition to eliminating the straddle dividend problem (as discussed in the Preamble), this is consistent with the single entity approach. If P and S were a single corporation and the S division were incorporated and sold, S would not have any E&P.

The Preamble (¶F.3.a) requests comments regarding any “adjustments” to this rule that may be appropriate “if S's stock is not wholly owned by members of the consolidated group immediately before S becomes a nonmember.” Without any adjustments, eliminating P's share of S's E&P could adversely affect such nonmember shareholders.

> Example (5): S, a newly formed corporation, is owned 80% by P and 20% by public shareholders, many of which are corporations that purchased their S stock anticipating the benefits of the dividends received deduction. S earns $100 of E&P, of which $80 is allocated to P and reflected in P's E&P under Prop. Reg. §1.1502-33. S then issues an additional

[45] See Rev. Proc. 90-39, 1990-2 C.B. 365 (eliminating the requirement of the consent of the Commissioner in certain cases).

> 10% of its stock to the public, deconsolidating P and S. The proposed regulations would eliminate $80 of S's $100 E&P arising in the P group (i.e., the portion reflected in P's E&P). Therefore, after deconsolidation, S will have only $20, rather than $100, of accumulated E&P to support distributions to all of its shareholders, thus increasing the likelihood that distributions made to S's minority shareholders after deconsolidation will represent return of basis rather than dividends eligible for the dividends received deduction.

The Committee is troubled by this result, but is unable to suggest a solution that would not lead to substantial complexity. One approach considered is to permit or require S to set aside the portion of its E&P that is not eliminated under the proposed deconsolidation rule (i.e., $20 in the above example) solely for the benefit of its minority shareholders. Unfortunately, this approach raises a host of difficult policy and technical issues arising from the need to track separately the retained E&P. Presumably one or more separate E&P accounts would need to be credited with the retained E&P and then reduced by the minority portion of future E&P deficits and by distributions made to minority shareholders. Significant complexity would arise from changes in the percentage of S stock held by minority shareholders (e.g., through issuances or redemptions of S stock) and from other subsequent transfers of S stock. In the above example, for instance, public ownership of S increases from 20% to 30%. Since 80% of S's E&P is eliminated, the 30% post-deconsolidation minority is left with only 20% of S's pre-deconsolidation E&P, and the original 20% minority, which invested with the expectation that S would have E&P, arguably is still disadvantaged. Nevertheless, since S is a public company whose shares are fungible, it would not be feasible to maintain a separate E&P account applicable only for distributions to the original 20% minority holders. Similarly, it would need to be determined under what circumstances P's sale of its remaining S shares would cause separate tracking of S's $20 retained E&P to cease, so that the E&P became available pro rata for all S shareholders. For example, a distinction might need to be drawn between P's sale of its remaining S shares to the public (in which case separate tracking would no longer be feasible) and P's sale of its S shares to another, presumably unrelated, corporation (where separate tracking could continue).

The Committee believes that allocating pre deconsolidation E&P to minority shareholders in a manner that deals reasonably with these myriad issues would likely lead to an overly complex provision that would continue to be flawed in one way or another. On balance, we therefore recommend not including such a provision in the final regulations.

Prop. Reg. §1.1502-33(e)(4) provides two exceptions to the E&P elimination rule for certain distributions to banks and insurance companies. The Committee is not troubled by these exceptions as a policy matter. However, we are concerned about certain administrative difficulties that the insurance company exception raises. In particular, that exception apparently would require every deconsolidated S to continue indefinitely to monitor its E&P arising in the P group for purposes of determining the character of distributions to insurance company shareholders, no matter how large or small the insurance company's interest, or when acquired. We suggest that consideration be given to limiting the application of the insurance company exception in a manner that alleviates the attendant shareholder identification and other administrative burdens on S. For example, the final regulations might provide that the insurance company exception will apply (i) only to an insurance company that owns, at the time of S's deconsolidation, a stated threshold amount of S's stock (e.g., 5% or more of S's aggregate common or preferred stock by value, or, alternatively, the lesser of 5% and a. minimum dollar amount of S's common or preferred stock) and (ii) only for so long as that holder continues to maintain the minimum stock ownership threshold.

6. Overriding Adjustments. Regarding Prop. Reg. §1.1502-33(g), which provides for adjustments consistent with the purposes of the proposed regulations if any person acts with “a principal purpose to avoid the effect of the [E&P] rules,” see the discussion of the corresponding investment adjustment provision in IV.A.5 above.

7. Elimination of Deemed Dividend Election. See IV.A.6 above.

8. Predecessors and successors. In connection with the predecessor/successor rule of Prop. Reg. §1.1502-33(h), see IV.A.8 above.

9. Effective Date. See IV.A.10 above.

C. Excess Loss Accounts (Prop. Reg. §1.1502-19).

1. Treatment as Negative Basis. Subject to the discussion in D.2 below, the Committee supports the general treatment in the proposed regulations of an excess loss account (“ELA”) as negative basis. By incorporating nonrecognition and other familiar principles, this approach simplifies the ELA rules, clarifies their operation for some transactions (e.g.,

tax-free spinoffs and reorganizations) and better coordinates them with the basis adjustment rules.

2. Disposition of Stock. Like the current regulations, Prop. Reg. §1.1502-19(b)(1) generally provides that P realizes its ELA in S's stock when P is treated as "disposing" of the S stock.

The Service's position appears to be that, where S owns T stock with an ELA, S's section 311 distribution of the T stock to P is not a "disposition" of the T stock for ELA purposes.[46] The current regulations, however, are somewhat confusing on this issue.[47] In contrast, the definition of "disposition" in Prop. Reg. §1.1502-19(c)(1)(i) (which includes any transfer in which S recognizes gain or loss on the T stock) appears to cover such a distribution. As a result, the proposed regulations convert S's ELA in T's stock into deferred intercompany gain of S (in contrast to converting S's ELA into an ELA of P in T's stock if the distribution of T stock were not treated as disposition for ELA purposes).[48] Given the history of confusion on this basic

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46 See Private Letter Ruling 8917077 (February 2, 1989).

47 Compare Treas. Reg. §1.1502-19(d)(1) (intragroup transfer of S stock is not a "disposition" for ELA purposes if transferee's basis in the S stock is determined by reference to transferor's basis), Treas. Reg. §1.1502-31(b)(1), section 301(d)(2)(B) (before amendment in 1986) and S. Rep. No. 445, 100th Cong., 2d Sess. 62 (1988) (changes in section 301 are not intended to alter consequences of a distribution under the consolidated return regulations); with Treas. Reg. §1.1502-14T(c)(2), Example (2) (treating intragroup section 301 distribution of S stock as a disposition for ELA purposes).

48 We note that one potentially significant adverse consequence of the proposed conversion of an ELA into a DIG is that the taxpayer can not eliminate the potential gain inherent in the DIG through subsequent earnings of T or other transactions (e.g., a section 332 liquidation of T into P, which would eliminate an ELA of P in T's stock, but would trigger a DIG of S with respect to T's stock under Treas. Reg. §1.1502 13(f)(1)(vi)).

issue, a clarifying statement to that effect, or an example addressing this transaction, would be helpful. Under the current and proposed regulations, worthlessness is a disposition that triggers ELA income inclusion. Prop. Reg. §1.1502-19(c)(iii) provides that S stock is worthless on any day that either (i) "substantially all of S's assets are treated as disposed of, abandoned, or destroyed within the meaning of section 165(a)" or (ii) debt of S is discharged and the amount discharged and excluded from gross income under section 108(a) exceeds the amount of resulting tax attribute reduction under sections 108(b) and 1017. In contrast to the current regulations, the proposed regulations reflect a single entity approach by generally deferring the worthlessness of S's stock until the impairment of S's assets is reflected at the S level.

The Committee supports this general approach, which eliminates inequitable results to taxpayers under the current regulations arising, in particular, from the operation of the LDR and section 382(g)(4)(D) (see Preamble ¶G.2).

We have two comments to the proposed section 165 test. First, we suggest that the final regulations clarify the section 165 standard by example or otherwise.[49] The standard is somewhat confusing. For example, the words "are treated as" suggest the possibility of a constructive disposition, abandonment or destruction under section 165(a). Is that intended, or is an actual disposition, abandonment or destruction required? In addition, the proposed regulations could be read to trigger an ELA whenever S incurs a loss in connection with selling substantially all of its assets for cash, even though S continues

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[49] Prop. Reg. §1.1502-19(e) Example 5 illustrates only the more straightforward section 108 trigger.

to have assets (cash) with substantial value. This is because such a sale is literally a “disposition” of “substantially all of S's assets” on which S has sustained a loss under section 165.[50] We believe this result would be inappropriate, because it runs contrary to the policy of the proposed section 165 trigger, which is to postpone, not accelerate, ELA inclusion.

Second, the proposed regulations provide that, for purposes of the section 165 trigger, S's assets are considered to be disposed of “if they are maintained for the principal purpose of avoiding a disposition of S's stock.” This vague standard injects considerable uncertainty into the operation of the worthlessness rule. Moreover, it presupposes that the taxpayer has control over when substantially all of its assets will be considered “disposed of, abandoned, or destroyed” for section 165 purposes. We recommend that the final regulations either eliminate this principal purpose test or clarify the circumstances in which it might apply.

3. Elective Basis Reduction Should Be Retained. Current Treas. Reg. §1.1502-19(a)(6) permits P, in lieu of including in income its ELA in S's stock in connection with a disposition of the S stock, to elect to reduce its basis in other stock or debt of S. The proposed regulations eliminate this election on the theory that little is left of the election after enactment of section 1503(e)(4) (prohibiting elective reduction of debt basis) and the adoption of Treas. Reg. §1.1502-19(a)(6)(ii) (prohibiting elective reduction “to the extent the

[50] Cf. Rev. Rul. 88-84, 1988-1 C.B. 117 (corporation X's transfer of all its assets to corporation Y meets the “substantially all” requirement of section 368(a)(1)(C), even though immediately before the transfer X sold 50% of its historic assets to unrelated parties for cash and transferred that cash to Y instead of the historic assets).

reduction has the effect of netting gain or loss in a manner that would not be permitted” under the LOR) (the “anti-netting rule”).[51]

The Committee believes the basis reduction election is a useful and nonabusive rule that should be preserved. It can alleviate potentially harsh results to P where, for example, strict application of the ELA rules would require P to include an ELA in income despite P's having suffered an overall economic loss on its investment. In addition, the Committee believes the existing anti-netting rule can be read to limit unreasonably the manner in which the current basis reduction election applies to preferred stock, as illustrated below.

> Example (6): On January 1 of Year 1, P forms S with $1,100 cash and has an initial tax basis of $100 in S common stock and $1,000 in S preferred stock. P owns all of S's common and preferred stock. The preferred stock has a $100 annual, cumulative dividend preference. During Year 1, S has a $300 taxable loss, all of which is absorbed by the P group, and which is allocated entirely to the S common stock, creating a $200 ELA. On December 31 of Year 1, P sells its S common stock for $5. At that time, the S preferred stock retained by P has a fair market value of $800 I i.e., S's net asset value).
>
> Under the proposed regulations, upon sale of the S common stock, P must include in income its $200 ELA in the S common stock. Hence P would have taxable income of $205 on the sale, despite a decline in the value of P's overall investment from $1,100 to $800. P would have a $200 built-

[51] See Preamble §G.3.

in loss in its S preferred stock.[52]

In the above example, the Committee believes P should be permitted to elect to reduce its basis in the S preferred stock by $200, to $800, in lieu of including in income its $200 ELA in the S common stock. Under such an election, P would have taxable income of only $5 on the sale of the S common stock, and P's preferred stock in S would have a basis equal to its $800 value.

There is nothing offensive about this result under the LDR, because the preferred stock itself (as noted above) would not be subject to loss disallowance or basis reduction under the current or proposed LDR.[53] Moreover, a basis reduction election is more consonant with the decline in the value of P's total equity investment. In particular, the result is no better for P than if P originally had invested $1,100 solely in common stock of S, S had incurred a $300 taxable loss (reducing P's S stock basis to $800), P had recapitalized the common for $800 face amount of new preferred stock and for new common stock, and P then had sold the new S common stock for $5.

Finally, we believe such an election is not inconsistent with the policy behind section 1503(e)(4), which prohibits elective reduction of debt basis. That provision was enacted largely to prevent taxpayers, in connection with a sale of S stock, from avoiding the interest charge rule of section 453A by applying the basis reduction election to debt to achieve a

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52 This assumes that Treas. Reg. §1.1502-20(b) would not apply because there is no potential loss duplication or other item under Treas. Reg. §1.1502-20(c)(1).

53 See Treas. Reg. §1.1502-20(a)(1), -20(b)(1); Prop. Reg. §1.1502-20(a)(1), -20(b)(1).

synthetic installment sale.[54]

> Example (7): In 1986, P forms S, contributing $100 in exchange for all of S's common stock. S has no net taxable, income, although the S stock appreciates in value to $1,000. In 1988 (i.e., after the effective date of section 453A but before the effective date of section 1503(e)(4)), P, in contemplation of selling S, has S distribute a $900 note, creating an $800 ELA in the S common stock. P thereafter sells the S common to X for $100 cash and, in lieu of taking into income the $800 ELA, elects to reduce by $800 P's basis in the S debt, to $100. Because the S note did not arise from the disposition of property, it is not an installment obligation, so that the interest charge rule of section 453A does not apply. In effect, P has sold the S stock for $100 cash and a $900 note without the application of section 453A. In contrast, if, instead of having S distribute the note, P had sold a portion of the S stock to X for $100 cash and caused S to redeem the balance for an S note in the amount of $900 (in a transaction governed by <u>Zenz v. Ouinlivan</u>), section 453A would have applied.

Section 1503(e)(4) appropriately eliminates the above abuse. However, this abuse will not occur with preferred stock. Assume, for instance, that instead of distributing a $900 note in the above example, S, in a recapitalization transaction, distributes $900 face amount of preferred stock with terms analogous to the note. In contrast to the note case, the distribution of the preferred stock will, not create an ELA in the common stock. Rather, P's $100 basis in the S common

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[54] <u>See</u>, <u>e.g.</u>, H.R. Rep. No. 247, 101st Cong., 1st Sess. 1234 (1989).

stock will be allocated between the preferred and the common based on their relative fair values. Accordingly, when S sells the common stock for $100, P will recognize gain on the difference between the $100 sale price and P's approximately $10 basis in the common stock, but there will be no ELA to recapture. The effect of the transaction is similar to a synthetic installment sale using an S note. However, the preferred stock result is expressly permitted by the tax-free recapitalization provisions of the Code. Moreover, the parties do pay a toll charge to the Service for using preferred stock in this manner, because dividends on the preferred are nondeductible by S and partly taxable to P (to the extent the dividends received deduction does not apply). Indeed, the incremental tax to the parties could well exceed the section 453A interest charge on the debt transaction. In short, there is no need to prevent elective reduction of preferred stock basis in cases such as this, because there will be no ELA and, even if there were, the parties pay a comparable cost by using stock rather than debt.

It is unclear whether merely preserving Treas. Reg. §1.1502-19(a)(6) in its current form would reach the recommended result. On one hand, the anti-netting rule can be read to apply only where the preferred stock itself is subject to loss disallowance because of a positive basis adjustment or other item described in Treas. Reg. §1.1502-20(c)(1). That reading would permit basis reduction of the preferred stock in the above example, because there has been no positive adjustment, etc. to the preferred. Alternatively, the anti-netting rule can be read to apply whenever the stock whose basis is to be reduced does not have “the same material terms” as the stock subject to the ELA. Under that broader reading, it would never be possible to net a common stock ELA against preferred stock basis.

In order to permit netting in the above example, we recommend that the final regulations (i) restore the basis reduction election of Treas. Reg. §1.1502-19(a)(6) (eliminating the reference to a reduction of debt basis) and (ii) modify the anti-netting rule in a manner that would permit elective basis reduction in cases such as the preceding example. This could be accomplished by adding to Treas. Reg. §1.1502-19(a)(6)(ii) the following sentence: “This limitation shall apply only to the extent the stock whose basis would be reduced by such election would be subject to loss disallowance under section 1.1502-20(a)(1) or basis reduction under section 1.1502-20(b)(1) if disposed of or deconsolidated on the date of such basis reduction.”

This recommended change to Treas. Reg. §1.1502-19(a)(6) is not intended to permit netting to the extent the preferred stock itself is subject to the LDR.

D. Deferral of Section 165(g); Non-Applicability of Section 357(c) (prop. Reg. §1.1502-80).

1. Deferral of Section 165(g). Prop. Reg. §1.1502-80(c) provides that, for consolidated return years ending after the date final regulations are published, P may not treat S stock as worthless under section 165(g) until the stock is considered disposed of under Prop. Reg. §1.1502-19(c)(1)(iii). This rule sensibly tracks the general postponement of the worthlessness trigger for ELA income inclusion under Prop. Reg. §1.1502-19(c)(1)(iii) and, like the ELA rule, reduces the potential for complete elimination of the loss at the corporate level under the LDR, for example (see Preamble at L.1). It is unfortunate that this rule could significantly defer the deductibility of those

losses that remain deductible after application of the LDR.[55] Nonetheless, because no straightforward alternative approach is readily apparent, the Committee supports the rule.

2. Nonapplicability of Section 357(c).

a. In general. Prop. Reg. §1-1502-80(e) provides that section 357(c) (concerning taxation of liabilities in excess of basis in section 351 and 368(a)(1)(D) transactions) does not apply to any transfer between members occurring on or after the date final regulations are published. Instead, any liabilities assumed by the transferee in excess of the basis of the transferred assets, rather than resulting in deferred intercompany gain to the transferor (which would increase the basis of the property in the hands of the transferee), would merely reduce the transferor's stock basis under section 358(d). This exception does not apply "if the transferee becomes a nonmember as part of the same plan or arrangement," unless the transferor and transferee continue to be members of the same consolidated group.

This significant change has the effect of converting, in the case of a downstream contribution of property by P to S, for example, what would be deferred intercompany gain ("DIG") to P under the current regulations (i.e., the excess of liabilities over basis under section 357(c)) to a negative basis

[55] See, e.g., Rev. Rul. 70-489, 1970-2 C.B. 53 (where S's stock becomes worthless under section 165(g), P may claim a worthless stock deduction despite P's continued operation of S's business as a branch following a liquidation of S). Although this ruling is silent as to whether P and S file consolidated returns, it should apply in either case, in part because of the rejection in 1966 of Treas. Reg. §1.1502-37A(a)(2) (prohibiting loss recognition in a non-section 332 transaction where the business of the liquidated member was continued by another group member).

adjustment in the same amount. The negative basis adjustment both reduces P's basis in S's stock and deprives S of a step-up in the basis of the contributed property.

The Committee supports the general repeal of section 357(c) in this context, subject to the “plan” exception. Repeal is consistent with the treatment of an ELA as negative basis. In addition, the Committee appreciates that Prop. Reg. §1.1502-80(c) is intended in part to eliminate complexities associated with allocating liabilities under section 357(c) where multiple assets are contributed.

We note that, by depriving the transferee of the increase in inside basis associated with the recognition of section 357(c) gain, the proposed regulations potentially tax the parties twice on such amount: once upon disposition of the transferee's stock, and again upon the transferee's subsequent sale of the contributed asset.

> Example (8): On 1/1/93, P owns all of S's stock with a zero basis and makes a capital contribution to S of property with a \$100 basis (and \$175 value) that is subject to a \$150 liability. On 1/1/94, in a transaction unrelated to the 1/1/93 contribution, P sells S's stock for \$25 (without a section 338(h)(10) election). On 1/1/95, S sells the contributed property, subject to the \$150 liability, for \$25.
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> Under current law, section 357(c) would apply to the 1/1/93 contribution, so that P would have a DIG of \$50 (i.e., the section 357(c) gain, equal to the excess of the \$150 liability assumed by S over P's \$100 basis in the contributed property). P would have a \$0 basis in the S

stock under section 358, and S would have a $150 basis in the contributed property under section 362. In 1994, P would recognize the $50 DIG and $25 of additional gain (i.e., the amount of cash received in excess of a $0 basis) on the sale of the S stock. In 1995, S would recognize $25 gain on the sale of the property ($25 cash received plus $150 liability assumed less $150 basis).

Under the proposed regulations, since S's deconsolidation is not "part of the same plan or arrangement" as the 1/1/93 contribution, section 357(c) would not apply to the 1/1/93 contribution. Hence, at 12/31/93, P would have a $50 ELA in the S stock, and S would have only a $100 basis in the contributed property.[56] In 1994, P would recognize the $50 ELA and $25 additional gain on the sale of the S stock (i.e., the same total gain recognized by P under current law). In 1995, however, S would recognize §75 gain on the sale of the property, or a total of $50 more than under current law.[57]

While the above result may seem harsh at first blush, it is analogous to the double tax problem that can occur whenever P contributes appreciated property to S and later sells the S stock before S disposes of the contributed property. In either case, P could eliminate the double tax potential by selling (rather than

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56 See Prop. Reg. §1.1502-19(d)(3).

57 This double tax problem arises only where S sells the contributed property after P has disposed of the S stock, If S sells the contributed property before P disposes of the S stock, S's gain on the asset sale will be reflected in P's basis in the S stock, eliminating the double tax problem. More generally, a potential benefit of the proposed repeal of section 357(c) is that, in contrast to a DIG, P's resulting ELA in S's stock can (under the normal rules) be eliminated by the future earnings of S or by other means.

contributing) the property to S, thus increasing S's basis in the transferred property by the amount of P's DIG on the sale (although this remedy changes the economics of the transaction and may be unavailable or overlooked in some cases).

We recommend two changes in connection with the proposed repeal of section 357(c):

First, the proposed regulations provide no guidance regarding the subjective "same plan or arrangement" test. The Preamble (at L.3) indicates that this rule is intended to protect taxpayers from the duplicated gain problem described above. We recommend that the final regulations either clarify what constitutes a plan or arrangement or replace or supplement this subjective test with a more objective one (such as a one-year or two-year rule or presumption).

Second, we recommend adding to the final regulations a provision that, for purposes of applying section 357(c), an ELA will not be treated as negative basis. This assumes that section 357(c) will continue to apply in some cases after the proposed ELA rules take effect (e.g., under the "plan or arrangement" exception discussed immediately above, or because of the effective date mismatch described in (b) below). Without a special rule of this type, whenever stock subject to an ELA is transferred between group members in a section 351 transaction or a section 368(a)(1)(D) reorganization, section 357(c) could apply to convert the ELA into a DIG. This is because the proposed regulations treat an ELA as negative basis. Therefore, even if no liabilities are assumed in connection with such a transfer, section 357(c) could be read literally to create a DIG equal to the excess of liabilities assumed (zero) over the transferor's negative "basis" in the transferred stock, i.e., a DIG equal to the amount of the ELA.[58] It would be ironic if the proposed regulations, which are designed generally to eliminate DIGs in section 357(c) circumstances, created such gains even where they do not exist under current law.

b. Effective date. Due to a mismatching of the effective dates provisions applicable to the section 357(c) repeal rule and the ELA rules, the proposed regulations can have the surprising and unfortunate effect of transforming an existing ELA into a DIG if stock subject to the ELA is transferred between group members in a section 351 transaction or a section 368(a)(1)(D) reorganization before the proposed regulations are finalized.

Under the proposed regulations, section 357(c) would continue to apply to any transaction between members of a consolidated group occurring before the date the proposed regulations are finalized.[59] Similarly, the proposed ELA rules (treating an ELA as negative basis) would only apply for determining basis in connection with a stock sale or other transaction on or after the date the regulations are finalized.[60] For purposes of the proposed ELA rules, however, a deferred intercompany transaction (however long ago it occurred) "is deemed to occur at the time the income, gain or loss is taken into account."[61] Thus, the proposed regulations control, for

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[58] In contrast, the result under current law, and the result one would expect under the proposed regulations, is that the transferor's (e.g., P's) ELA in the transferred stock, rather than being converted into a DIG, reduces P's basis in the stock of the transferee that P takes back in the exchange. See Treas. Reg. §1.1502-19(d)(2); Prop. Reg. §1.1502-19(d)(2).

[59] Prop. Reg. §1.1502-80(e).

[60] Prop. Reg. §1.1502-19(g)(1).

[61] Prop. Reg. §1.1502-19(g)(3).

example, the calculation of any DIG that is (i) recognized in a section 351 transaction before the date the proposed regulations are finalized and (ii) deferred under Treas. Reg. §1.1502-13(c)(1) until after such date. The net effect of these effective date provisions is that any transfer occurring before the date the proposed regulations become final, but as to which gain is deferred until after such date, is governed by section 357(c), but the amount of the section 357(c) gain is determined under the proposed regulations. Because the proposed regulations treat an ELA as negative basis (including for section 357(c) purposes), these rules interact to convert an ELA into deferred section 357(c) gain in the cases described above.

We assume this inappropriate result is unintended. Moreover, to the extent an ELA was reduced by earnings or capital contributions after the date of the section 357(c) transaction, but before the ELA is triggered, converting the original ELA into a DIG under the above analysis would unfairly deprive the taxpayer of the ELA reduction.

We recommend that the final regulations correct the above problem by either (i) providing an effective date rule for eliminating section 357(c) that treats transactions giving rise to a DIG as occurring when the gain is taken into account, as is provided in the ELA rule described above and in the investment adjustment rules,[62] or (ii) as recommend in D.2.a above, adding a special rule that, for purposes of applying section 357(c), an ELA will not be treated as negative basis.

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[62] Prop. Reg. §l-1502-19(g)(3), §1-1502-32(h)(3).

E. Impact on the Loss Disallowance Regulations (Prop. Reg. §1.1502-20).

This section of the report discusses the impact of the proposed regulations on the LDR. We have two sets of comments: the first addresses the consequences of the specific amendments to the LDR, and the second addresses the collateral consequences that the proposed investment adjustment rules might have on the LDR.

1. The Scope of LDR Should Not Be Enlarged to Include Pre-1966 Earnings. While the proposed amendments to Treas. Reg. §1.1502-20 generally appear necessary to conform the LDR to the changes in the consolidated return regulations and do not appear to be inconsistent with its objectives, we are concerned that Prop. Reg. §1.1502-20(c)(1)(ii) may have the unintended effect of increasing the amount of the disallowable loss attributable to positive annual basis adjustments.

This history of the LDR demonstrates that it was intended in principal part to resolve the "son-of-mirrors" problem, and was adopted as a rule of administrative convenience in lieu of somewhat more targeted alternatives which would have required, to a greater or lesser degree, the tracing of built-in gain assets.[63]

[63] See Notice 87-14, 1987-1 C.B. 445, which embodied a specific tracing approach. The specific tracing concept was first rejected in temporary regulations promulgated March 9, 1990. 55 FR 9426 (March 14, 1990). The LDR in its current form was finalized in September 1991 effective for dispositions after January 31, 1991. 56 FR 47379 (September 19, 1991). The NYSBA submitted its concerns with this approach in separate reports dated January 17, 1990 and January 29, 1991. Those concerns will not be repeated here.

In general, the LDR disallows loss on the sale of stock of a consolidated subsidiary to the extent it does not exceed the sum of three factors: (1) the amount of income generated by certain extraordinary gain dispositions, (2) certain positive investment adjustments and (3) the amount of any "duplicated loss."[64] For years ending before September 13, 1991, the amount of positive adjustments taken into account for this purpose is generally limited to the net increase in the basis of the stock since the date of its acquisition.[65]

While the existing investment adjustment provisions adjust stock basis only with respect to tax years beginning after 1965, the proposed changes generally provide for adjustments for all consolidated return years going back, theoretically, to 1919. As a result, as discussed below, the proposed regulations could increase the amount of the disallowable loss in many cases.

The overall effect of this increase in disallowable loss on a particular disposition of stock will depend in part on whether a deemed dividend election has been made with respect to such stock. If no deemed dividend election has been made, the increase in disallowable loss resulting from the proposed amendments should generally be accompanied by a basis increase of comparable magnitude. This is because the regulations, as amended, would permit a group to take into account all adjustments since the inception of consolidation, and not just post-1965 adjustments, in computing S's outside basis. As a result, in the typical case, the amount of allowable loss under the proposed amendments should not differ substantially from the amount of loss allowable under existing law.

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64 Treas. Reg. §1-1502-20(c)(1).

65 Treas. Reg. §l-1502-20(c)(2)(v)(A).

If a deemed dividend election has been made, however, it appears that the amount of allowable loss will be reduced. In such cases it appears that the proposed amendment will generally increase the amount of disallowable loss without correspondingly increasing outside basis. The crux of the problem is the proposed amendment to Treas. Reg. §1.1502-20(c)(1)(ii).

Under existing law, the basis adjustment that results from a deemed dividend election is not taken into account in computing the disallowed loss. This is because the "bad" positive basis adjustments are limited to those described in Treas. Reg. §1.1502-32(b)(2)(i) or (c)(1), while the adjustment in the case of a deemed dividend arises by virtue of a deemed contribution of pre-1966 affiliated group earnings, which is described in Treas. Reg. §1.1502-32(f). Since the additional basis in the case of a deemed dividend results from a deemed contribution of pre-1966 affiliated year earnings, such basis increase is not currently subject to Treas. Reg. §1.1502-20(c)(1)(ii).

As amended, however, the scope of the provision would be expanded to cover all positive adjustments for all consolidated return years, including pre-1966 years. See Prop. Reg. §1.1502-32(b)(3)(i)-(iii). It would thus take into account all affiliated pre-1966 taxable income, including income corresponding to the E&P that were deemed distributed and recontributed pursuant to the deemed dividend election.

Therefore, even though the effective date rules in Prop. Reg. §1.1502-32(b)(4) provide that deemed dividend elections prior to finalization of the new rules will be recognized, the fact remains that P's basis in S has already been increased by such taxable income, which technically remains as an adjustment that Prop. Reg. §1.1502-20(c)(1)(ii) sweeps into the gunsights of the LDR. Whether or not this result was intended, we think it is wrong to enlarge the scope of the LDR.

The proposed regulations raise the question whether the LDR should apply to positive basis adjustments arising prior to 1966 in the same manner in which they apply to post-1966 adjustments. The balance struck in 1990, which applied the LDR only to post-1966 adjustments, was not inappropriate, particularly since there was no positive basis adjustment regime in place for years prior to 1966, and no subsidiaries could have been acquired in such years with a view to effecting an abusive "son of mirrors" transaction as described in Notice 87-14.

In view of these factors, and recognizing that the disallowance of losses linked to post-1965 positive basis adjustments generally relates to day-to-day operating profits that bear no relation to the recognition of built-in gains, the Committee believes that a more appropriate balance would be struck by the LDR if the proposed amendments were revised so that adjustments for pre-1966 taxable years are not taken into account in determining the amount of disallowable loss. The most straightforward way to do this would be to insert the phrase "with respect to taxable years beginning after 1965" after the word "adjustments" in Treas. Reg. §1.1502-20(c)(ii).

2. Positive Adjustments Appear to Be a Target Even if Mo Loss Is to Be Disallowed. The second concern is based on certain overly broad language that may eliminate positive basis adjustments which seemed safe, even under the LDR. Prop. Reg. §1.1502-32(a)(2) states that "an adjustment must not have the effect of duplicating an item in S's stock basis." In addition, Prop. Reg. §1.1502-32(e)(1) provides that "[i]f any person acts

with a principal purpose to avoid the effect of the rules of this section, or uses the rules of this section to avoid the effect of any other provisions of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.” Example 3 of Prop. Reg. §1.1502-32(e) (4) goes on to provide a case in which appreciated property is transferred, and the gain is traced and*eliminated for purposes of the basis increase provisions of Prop. Reg. §1-1502-32.

A Revenue Agent might use these principles to apply rules that are inconsistent with the policies underlying the LDR. The ultimate risk caused by this language is reflected by the following example:

> Example (9): S holds two assets, Asset A and Asset B, each with a basis of $40 and a fair market value of $100. P purchases S for $200 and then promptly sells Asset A for $100, recognizing $60 of gain and triggering an upward basis adjustment of $60, bringing the stock basis of S to $260. Five years later, after Asset B has appreciated in value to $200, P sells S for $300, recognizing a gain of $40. If the Service were to determine that the $60 of built-in gain in Asset A was already reflected in P's $200 cost basis, then the $60 upward basis adjustment triggered by the sale of that asset could be reversed.

This tracing approach, suggested in Notice 87-14, was explicitly rejected upon the adoption of the LDR. It arguably attacks the “gain side” of the LDR, which the Treasury viewed as a key trade-off for the limitation on losses.

We make the following suggestions to guard against the misapplication of the general principle and the overriding adjustment rule. First, the language "an adjustment must not have effect of duplicating an item in S's stock basis" contained in Prop. Reg. §1.1502-32(a)(2) should be modified to clarify that no item is required to be taken into account as an adjustment more than once with respect to determining the basis of any subsidiary. Second, the overriding adjustment rule of Prop. Reg. §1.1502-32(e)(1) should be clarified so that the rule will not be applied in a manner that would generally require specific tracing of assets. Finally, the Preamble to the final regulations should provide that the purposes of the revised investment adjustment rules are consistent with those of the LDR, and they are not intended to disallow positive adjustments with respect to recognized built-in gains.

F. Stock Basis after Group Structure Change (Prop. Reg. §1.1502-31, §1.1502-33(f)).

1. Current Regulations. In 1988, the Treasury issued temporary regulations (the "Temporary Regulations") providing for uniform basis results and E&P adjustments where a corporate restructuring (e.g., a section 351 exchange or a section 368 reorganization) converts a common parent corporation into a subsidiary member of a continuing consolidated group (a "Group Structure Change").[66] A Group Structure Change generally is a transaction in which (i) gain or loss is not recognized in whole or in part and (ii) the transaction is either (x) a transfer by the common parent of its assets to another member of the consolidated group in accordance with Treas. Reg. §1.1502-75(d)(2)[67] or (y) a reverse acquisition defined in Treas. Reg.

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66 Treas. Reg. §1.1502-31T and 33T.

67 In Rev. Rul. 82-152, 1982-2 C.B. 205, the Service extended the principles of Treas. Reg. §1.1502-75(d)(2)(ii) to a reverse subsidiary merger in which the former common parent survived as a subsidiary of the group.

§1.1502-75(d)(3), provided the shareholders of the former common parent own at least 80% of the value of the outstanding stock of the new common parent immediately after the transaction.[68]

If a Group Structure Change occurs, members of the continuing consolidated group that own stock of the former common parent (or a successor corporation to the former parent corporation) are deemed to have a tax basis in such stock generally equal to the net inside basis of the property of the former common parent immediately after the transaction. Reg. §1.1502-31T(a)(2) and (3).

The purpose of these basis rules is to prevent taxpayers from selecting alternate stock bases, based on differences between outside and inside basis, depending on the form of the transaction.[69] To eliminate the disparate basis results depending on the form of the transaction, the Treasury adopted a uniform basis rule for these transactions that approximates the basis result required where the former common parent adopted a holding company structure by dropping its assets into a subsidiary in a Section 351 transaction.

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[68] Treas. Reg. §1.1502-31T(a)(1). The reverse acquisition prong of the definition of a Group Structure Change requires a continuing ownership interest of 80% whereas a reverse acquisition only requires more than a 50% continuing ownership interest. One justification for retaining the 80% test is to limit the application of the operative basis and earnings and profits rules to transactions that are basically equivalent to the restructuring of a single group of corporations, rather than the acquisition of one consolidated group by another group.

[69] Preamble to T.D. 8226, 1988-2 C.B. 325, 326.

Treas. Reg. §1.1502-33T(a)(1) provides that the E&P of a new common parent corporation resulting from a Group Structure Change are adjusted to reflect the E&P of the former common parent. This rule is needed because distributions by the new common parent otherwise would be treated as return of capital distributions, rather than dividends, even though the group has E&P.[70] Similarly, Treas. Reg. §1.1502-33T(a)(2) requires proper adjustments to the E&P of members of a consolidated group, if any member's position within the group changes and the group remains in existence. This rule is needed because, for example, if a member moves within a group (e.g., the stock of a first-tier member is contributed to another first-tier member), the E&P of that member may not be reflected properly in the E&P of higher tier members.

The Temporary Regulations were criticized on several grounds.[71] One criticism of the net inside basis rule was that Treasury lacked the authority to override the Code. The basis issue in holding company formations is the same regardless of whether the constituent corporations file consolidated returns and should be governed by general statutory rules, such as) section 362.

[70] Id. at 327.

[71] Letter of August 25, 1989 from Willard B. Taylor, 89 TNT 179-20; Letter of July 12, 1989 from Lawrence M. Axelrod, 89 TNT 146-40; and Sheppard, The Basis of the New Parent of a Preexisting Consolidated Group, 44 Tax Notes 1317 (September 18, 1989). Commentators also argued that the Temporary Regulations were invalid because they were not issued in compliance with the Administrative Procedure Act.

2. Proposed Regulations. Prop. Reg. §1.1502-33(f) makes two significant changes to the definition of a Group Structure Change. One change is the elimination of 80% continuing ownership requirement for reverse acquisitions constituting Group Structure Changes. The other change, which also is consistent with aligning the definition of a Group Structure Change with a reverse acquisition, is that a Group Structure Change is no longer limited to a non-recognition transaction. These changes expand the number of transactions that constitute Group Structure Changes and, therefore, exacerbate the concern that the operative basis rule will override specific statutory rules.

3. Proposed Regulations Overreach. Our comments on the proposed regulations primarily focus on the propriety of expanding the types of transactions that constitute Group Structure Changes, the consequence of which is that the net inside basis rule of Prop. Reg. §1.1502-31 would override the basis consequences required by both sections 362 and 1012. In particular, we recommend that the cost basis rule of section 1012 not be overridden where a <u>taxable</u> stock acquisition qualifies as a reverse acquisition. We also have several technical comments regarding the proposed regulations.

By adopting the definition of a reverse acquisition for a Group Structure Change, the proposed regulations significantly expand the types of transactions to which the basis and E&P rules for Group Structure Changes apply. The adoption of the reverse acquisition definition indicates that the Treasury considered the policy of the reverse acquisition rules equally applicable in determining the basis and E&P consequences for Group Structure Changes. The fundamental purpose of the reverse acquisition rule is to identify the consolidated group's tax attributes that should be limited by the SRLY rules[72]; that is, the reverse acquisition rule is designed to identify the continuing consolidated group in the context of an acquisition so that the acquired corporation's attributes are subject to limitation. As a conceptual matter, we have no objection to expanding this anti-abuse rule to insure that the E&P of the continuing group is used to measure whether a distribution is a dividend or a return of capital, since we view E&P essentially to be a group attribute. However, tax basis in the stock of the common parent is a shareholder attribute and not an attribute of the consolidated group, and we object to the possibility that the cost basis rule of section 1012 will be overridden in the case of certain taxable stock acquisitions qualifying as reverse acquisitions. In the case of a taxable acquisition for fair market value, depriving the acquiring corporation of a fair market value basis in the stock acquired violates the principle that a single tax should be paid on the same economic gain with respect to an asset.

> Example (10): Assume that a corporation whose stock is traded ("T") is acquired by P in a taxable stock acquisition qualifying as a reverse acquisition and that T's assets are appreciated in value. In that case, the net inside asset basis of T's assets is lower than the fair market value of T's outstanding stock. Nevertheless, as a result of the acquisition qualifying as a reverse acquisition, P's basis in T's stock would equal the net inside basis of T's assets rather than the higher cost basis, even though T's shareholders paid tax on the appreciation in those assets as reflected in their stock. Further, if P were to sell the T stock, P would be subject to tax on gain of which the former T shareholders already have paid tax.

[72] Rev. Rul. 72-322, 1972-1 C.B. 287.

This result is surprising for a number of reasons. First this result is one that would be achieved under a conforming basis regime, which the Treasury acknowledged it would not adopt in modifying the investment adjustment rules. Further, it is always extremely difficult to justify a rule that eliminates basis.[73] Finally, the basis selectivity concern that led to the adoption of the net inside basis rule does not exist in taxable stock acquisitions where the shareholders of the acquired corporation are taxed and any tax with respect to a built-in gain in the assets is preserved. Thus, it is difficult to identify any policy or administrative reason for overriding the cost basis rule of section 1012 in taxable stock acquisitions qualifying as reverse acquisitions.

4. Technical Comments. In addition, we have two technical comments regarding the proposed regulations:

a. A technical defect in the net inside basis rule of Prop. Reg. §1.1502-31 is that these provisions do not treat net operating loss carryforwards attributable to the former common parent as an asset. The proposed investment adjustment regime requires a downward adjustment for the absorption (or expiration) of the net operating loss carryforwards even though the net operating loss carryforward was not taken into account in determining initial stock basis of the former common parent after the Group Structure Change. To prevent this result, absorbed net operating loss carryforwards attributable to the former common parent should do nothing more than wash.

[73] See Doyle v. Mitchell Brothers, 247 U.S. 179 (1920) and Koshland v. Helvering, 298 U.S. 442 (1936) which, on constitutional grounds, both hold that “gain derived” from property is not properly determined unless the taxpayer's cost basis is fully recovered.

b. The proposed regulations, unlike the existing regulations, do not provide an explicit rule for E&P adjustments when a member changes locations within the group. We are concerned that the silence of the proposed regulations could be read as repealing the current rule of Treas. Reg. §1.1502-33T(a)(2). We recommend that the explicit rule not only be retained, but also be clarified. For example, we recommend that the final regulations expressly provide that, where P contributes all of the stock of S to a new middle-tier holding company ("M"), M's E&P includes the E&P of S and its subsidiaries.

G. Allocation of Items Between Consolidated and separate Returns; 30-Day Rules (Prop. Reg. §1.1502-76(b)).

1. Adoption of an "End of the Day" Rule. Prop. Reg. §1-1502-76(b)(1) states that, "[u]nless otherwise provided under applicable law, a corporation becomes or ceases to be a member as of the close of the date on which the event occurs" that causes the corporation to become or cease to be a member. Thus, the proposed regulations reject the so-called "lunch rule" that may be inferred from several private letter rulings,[74] whereby when a corporation becomes or ceases to be a member of a group depends on the time of day at which the transaction takes place. As indicated in the Preamble, this "end of the day" rule is consistent with other provisions of the Code (including sections 338, 381 and 382).

The Committee favors the certainty and consistency of the "end of the day" rule, subject to the following comments:

[74] See Private Letter Ruling 7904002 (December 16, 1977) (2 p.m. closing; acquisition treated as taking place at close of day of acquisition); Private Letter Ruling 7914004 (December 13, 1978) (10 a.m. closing; acquisition treated as taking place at close of day prior to acquisition).

a. Scope of “otherwise provided under applicable law” unclear. The final regulations should clarify what is meant by “unless otherwise provided under applicable law” or delete that clause altogether. The Committee is not aware of any other applicable tax law provision. If the IRS has certain provisions in mind, they should be set forth in the regulations.

The Committee further believes that corporate law provisions (such as merger statutes that provide that a merger becomes effective upon the filing of a certificate with the secretary of state) should not control the time of day that a corporation joins or leaves a consolidated group, because (i) it is undesirable to divide a single day for these purposes and (ii) such a rule would draw an artificial distinction between situations in which a corporation joins or leaves the group through a merger transaction and situations in which a corporation joins or leaves the group through a practical merger (a “C” reorganization) or a stock purchase transaction.

b. Contradiction as to tine of deconsolidation. It is not easy to square these two phrases in Prop. Reg. §1.1502-76(b): (i) “the corporation's taxable year is treated for all federal income tax purposes as ending <u>as of the event</u> causing the corporation to become or cease to be a member; and (ii) “a corporation becomes or ceases to be a member <u>as of the close of the date</u> on which the event occurs.” (Emphasis supplied.) The first seems to suggest the possibility of a closing sometime during the day, whereas the second clearly identifies the end of the day as the appropriate closing point. We assume the latter is what was intended, and it should be clarified.

c. Extraordinary transactions on date of sale. The Committee recommends that consideration be given to a special rule for extraordinary items that arise after the occurrence of the event by which a corporation becomes or ceases to be a member ("change of status"), but on the change of status date, in order to protect the reasonable expectations of the purchasing and selling shareholders. For example, in the absence of such a special rule, if S is sold by group A to group B, and group B sells a division of S on the same day it acquires S, the gain from the sale of the division would be allocable for federal income tax purposes to group A. Sellers should not have to rely on the foresight of their lawyers or the adequacy of the indemnity provisions that they negotiate but instead should be entitled to rely on a rule that produces appropriate results under reasonably foreseeable and common circumstances.[75]

Accordingly, the Committee recommends that consideration be given to a rule that, unless the purchaser and seller agree otherwise,[76] an "extraordinary item" (as defined in Prop. Reg.

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[75] A similar problem in the context of section 338 elections prompted Congress to enact section 338(h)(9). See H.R. Rep. 986, 97th Cong. 2d Sess. 22-23 (1982). It should be noted, however, that while section 338(h)(9) protects the selling group from having to report income from the section 338 election, the temporary and proposed regulations provide that the selling group must report any transactions occurring on the acquisition date other than the deemed sale under section 338. See Treas. Reg. §1.338-1T(f)(3)(i); Prop. Reg. §1.338-l(e)(2)(i). If the recommendation made in this report is adopted, consideration should be given to making similar changes should be made to the regulations under section 338.

[76] The Committee believes that it is appropriate to permit the parties to a transaction to agree to allocate such extraordinary items to the seller in order to provide flexibility in the structuring of a series of related transactions and to avoid disputes as to whether an extraordinary item (e.g., cancellation of indebtedness income) that arose as part of the acquisition transaction occurred immediately before or after the change of status. Such flexibility does not appear to be abusive since a purchaser and seller usually could have agreed in any event to cause the corporation to do the transaction giving rise to the extraordinary item immediately before the change of status.

§1.1502-76(b)(2)(C)(1), (2), (3), (4) and (7) plus the other items described in 3.b.i below—all of which generally deal with volitional dispositions, exchanges or other acts by the buyer) that arises after the change in status (but on the change date) should be treated solely for purposes of Prop. Reg. §1.1502-76(b) as arising at the beginning of the day following the change of status (i.e. the gain or loss will be reported by the buyer).

We recognize that a special rule of this type for extraordinary items would require determining the precise time of the status change, which is a difficulty that the end-of-the-day rule is intended to eliminate. Nevertheless, we believe that the importance of allocating significant tax items in a manner consistent with the parties' reasonable expectations outweighs the administrative inconvenience of applying this narrow exception. Moreover, the administrative burden on the Service could be alleviated by treating any extraordinary item that occurs on the date of the status change as reportable by the seller (consistent with the general end-of-the-day rule) unless the taxpayer proves that the item occurred after the status change.

As an alternative way of dealing with this issue, the Committee recommends that consideration be given to permitting taxpayers to agree contractually that S will be deemed to change its status as of the end of the day preceding the normal cessation date, thus placing all closing day transactions in the income of the acquiring group. We note that this is the rule under subchapter S (section 1362(d)(2)(B)).[77]

[77] We also note that for those wanting a month end closing, plus the benefit of this rule, the actual closing date should be held on the first day following the close of the month.

2. General Allocation Rule: Short Taxable Year Closing of the Books Method — Need for Additional Guidance. The proposed regulations adopt the general rules of the Code applicable to short periods as the basis for allocating items of income between the separate and consolidated returns of a corporation that joins or leaves a consolidated group during its taxable year. The proposed regulations delete the rule contained in existing Treas. Reg. §l.1502-76(b)(4) that S's income is to be allocated between S's separate and consolidated returns on the basis of S's permanent records (including work papers) or, with respect to items whose allocation cannot be clearly determined from the permanent records, on a ratable allocation basis. The proposed regulations also contain special rules for allocating taxes (discussed in 4 below) and for items of pass through entities.

The Preamble suggests that the adoption of the general short period rules of the Code is a change from existing law that will ameliorate the lack of adequate guidance under the permanent records rule, and provide greater certainty and consistency of allocations. The Committee does not understand what substantive change will be achieved by adoption of the general short period rules (apart from repealing the regulatory language that led a court to conclude that taxpayers may rely on incorrect books and records),[78] since Treas. Reg. §1.1502-76(d) now provides that any short period for which a separate return is filed is treated as a separate taxable year. Furthermore, although the proposed regulations provide welcome guidance on a number of specific allocation issues, some of which have been addressed previously

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[78] See Petroleum Heat & Power Co. v. United States, 405 F. 2d 1300 (Ct. Cl. 1969) (court refused to consider argument that taxpayer allocation of income violated Schlude v. Commissioner, 372 U.S. 128 (1963), because taxpayer used books and records to allocate income for short period in compliance with predecessor of Treas. Reg. §1.1502-76(b)(4)(i)).

in rulings,[79] neither the proposed regulations nor any other provision of the Code or regulations articulates a general method for determining the income attributable to a short taxable year.[80]

In view of the foregoing, the Committee believes that it is preferable to retain a permanent records rule along the lines of existing law, and to clarify that that rule provides a closing of the books method (as practitioners have assumed to date) for determining what income is to be allocated to the separate and consolidated returns. Any concern on the part of the Service that taxpayers may rely upon incorrect books and records can be addressed by providing that the taxpayer's books and records must clearly reflect income for federal income tax purposes. The Committee also recommends that final regulations retain the flexibility of a ratable allocation method along the lines of either existing Treas. Reg. §1.1502-76(b)(4)(ii),[81] or Prop. Reg. §1.1502-76(b)(2)(ii) (described in 3 below).

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[79] See, e.g., Revenue Ruling 78-165, 1978-1 C.B. 276 (section 481(a) adjustments); Revenue Ruling 75-532, 1975-2 C.B. 295 (foreign tax credits); Revenue Ruling 71-11, 1971-1 C.B. 61 (real estate taxes); Revenue Ruling 58-329, 1958-1 C.B. 337 (net operating losses); see also Private Letter Ruling 8514002 (Dec. 17, 1984) (pension plan contributions); Private Letter Ruling 8214020 (Dec. 31, 1981) (vacation pay).

[80] Section 443, which provides rules generally applicable to short periods, does not provide any guidance as to how the income attributable to a short period should be determined, but principally requires that the taxable income for the short period be annualized in computing the tax liability. Cf. §1.818-5 which contain a number of specific rules for short periods of a life insurance company. Under the Proposed Regulations, section 443 is applicable to a consolidated return only to the extent that it is applicable without taking Prop. Reg. §1.1502-76(b) into account. The Proposed Regulations should clarify that the rule of Revenue Ruling 67-189, 1967-1 C.B. 255, that no annualization is required for the separate return of a new member of a consolidated group, continues to apply.

[81] Cf. Revenue Ruling 92-62, 1992-33 I.R.B. 5 (providing, under principles similar to those of regulations section 1.1502-76(b)(4), that taxpayers may make reasonable estimates of items whose amounts cannot be accurately determined).

As a matter of clarification, Example 5 of Prop. Reg. §1.1502-76(b)(3) should be revised to make clear the factual distinctions between paragraphs (a) and (c) that give rise to the different conclusions therein, e.g., that in (a) the contribution on March 15 of Year 2 was made after the due date (including extensions) for filing the return for the taxable year beginning on January 1 of Year 1, whereas in (c) the contribution was made prior to the due date.

3. Ratable Allocation Election. Prop. Reg. §1.1502-76(b)(2)(ii) generally permits taxpayers to make a joint, irrevocable election to allocate items (other than "extraordinary items") ratably to each day of a member's original year. Extraordinary items, as defined in the proposed regulations, must be allocated to the day that they affect income.

We have the following comments regarding the ratable allocation election and the definition of extraordinary items.

a. Ratable allocation election – partial year lection. The Committee welcomes the ratable allocation election and is in general agreement as to its proposed scope and manner of operation.

However, in order to more clearly reflect income, the Committee believes that the parties to a ratable allocation election should be permitted to elect a hybrid ratable method whereby ratable allocation would apply only for the month in which the change of status occurs. For example, in lieu of making a ratable allocation election for the entire taxable year, the parties might agree to a closing of the books as of the end of the month immediately preceding the change of status, with ratable allocation applying for the month in which the change of status takes place. This approach is likely to result in the income of the corporation being allocated between purchaser and seller for federal income tax purposes in a manner that more closely tracks the allocation of income for business purposes under the acquisition agreement. Moreover, such flexibility appears to be particularly appropriate in the case of companies that are engaged in businesses with seasonal cycles.

b. Extraordinary items. We have the following comments on the definition of “extraordinary items” contained in Prop. Reg. §1.1502-76(b)(2)(ii)(C):

i. Certain other extraordinary payments. The list of extraordinary items should be expanded to include deductions arising from certain payments actually made by the corporation (perhaps in excess of a specified de minimis amount) at any time during its original year, including specifically (i) compensation-type expenses relating to the change of status to the extent otherwise deductible (such as payments cancelling stock options and bonuses that are not disallowed under section 280G), (ii) deductions arising from payments in settlement of a tort liability, and (iii) by analogy to COD income, deductions arising from premiums paid to retire outstanding bonds. We believe expanding the definition in this manner is appropriate, because it permits a taxpayer to elect ratable allocation for “routine” items, as to which the election is intended to provide a rule of administrative convenience, without having to forgo a deduction for the entire amount of an “extraordinary” payment.

ii. Deemed inclusions from a foreign corporation. Under Prop. Reg. §l.l502-76(b)(2)(ii)(C)(10), the entire amount of any deemed income inclusion from a foreign corporation under section 551, 951 or 1293 is reported in the short taxable year of the corporation that undergoes a change of status in or with which ends the taxable year of the foreign corporation. Thus, the taxation of such items under a ratable allocation election would be the same as under a closing of the books method, and is also consistent with the rule that would apply if the U.S. corporation were to sell its interest in the foreign corporation. Notwithstanding such consistency, and recognizing that the general policy issues relating to the timing and allocation of deemed income inclusions from foreign corporations are beyond the scope of this report, the Committee suggests that consideration be given to extending the proposed rule for pass through entities contained in Prop. Reg. §1.1502-76(b)(2)(iv) to income inclusions under sections 551, 951 and 1293.

iii. Other items or additions should be prospective. Under Prop. Reg. §1.1502-76(b)(2)(ii)(C)(11), the term “extraordinary item” includes “[a]ny item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included.” This provision could be construed to give the IRS authority both (a) to issue announcements and rulings regarding additional generic categories of items and (b) to challenge upon audit specific items that result in a substantial distortion of income. This is very troublesome since a revision of the allocation will change the economic deal struck by the parties; the ability of the parties to “true up” the prior years as a result of the audit changes is problematic at best. We urge that any new items be announced and applied prospectively.

c. Rules for electing ratable allocation. The time for making an election to allocate is not prescribed. An appropriate time would be the due date (including extensions) of the return for the original year of S. It is also not clear why the common parent of the electing member is not the proper signatory to the election in cases where the electing member is part of a consolidated group both before and after the sale. In such cases, requiring the signature of the member undercuts the agency doctrine of Treas. Reg. §1.1502-77(a).

4. Taxes. Prop. Reg. §1.1502-76(b)(2)(iii) states that taxes are allocated under the general closing of the books method and the ratable allocation method "on the basis of the items or activities to which the taxes relate." It is not clear whether this rule is intended to modify or preserve the current treatment of real and personal property taxes, which presently are to be deducted in full by an accrual basis taxpayer in the taxable year in which the tax liability arises under the applicable statute (unless an election is in effect under section 461(c) to accrue the taxes ratably).[82] If the proposed regulations preserve the current treatment, in order for the parties to a transaction to achieve for federal income tax purposes the ratable allocation of real and personal property taxes that invariably is agreed to as a contractual matter, either (x) a corporation would have to make a section 461(c) election, which would be binding in future

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[82] See, e.g., Revenue Ruling 71-11, 1971-1 C.B. 61 (because property taxes in Texas are imposed on the owner of property on each January 1, an accrual method taxpayer filing a return for a short taxable year of six months that includes January 1 must deduct the entire property tax liability for the year on the return for the short period). In contrast, section 164(d) provides for the apportionment of real property taxes between the seller and purchaser of real property.

years, or (y) the parties to the transaction would have to make a ratable allocation election under Prop. Reg. §l.1502-76(b)(2)(ii) for all non-extraordinary items. Accordingly, the Committee recommends that the final regulations either (a) clarify that for these purposes, property taxes relate to the activity of owning property throughout the year (regardless of when they are deemed to accrue under the applicable statute), or (b) permit parties that do not make a-general ratable allocation election to elect ratable allocation with respect only to such taxes.

5. Repeal of the 30-Day Rules. The proposed regulations would repeal the 30-day rules of Treas. Reg. §1.1502-76(b)(5). The reasons given in the Preamble for repealing the 30-day rules are, first, that some groups have used the rules to achieve unintended results (not described in the Preamble), and second, that it is not feasible to resolve all of the numerous issues that arise where, for example, the rules conflict with statutory or regulatory rules relying on precise timing, or the facts of the transaction conflict with the presumption of the rules. The Preamble suggests that these administrative burdens are ameliorated by the simplified allocation rules.

The Committee believes that the 30-day rules serve a number of useful purposes and should be retained. For example, the benefits of the rules include the administrative convenience of avoiding having to file a separate return for de minimis periods, mitigation of the harsh results arising from treating a de minimis short taxable year as a full year for purposes of section 481(a) adjustments and net operating loss (and other attribute) carryovers, and permitting a subsidiary to avoid several liability under Treas. Reg. §1.1502-6 for a taxable year as to which it is a member for only a de minimis period.

In the Committee's experience, the 30-day rules have been particularly useful in the combination of related corporations into an affiliated group (often in situations involving small businesses) and in other situations in which practical difficulties arise in synchronizing all events to achieve consolidation on December 31 (or the last day of the fiscal year). Moreover, the ratable allocation rule of the proposed regulations does not preserve all of the benefits, described above, conferred by the 30-day rules.

In assessing whether the concerns expressed in the Preamble outweigh these useful purposes, the Committee generally is not aware of widespread abuses of the rules, and in any event suggests that any unintended results could well be prevented by less severe steps than a complete repeal of the rules. For example, if the Service believes that it is necessary to prevent unintended results (taking into account the existence of sections 269, 382 and 384 as well as the SRLY rules), the 30-day rules might be made unavailable if extraordinary items during the short period account for more than a de minimis amount.

Alternatively, the 30-day rules should be preserved only to avoid harsh consequences caused by the consolidated return rules. For example, the deemed closing of the year, and consequent creation of a short year, is caused by the consolidated return regulations. The 30-day rules should be reserved to ameliorate such problem. Another example is several liability under Treas. Reg. §1.1502-6. If S is a member of the old P group for only three days, for example, it seems clear that it is economically unsound to make S liable for P's tax liabilities.

We therefore recommend, as an alternative, that a limited version of the 30-day rules be retained. The 30-day rules would be retained for certain, pre-designated purposes; e.g., (1) the number of available taxable years with respect to attribute carryovers and section 481 adjustments, and (2) several liability under Treas. Reg. §1.1502-6. Other areas might be added, such as the five-year qualification period for life-nonlife consolidation under section 1503(c)(2).

A further possible limit on such a rule is to require the parties to demonstrate that the economic impact of the deal took effect as of the first day of P's taxable year in order to treat S as having been a member as of such date. In effect, this rule would sanction "as of" closings, for a very limited purpose.[83]

[83] This would be similar to the flexibility for selecting a closing date for GAAP purposes. See paragraphs 93 and 94 of Accounting Principles Board Opinion 16.