Tax Report #938

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

TAX SECTION

1998-1999 Executive Committee

STEVEN C. TODRYS
Chair
Simpson Thacher & Bartlett
425 Lexington Avenue
New York, NY 10017
212/455-3750
HAROLD R. HANDLER
First Vice-Chair
212/455-3110
ROBERT H. SCARBOROUGH
Second Vice-Chair
212/906-2317
ROBERT A. JACOBS
Secretary
212/530-5664
COMMITTEE CHAIRS:
Bankruptcy and Losses
Linda Zan Swartz
David R. Sicular
Basis and Cost Recovery
Elliot Pisem
Joel Scharfstein
CLE and Pro Bono
James A. Locke
Victor Zonana
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Ann-Elizabeth Purintun
Jodi J. Schwartz
Corporations
Andrew N. Berg
Dana Trier
Employee Benefits
Robert C. Fleder
Barbara Nims
Estates and Trusts
Sherwin Kamin
Carlyn S. McCaffrey
Financial Instruments
Samuel J. Dimon
David S. Miller
Financial Intermediaries
Bruce Kayle
Andrew Solomon
Foreign Activities of U.S. Taxpayers
Stephen B. Land
James Ross Macdonald, IV
Fundamental Tax Reform
Peter v.Z. Cobb
Deborah L. Paul
Individuals
Sherry S. Kraus
Lisa A. Levy
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
New York City Taxes
Robert J. Levinsohn
William B. Randolph
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
New York State Sales and Misc.
John P. Dugan
Hollis L. Hyans
Partnerships
William B. Brannan
Patrick C. Gallagher
Pass-Through Entities
Kimberly S. Blanchard
Marc L. Silberberg
Real Property
Larry S. Wolf
Alan J. Tarr
Reorganizations
Eric Solomon
Lewis R. Steinberg
Tax Accounting and Character
Dickson G. Brown
Michael Hirschfeld
Tax Exempt Bonds
Linda L. D'Onofrio
Patti T. Wu
Tax Exempt Entities
Michelle P. Scott
Stuart L. Rosow
Tax Policy
David H. Brockway
Kathleen Ferrell
U.S. Activities of Foreign Taxpayers
Peter H. Blessing
David P. Hariton

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
Kenneth H. Heitner, Thomas A. Humphreys, Charles I. Kingson, Glen A. Kohl, Emily S. McMahon, Charles M. Morgan, III, Dale L. Ponikvar, Yaron Z. Reich, David M. Rievman, Leslie B. Samuels, Robert T. Smith, Ann F. Thomas, Eugene L. Vogel, David E. Watts, Mary Kate Wold

October 7, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section commenting on the temporary regulations concerning the application of Section 382 to consolidated groups. The report supports the general approach of the temporary regulations and makes a number of recommendations for changes that could be incorporated into final regulations, including the following:

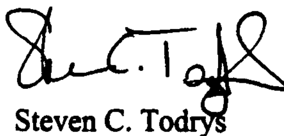
1. The report recommends that the definition of "subgroup" for purposes of applying Section 382 and the separate return limitation year rules (assuming such rules are retained) be conformed. We expect to submit a report in the near future concerning the SRLY rules.
2. We recommend that the testing period for the "fold in" rules be reduced from five years to three years.

FORMER CHAIRS OF SECTION:
Howard O. Colgan, Jr., Charles L. Kades, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey, Jr., Charles E. Heming, Ralph O. Winger, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos, Michael L. Schler, Carolyn Joy Lee, Richard L. Reinhold, Richard O. Loengard

3. The report suggests certain modifications to the "supplemental method" for determining ownership changes resulting from increases in ownership of subsidiary stock.
4. We recommend that, in the absence of an express election, the default rule for apportioning a group's Section 382 limitation when a member leaves the group should be based upon the departing member's share of the consolidated net operating losses of the group, limited to any new Section 382 limitation resulting from its departure.
5. The report recommends that the final regulations address the apportionment of consolidated net unrealized built-in gains and net unrealized built-in losses when a member leaves the group and suggests a possible apportionment method.
6. We recommend that gains or losses recognized with respect to intercompany debt should not be taken into account for purposes of the built-in gain and built-in loss rules.
7. The report suggests a number of clarifications in the value adjustment rules in the consolidated return context for redemptions and capital contributions.

Please let me know if we can be of any further assistance in addressing these issues.

Sincerely,



Steven C. Todrys

Enclosure

cc: <u>Internal Revenue Service</u>
The Honorable Stuart L. Brown
Philip J. Levine, Esq.
William D. Alexander, Esq.
Charles M. Whedbee, Esq.

<u>Department of the Treasury</u>
The Honorable Jonathan Talisman
Joseph M. Mikrut, Esq.
Karen Gilbreath, Esq.

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON REGULATIONS CONCERNING THE APPLICATION OF SECTION 382 TO CONSOLIDATED GROUPS

This report[1], prepared by the Committee on Bankruptcy and Losses of the Tax Section of the New York State Bar Association, comments on the temporary Treasury regulations[2] that determine the treatment of transactions involving consolidated group members for purposes of Section 382[3] (the "Temporary 382 Regulations"). Although, to the extent relevant to the issues discussed herein, the report also discusses the Temporary Regulations applying the separate return limitation year rules (the "Temporary SRLY Regulations"), this report expresses no opinion regarding the retention or elimination of the SRLY rules, a subject that will be addressed in a separate report.

The Committee strongly supports the general approach of the Temporary 382 Regulations that looks only to shifts in ownership of stock of a common parent of a consolidated group or loss subgroup to determine whether the group or subgroup has undergone an ownership change (the "Parent Change Method"), and that applies the Section 382 limitation on a consolidated group or subgroup basis. This report recommends that final regulations address a number of additional issues not covered by the Temporary Regulations and also recommends

---

1/ The report was drafted by Lawrence M. Garrett, Stuart J. Goldring and Linda Z. Swartz, co-chair of the Committee on Bankruptcy and Losses, with significant contributions by Mark A. Schneider, Jason B. Slatter and Scott M. Sontag. Helpful comments were received from Peter C. Canellos, Robert A. Jacobs, Michael L. Schler, and Steven C. Todrys.

2/ See Temporary Treasury Regulations §§ 1.1502-90T through 1.1502-99T (the Temporary 382 Regulations, together with the Temporary regulations regarding the separate return limitation year ("SRLY") rules, the "Temporary Regulations").

3/ All references to "Sections" are to Sections of the Internal Revenue Code of 1986, as amended. All references to NOLs are to net operating losses and net operating loss carryovers.

several changes to the Temporary 382 Regulations.[4] Specific recommendations for guidance are provided for each additional issue to be addressed in final regulations.

The Temporary 382 Regulations apply Section 382 principles to transactions involving consolidated group members. In very broad terms, Section 382 limits a loss company's annual use of its NOLs following an ownership change, i.e. a more than 50 percent change (by value) in the ownership of a loss corporation's stock within a testing period of up to 3 years. A loss corporation that has a net unrealized built-in gain (a "NUBIG") with respect to its assets at the time of an ownership change can increase its annual limit on the use of pre-change NOLs by the amount of any built-in gains recognized during the 5-year period following the ownership change (to the extent of such NUBIG). A loss corporation that has a net unrealized built-in loss (a "NUBIL") with respect to its assets at the time of an ownership change is limited in its use of built-in losses recognized during the 5-year period following the ownership change.

The application of the above-described Section 382 rules to consolidated groups depends, as a threshold matter, on whether the consolidated group is treated as a single entity for purposes of applying the Section 382 rules, or whether the rules are separately applied to each consolidated group member. A second, related question is whether the same consolidated group single entity or separate member treatment should apply both to determine whether an ownership change has occurred and to determine the Section 382 limitations on, and NUBIG and NUBIL

---

[4] It should be noted that the report, while extensive in dealing with what the Committee considers to be the most significant aspects of the Temporary 382 Regulations, is not exhaustive in its coverage of potential issues that may arise in connection with the application of Section 382 to consolidated groups. For example, the Temporary 382 Regulations do not provide guidance on applying the special rules of section 382(l)(5) and (6), relating to loss corporations under the jurisdiction of a court in a Title 11 or similar case, to consolidated groups or subgroups. Temp. Treas. Reg. § 1.1502-97T (which is reserved for this purpose). The Committee recommends that these issues be addressed in connection with the finalization of the Temporary 382 regulations.

rules regarding, consolidated group members' NOLs after a group member's ownership change. The Temporary 382 Regulations generally employ loss group and subgroup concepts to determine both ownership changes and Section 382 limitations after ownership changes. As a consequence, the regulations also include rules that apply when corporations join a consolidated group and when corporations cease to be members of a loss subgroup or consolidated group.

Our recommended changes to the Temporary 382 Regulations are summarized below.

Summary of Recommendations

The report recommends several significant additions and changes to the Temporary 382 Regulations, including the recommendations summarized below. Broadly speaking, the recommendations fall into 3 categories: (i) those that simplify certain rules provided in the Temporary 382 Regulations (Recommendations 1 and 2), (ii) those that tailor certain rules provided in the Temporary 382 Regulations more closely to their underlying purposes (Recommendations 3, 4, 5 and 8), and (iii) those that fill in gaps in the Temporary 382 Regulations or make other clarifying amendments (Recommendations 6, 7, and 9).

1. A single definition of a subgroup should be applied for Section 382 and SRLY purposes (assuming a separate SRLY limitation is maintained) in calculating both NOLs and built-in gains and losses. We recommend that two or more corporations joining a consolidated group be treated as a subgroup if (i) the members were affiliated with each other in a former group, (ii) the attribute in question (e.g., NOLs) was not a SRLY attribute as to the former group, and (iii) the members have been continuously affiliated

with each other since leaving that group (or, if later, since separate tracking ceased under "fold-in" rules of Temp. Treas. Reg. § 1.1502-96T(a)).[5]

2. The testing period for the "fold in" rules that treat members' tax attributes as consolidated group attributes should be shortened from 5 years to 3 years.

3. The Supplemental Method of Temp. Treas. Reg. § 1.1502-92T(c) (the "Supplemental Method") for determining ownership changes should be more narrowly crafted to apply to increases in subsidiary stock ownership only when increases are for a principal purpose of circumventing the Parent Change Method, and the common parent of the loss group has actual knowledge of such increases. The amount of any resulting deemed percentage increase in parent stock ownership should be limited to the actual percentage increase in subsidiary stock (determined on a separate entity basis).

4. The "plan or arrangement" test applied in connection with the Supplemental Method should be replaced by a "coordinated acquisition" standard in final regulations.

5. In the absence of an express allocation of a group's Section 382 limitation when a group member departs, the limitation should be apportioned based on the departing member's relative share of the consolidated NOL of the loss group (with similar allocations applying to subgroups).

---

[5] As discussed in the text below, the recommended definition would eliminate the current requirements that (i) the members of a subgroup for Section 382 purposes must bear the relationship to each other described in Section 1504(a)(1) through a loss subgroup parent immediately after they join the current group (the "Subgroup Parent Requirement"), and (ii) the members of a built-in gain and loss subgroup must have been continuously affiliated for 5 consecutive years (60 consecutive months for SRLY purposes) prior to joining the current group (the "Five Year Affiliation Requirement

6. Final regulations should permit express apportionment for a consolidated (or subgroup) NUBIG, but not for a consolidated (or subgroup) NUBIL when a member departs from a consolidated group.

7. Final regulations should provide that in the absence of express apportionment, a consolidated NUBIG or NUBIL generally will be apportioned to a departing member only if, and to the extent, the member had a net built-in gain or loss that contributed to the group's NUBIG or NUBIL, respectively (taking into account certain adjustments), and the built-in gain or loss has not yet been fully recognized.

8. Final Regulations generally should not treat items of gain, loss, income, or deduction recognized by members of a loss group or subgroup attributable to intercompany debt between group or subgroup members as recognized built-in gain or loss for purposes of Section 382(h).

9. Final Regulations should clarify that the value adjustment rules of Sections 382(e)(2), (l)(1), and (l)(4) apply in the consolidated return context on a single entity basis.

   a. Redemptions and corporate contractions that merely transfer value within the acquiring group should not reduce the value of a loss member or subgroup for Section 382 purposes.

   b. The anti-stuffing rule of Section 382(l)(1) does not apply to contributions of stock of one member to another in connection with an ownership change if the members involved would otherwise qualify as a subgroup after the contribution. On balance, we also recommend that contributions of non-stock assets by the selling group to departing members generally not be subject to the anti-stuffing

rule, but be subject to an anti-abuse rule similar to the rule provided in Temp. Treas. Reg. § 1.1502-91T(g)(4).

c. The substantial nonbusiness asset test of Section 382(l)(4) should be determined on a loss group basis, or in any event on a subgroup basis, treating the group (or subgroup) as a single entity.

Discussion of Recommendations

1. Elimination of Multiple Loss Subgroup Definitions.

As discussed below, we recommend that a single subgroup definition be employed for all purposes. A single definition would eliminate a substantial amount of the complexity created by multiple definitions and would be consistent with the single entity rationale of the subgroup rules. The Temporary Regulations adopt a subgroup approach to applying both Section 382 and SRLY limitations. The subgroup rules apply where two or more corporations are affiliated with each other and become members of a new consolidated group. For example, the subgroup rules are implicated when a consolidated group is acquired by another group. The Temporary SRLY Regulations employ two separate subgroup definitions for SRLY purposes, and two additional, different definitions are employed by the Temporary 382 Regulations, as described below.

With respect to NOLs, two or more corporations that become members of the current group compose a loss subgroup for Section 382 purposes if: (i) they were affiliated with each other in another group (whether or not consolidated returns were filed by such group), (ii) they bear a Section 1504(a)(1) relationship through a subgroup parent immediately after they become members of the current group, and (iii) at least one member carries over a NOL that was

not a SRLY NOL with respect to the former group, and is not so treated under the Temporary Regulations applying the SRLY rules (the subgroup, a "382 NOL Subgroup").[6]

With respect to NOLs, two or more corporations compose a SRLY loss subgroup if: (i) they were affiliated with each other in another group, (ii) one or more of the corporations may carry over a loss that is not a SRLY loss as to the former group, and (iii) the corporations enter the current group at the same time.[7] The Temporary SRLY Regulations do not require a Section 1504(a)(1) relationship through a subgroup parent (a "SRLY NOL Subgroup").

With respect to built-in gains and built-in losses, two or more corporations that become members of a current group compose a loss subgroup for Section 382 purposes if they: (i) have been continuously affiliated with each other for the 5 consecutive year period ending immediately before they become members of the current group, (ii) bear a Section 1504(a)(1) relationship through a subgroup parent immediately after they become members of the current group, and (iii) have a NUBIL on the day they enter the current group.[8]

With respect to built-in losses, two or more members compose a SRLY subgroup if they: (i) have been continuously affiliated with each other for the 60 consecutive month period ending immediately before they become members of the current group, and (ii) have a NUBIL when they enter the current group. Once again, the Temporary SRLY Regulations do not require a Section 1504(a)(1) relationship through a subgroup parent (a "SRLY Built-in-Loss Subgroup").[9]

---

[6] Temp. Treas. Reg. § 1.1502-91T(d)(1).

[7] Temp. Treas. Reg. § 1.1502-21T(c)(2)(i).

[8] Temp. Treas. Reg. § 1.1502-21T(d)(2).

[9] Temp. Treas. Reg. § 1.1502-15T(c)(2).

a. Eliminating the Differences Between the Subgroup Definitions. While we strongly support the loss subgroup concept, we believe that the four separate and distinct subgroup definitions employed by the Temporary Regulations are unduly complex. The complexity results principally from the distinctions between the four definitions. Indeed, the effect of the above definitional differences is that, in a number of consolidated return transactions, (i) Section 382 will be applied on a separate entity basis, while the SRLY rules will be applied on a single entity basis, and (ii) Section 382 will be applied on a single entity basis with respect to NOLs, but on a separate entity basis with respect to built-in gains and losses. The Committee does not believe the current disparity between the subgroup rules is warranted in light of the overall single entity approach of the consolidated return regulations and the common principal purpose of the Section 382 and SRLY rules of prohibiting trafficking in NOLs and built-in losses.[10]

Accordingly, we recommend that the Temporary Regulations be simplified to provide a single loss subgroup definition for all Section 382 and SRLY purposes. While simplification presents certain challenges, we note the basic differences in the existing four loss subgroup definitions result principally from two fundamental definitional differences: (i) the Subgroup Parent Requirement for Section 382 purposes, but not for SRLY purposes, and (ii) the Five Year Affiliation Requirement for built-in gains and losses, but not for NOLs. We recommend eliminating each of these requirements, and treating two or more members of the

---

[10] We note that other commentators have argued the SRLY regulations also serve the separate function of governing the transition from separate returns to consolidated returns, and from consolidated returns to separate returns. See, generally, Andrew Dubroff and John Broadbent, *Consolidated Returns: Evolving Single and Separate Entity Themes*, 72 Taxes 743 (1994); *Comments regarding Retention of the Consolidated Return SRLY Rules*, prepared by individual members of the Committee on Affiliated and Related Corporations, Tax Section, American Bar Association (April 30, 1998).

current group as members of a subgroup if (i) they were affiliated with each other in the former group, (ii) the attribute in question (e.g., the vintage of NOLs) was not SRLY as to the former group, and (iii) they have been continuously affiliated since their departure from the former group (disregarding periods before the application of the fold-in rules).[11] The anti-abuse rule of Temp. Treas. Reg. § 1.1502-91T(d)(4) would adequately deter any transactions, such as intragroup restructurings, intended to "game" this single subgroup definition.[12]

b. Eliminating the Subgroup Parent Requirement. We recommend eliminating the Subgroup Parent Requirement under the Temporary 382 Regulations. As an initial matter, the Subgroup Parent Requirement creates substantial complexity because it applies only for Section 382 purposes, and not for SRLY purposes. Consider the following example, which demonstrates that on the same set of facts Section 382 is applied on a separate entity basis while the SRLY rules are applied on a single entity basis, a result clearly at odds with the common principal purpose of the Section 382 and SRLY rules and the overall single entity approach to consolidated return taxation.

> Example 1. P is the common parent of a consolidated group consisting of P, L, L1, and L2. P owns all the stock of L and L1. L and L1 own, respectively, 40 percent and 60 percent of the stock of L2. During their inclusion in the P group, L and L1 have generally been profitable, while L2 has incurred losses. P sells the L and L1 stock to B, the common parent of another consolidated group. L2 is allocated a portion of the P group's consolidated NOL under Temp. Treas. Reg. § 1.1502-21T(b)(2)(iv).

---

[11] We recognize that certain computational differences may continue to exist for Section 382 and SRLY purposes even if a single subgroup definition is employed.

[12] Temp. Treas. Reg. § 1.1502-91T(d)(4) provides that members otherwise qualifying for subgroup status are not treated as a subgroup if any one of them is formed, acquired, or availed of with a principal purpose of avoiding the application of, or increasing any limitation under, Section 382.

In the above example, L, L1, and L2 comprise a SRLY subgroup, because L2's portion of the consolidated NOL was not a SRLY NOL as to the P group, and L, LI and L2 joined the B group at the same time. Thus, consistent with the single entity approach of the subgroup rules under the Temporary SRLY Regulations, NOLs of one member of the subgroup generally may be carried forward and offset against income of another member of the same subgroup. By contrast, L, L1, and L2 do not comprise a loss subgroup for Section 382 purposes; they lack a Section 1504(a)(1) relationship through a subgroup after they join the B group, as required by Temp. Treas. Reg. § 1.1502-91T(d)(1), because neither L nor L1 is a subgroup parent owning at least 80 percent of another member. Therefore, Section 382 would apply to each of L, L1, and L2 on a separate entity basis, a result that is inconsistent with the single entity objective of the Temporary 382 Regulations, especially given the opposite result in the related SRLY area.[13] In addition, the inconsistent definitions add another level of administrative complexity to an already complex set of rules. Under the definitions, L, L1, and L2 would have to separately track their individual Section 382 limitations, but would track losses on a combined basis to calculate their combined SRLY limitation. There appears to be no policy justification for this markedly different treatment of the same transaction.

One rationale often advanced in support of the Subgroup Parent Requirement is that it is necessary to track subsequent owner shifts where members entering into the current group are not aligned in a Section 1504(a)(1) relationship or cease to be so aligned after entering the group. However, as discussed below, where the entering members have an ownership change

---

[13] Temp. Treas. Reg. § 1.1502-91T makes clear that the objective of the Temporary Regulations is to apply Section 382 on a single entity basis in the consolidated return area: "These rules generally provide that an ownership change and the Section 382 limitation are determined with respect to these attributes for the group (or loss subgroup) on a single entity basis and not for its members separately."

in connection with joining the current group, separate tracking of member NOLs is eliminated under the fold-in rules of Temp. Treas. Reg. § 1.1502-96T(a). The fold-in rules treat the existing tax attributes of these corporations as consolidated attributes of the current group for purposes of determining the existence and effect of any subsequent ownership change, which would depend on owner shifts at the parent company level under the "Parent Change Method."[14] Thus, in cases such as Example 1, when L1 and L2 join the B consolidated group in a transaction involving an ownership change, the fold-in rules would end the separate tracking of Section 382 owner shifts of each corporation for Section 382 purposes. Instead, consistent with the single entity approach, the Temporary 382 Regulations would generally track only changes in ownership of the common parent of the current group thereafter.

Accordingly, maintaining the Subgroup Parent Rule separately to track ownership is not necessary when an ownership change occurs in connection with a loss subgroup entering the current group. In addition, under our recommended subgroup definition, the value of the subgroup for purposes of computing the subgroup's Section 382 limitation would be determined by aggregating the value of the stock of each member of the subgroup not owned by another subgroup member. In many cases, this will be easily determined, since it will equal the aggregate amount paid for the stock of the corporations that compose the subgroup. Moreover, the principles of Temp. Treas. Reg. § 1.382-8T could be applied to the determination to avoid duplication of value. Thus, maintaining the subgroup parent requirement is not necessary for purposes of applying the Section 382 limitation to a group of corporations undergoing an ownership change upon entering the current consolidated group.

---

[14] Temp. Treas. Reg. § 1502-91T(b)(1).

Where no ownership change occurs upon members entering the current group (or where an ownership change occurs, but the Section 1504(a)(1) relationship is later broken), we recommend the current group be permitted to choose one of the new members to act as the subgroup parent. The existence of an ownership change as to the subgroup, as a whole, would be determined by reference to owner shifts with respect to the designated parent. To prevent abuse, such as designating a member as the parent for a principal purpose of avoiding an ownership change that would have occured had another member been the designated parent, a supplemental method of determining when an ownership change occurs, based on the principles of Temp. Treas. Reg. § 1.1502-92T(c), with our recommended modifications, could be applied.

Eliminating the Subgroup Parent Rule would also permit the elimination of the corollary rule requiring apportionment of a subgroup limitation when a member ceases to be a member of the subgroup as a result of failing to maintain a Section 1504(a)(1) relationship through the subgroup parent.[15] This result would obtain for example, if a subgroup parent distributes the stock of a subgroup member to its parent corporation. In such case, under the Temporary 382 Regulations, no portion of the subgroup limitation is allocated to the "departing" member unless the common parent of the current group makes an affirmation allocation.[16] Thus, the mere shifting of entities within the consolidated group carries with it the potential to trigger the apportionment rules and represents a trap for the unwary. Accordingly, the Committee recommends that final regulations provide that any such apportionment be required only when the subgroup member leaves the current consolidated group, as there is no significant

---

[15] Temp. Treas. Reg. § 1.1502-95T(d).

[16] Temp. Treas. Reg. § 1.1502-95T(d)(2), Example 3.

administrative impediment to applying the subgroup 382 limitation following shifts of position of members within a consolidated group.

Finally, we do not believe that Temp. Treas. Reg. § 1.1502-91T(d)(4), which excepts from the operation of the subgroup anti-abuse rule transactions that align subgroup members entering the current group in the requisite Section 1504(a)(1) relationship, is an adequate solution to the concerns addressed above. While the regulation would permit the contribution of the stock of a brother corporation to a sister corporation immediately before an acquisition of the stock of the sister corporation, it is not always possible or desirable to accomplish this result because of regulatory or business impediments.[17] Moreover, a newly-formed holding company may not have the requisite 5-year history necessary to establish a subgroup among the contributed members for NUBIG and NUBIL purposes.[18] Finally, contributions may not always be possible in the context of a tax-free transaction. This might occur, for example, where the acquisition is structured as a reverse subsidiary merger intended to qualify as a tax-free reorganization under Section 368(a)(2)(E), predominantly in exchange for stock of the parent of the buying group, but also for some amount of boot. Applying the position

---

[17] See, e.g., Philadelphia Bar Association, Tax Section, Proposed Regulations Regarding the Application of Section 382 and 383 to Consolidated Groups and Related Matters (July 19, 1991), reprinted in 91 TNT 161-49 (LEXIS). Where it is not possible to restructure prior to an acquisition, it is unclear whether restructuring by the buyer following an acquisition of brother/sister corporations is effective in establishing the requisite Section 1504(a)(1) relationship through a subgroup parent. Temp. Treas. Reg. § 1.1502-91T(d) requires that the relationship exist immediately after the acquisition. No guidance is provided as to whether events that occur in connection with the acquisition are to be taken into account for these purposes.

[18] This result would not occur if the holding company is treated as a successor to the contributing member under Temp. Treas. Reg. § 1.1502-91T(j). However, it should be noted that this successor rule may not be applicable where, on an overall basis, there is not a material difference between the value and the basis of the stock of the brother and sister corporations.

enunciated by the IRS in Rev. Rul. 70-140, 1970-1 C.B. 73, the transaction could be recast as a direct acquisition by the parent of the acquiring group of the stock of the brother corporation for stock and boot, which would not qualify as a reorganization under section 368(a)(1)(B).

c. Eliminating the Five Year Affiliation Requirement. In general, if a loss corporation has a NUBIG at the time of a Section 382 ownership change, built-in gain recognized within the 5-year period following the ownership change increases the Section 382 limitation.[19] By contrast, if a loss corporation has a NUBIL at the time of an ownership change, a built-in loss recognized within the 5-year period following the ownership change is treated as a pre-change loss limited under Section 382. The Temporary SRLY Regulations incorporate a similar built-in loss concept. That is, if a corporation having a NUBIL becomes a member of a consolidated group, a recognized built-in loss will be subject to the SRLY rules. In this regard, the Temporary SRLY Regulations generally cross-reference the relevant provisions and definitions of the built-in loss rules of the Temporary 382 Regulations.

The Temporary Regulations utilize a subgroup concept in determining the existence of a NUBIG or NUBIL for both Section 382 and SRLY purposes. As in the case of NOLs, the Committee supports this approach and believes it consistent with single entity principles. However, we believe that the requirement of 5 years of continuous affiliation prior to members entering a larger consolidated group as a prerequisite for Section 382 and SRLY subgroup status[20] adds unnecessary complexity and should be deleted in the final regulations.

---

[19] The Five Year Affiliation Requirement may have been intended as a rough cut, bright line rule to avoid the administrative difficulties inherent in determining when built-in gains and losses actually accrued economically, and the 5-year period may have been chosen by reference to the 5-year recognition period applicable under Section 382(h)(7).

[20] See Temp. Treas. Reg. §§ 1.1502-15T(c)(2), 1.1502-91T(d)(2)(i).

The Five Year Affiliation Requirement is complicated both for taxpayers to apply and for the IRS to administer, frequently mandating the application of Section 382 and SRLY on a single entity basis with respect to NOLs, but on a separate entity basis with respect to built-in gains and losses. This complexity is illustrated by the following example.

> Example 2. P is the common parent of another consolidated group consisting of P, L, L1, and L2. P owns all of the stock of L. L owns all of the stock of L1 and L2. During their inclusion in the P group, L has generally been profitable, while L1 and L2 have incurred losses. P sells all of the stock in L to B, the common parent of a consolidated group. L1 and L2 are allocated a portion of the P group's consolidated NOL under Temp. Treas. Reg. § 1.1502-21T(b)(2)(iv). L2 became a member of the P group within the 5-year period prior to B's purchase, in a transaction that did not involve L2's having an ownership change. On a separate company basis, L and L1 each have a NUBIG and L2 has a NUBIL. On an overall basis, L, L1, and L2 have a NUBIL. L, L1, and L2 constitute a loss subgroup with respect to the portion of the P group's consolidated NOL allocated to L1 and L2. However, only L and L1 constitute a loss subgroup with respect to built-in gains and losses, and together they have a NUBIG. L2 is not a member of the built-in gain and loss subgroup because it fails to satisfy the Five Year Affiliation Requirement.

Even in this relatively simple example, the application of the Temporary 382 Regulations is complex. For example, recognized built-in gains of L and L1 would clearly increase the subgroup 382 limitation as to L1's NOL, but it is unclear whether the same increase would obtain as to L2's NOL.[21] Moreover, while the subgroup 382 limitation applicable to the NOLs of L1 and L2 would be determined by reference to the value of L's stock, a separate company Section 382 limitation would apply to L2's NUBIL, which would be determined solely

[21] If L1 did not have a five year history, query whether the subsidiary's Section 382 limitation would have been increased, at least to the extent of L1's NUBIG, by L1's recognized built-in gain. As a policy matter, such increase should be permitted, but it is not clear that this result obtains under the Temporary Regulations.

by reference to the value of L2's stock. We do not believe these disparate results are warranted, particularly in light of the single entity policies of the consolidated return regulations.

The interaction of the Five Year Affiliation Requirement and the predecessor and successor rules of Temp. Treas. Reg. § 1.1502-91T(j) which provide that the determination of whether a successor meets the Five Year Affiliation Requirement is made by reference to its predecessor, will often require additional separate entity calculations. Under Temp. Treas. Reg. § 1.1502-91T(j), a predecessor includes a transferor in a Section 351 transaction only if the amount by which the value and basis of assets transferred differ is "material." The materiality requirement is difficult to apply because of the uncertainty as to what constitutes a material difference between value and basis in this context. Moreover, the material difference requirement in combination with the Five Year Affiliation Requirement may produce unwarranted limitations on losses recognized by group members formed and funded with cash as illustrated by the following example.

> Example 3. P owns all of the stock of L. In Year 1, L wishes to invest in a foreign joint venture. For limited liability concerns, L incorporates L1 as a wholly-owned first-tier subsidiary and contributes cash to L1 to fund L1's investment in the venture. In Year 4, L is acquired by B, the common parent of another consolidated group. At the time of the acquisition, L has a NUBIG and L1 has a NUBIL. On an overall basis, L and L1 have a NUBIG. In Year 8, L1 sells the venture interest, recognizing a substantial loss.

L1 does not appear to qualify as a successor to L, because L1 was formed with cash. Accordingly, L and L1 do not constitute a loss subgroup with respect to built-in gains and losses, and a separate company Section 382 limitation applies to the loss recognized by L1. This is true even though L entirely funded L1's acquisition of assets, the two corporations were continuously affiliated since L1's formation, and L did not acquire L1 from a third party. On its

face, such a result seems wholly inconsistent with the preamble to the Temporary Regulations, which indicates that a consolidated group or subgroup should be treated as if the parent corporation was engaged in operating its business through divisions rather than wholly-owned subsidiaries. We do not believe L should be denied the use of the loss generated as a result of its investment in the venture simply because it invested through a wholly owned subsidiary.[22]

The Committee believes other statutory and regulatory provisions adequately police the potential for abuse through selective affiliation. In this regard, Section 384 generally prohibits one corporation from offsetting its built-in gains or losses against the built-in losses or gains, as the case may be, of another corporation recognized within 5 years of the first corporation's acquisition of control of the second corporation. The limitations of Section 384 apply in addition to, rather than in lieu of, the limitations under Section 382, and thus serve as a check under the Code itself on the inclusion of corporations within a subgroup to manipulate the subgroup definition. The current anti-abuse rule in Temp. Treas. Reg. § 1.1502-91T(d)(4) also clearly provides the IRS with authority to prevent such abuses, as it permits the IRS to void the formation of a loss subgroup if a subgroup member was acquired with a principal purpose of avoiding the application of Section 382. There is no doubt the acquisition of a built-in gain corporation for the purpose of combining its built-in gains with existing built-in losses of other subgroup members could be prevented through the application of the anti-abuse rule. Thus, the specific abuses the Five Year Affiliation Requirement was intended to prevent would be independently and adequately policed even were the requirement eliminated.

d. Requiring Continuous Affiliation. The Committee's recommended subgroup definition would provide that only corporations that were affiliated with other in the

---

[22] We note that the same result obtains under the Temporary SRLY Regulations.

group in which the attribute arose, and that have been continuously affiliated with each other since leaving that group may comprise a loss subgroup. The Committee believes that limitation is consistent with single entity principles. The following example illustrates this principle, and the resulting problems we perceive, under the Temporary Regulations.

> Example 4. In Year 1, P owns 80 percent of L1, L2, and L3, with B owning the remaining 20 percent of each subsidiary. In Year 2, B acquires another 40 percent in each from P. L1, L2, and L3 file separate returns following the acquisition. L1 is allocated a portion of the P group's consolidated NOL. In Year 6, B acquires the remaining 40 percent of each of the loss corporations from P, and they become members of the B group. There are no other owner shifts with respect to the stock of P and B during the relevant periods.

The key point in Example 4 is that in Year 6 the loss corporations all become members of the P group without triggering a Section 382 ownership change, because P did not acquire more than 50 percent of any of the corporations within the Section 382 3-year testing period. Under the Temporary 382 Regulations, L1, L2, and L3 do not constitute a loss subgroup as to L1's portion of the P group's consolidated NOL because they are not in a Section 1504(a)(1) relationship through a loss subgroup parent. However, they would constitute a loss subgroup for Section 382 purposes when they enter B's consolidated group if immediately prior to B's acquisition in year 6 the stock of L2 and L3 were contributed to L1 and the stock of L1 were sold to B. This result would obtain even though the corporations were disaffiliated in Years 2 through 6, because L's NOL is not a SRLY NOL as to the P group.

The Committee believes continuous affiliation, beginning with the group in which the attribute arose and including all subsequent groups, should be a conceptual predicate for single entity treatment of two or more corporations, except in cases governed by the fold-in rules. Once affiliation is broken, it is no longer appropriate to subsequently treat corporations as a single entity for Section 382 purposes, unless and until the fold-in rules terminate separate

tracking of attributes e.g., once there is an ownership change or the requisite number of years has elapsed without an ownership change.[23]

It should be noted that, in applying the continuous affiliation requirement, unrealized built-in gains and losses would not be treated as arising until the corporation has an ownership change while having a NUBIG or NUBIL.

> Example 5. S becomes a member of the P consolidated group in year 1 in a transaction not involving an ownership change. At that time, S has a NUBIG. The P group (excluding S) has a NUBIL. No ownership change of the P group occurs in year 2. At the beginning of year 3, the P group is acquired by B, the common parent of another consolidated group, causing the P group to have an ownership change.

In the above example, S would be considered to be a member of the P subgroup for purposes of determining the P subgroup NUBIG or NUBIL even though S was not a member of the P group for five years and even though S had a NUBIG upon entering the P group. However, if S was acquired by the P group for a principal purpose of affecting the P group's NUBIG or NUBIL, S would be excluded from the P subgroup for these purposes under the anti-abuse rule of Temp. Treas. Reg. § 1.1502-91T(d)(4).

The elimination of the Subgroup Parent and Five Year Affiliation Requirements would streamline and simplify the consolidated Section 382 regulations by creating a single subgroup definition, rather than four subgroup definitions. Additionally, our proposal that members of a loss subgroup generally must be affiliated in the group in which the attribute arose and maintain affiliation after leaving that group insures consistent application of single entity principles. We believe current anti-abuse rules adequately police potentially abusive situations without adding complexity to the consolidated return regulations.

---

[23] Under current law, five years are required, but we recommend that this period be reduced to three years.

2. Reduction of the Fold-In Period from Five Years to Three Years.

The Committee believes the fold-in rules of Temp. Treas. Reg. § 1.1502-96T(a) are sensible. However, we recommend that the current five-year testing period be shortened to three years.

Under the fold-in rules, a member's separate return tax attributes are treated as consolidated group attributes upon the earlier of (i) its having a separate ownership change upon entering the current group or thereafter, or (ii) five years from its entering the group. We recommend that the testing period for fold-in purposes be reduced to three years, consistent with the general three-year testing period for Section 382 purposes. This would streamline the application of these rules.

3. Limitation of the Supplemental Method.

Temp. Reg. § 1.1502-92T(c) contains a modification of the general parent change approach to determine ownership changes within consolidated groups (hereafter, the "Supplemental Method"). The Committee recognizes the need for an "anti-abuse" rule that prevents end runs around the Parent Change Method through issuances and sales of subsidiary stock, and thus supports the general concept of a modified parent change approach. Nevertheless, the Committee believes the rule should be narrowly tailored to curb abusive transactions without interfering with legitimate business transactions and without creating undue complexity and uncertainty.

Currently, the Parent Change Method and the Supplemental Method each applies to determine whether an ownership change of a loss group occurs if a 5% shareholder of the common parent increases its ownership (by any amount) in both the common parent and any

subsidiary member of the loss group during a 3-year period (or, if shorter, the period since the last ownership change). For this purpose, the 5% shareholder is treated as increasing its ownership in the common parent or subsidiary to the extent, if any, that any person "acting pursuant to a plan or arrangement with the 5-percent shareholder" (hereafter, referred to as a "Co-Purchaser") increases its percentage ownership in such entity. Where the Supplemental Method applies, the common parent is treated as if it had issued to the 5% shareholder an amount of parent stock having the same fair market value as the value of the subsidiary stock represented by the percentage increase in the 5% shareholder's or Co-Purchaser's ownership of the subsidiary.[24] In addition, even though the Co-Purchaser is not a 5% shareholder of the common parent in its own right (in which case its purchase of the subsidiary stock would have automatically "tripped" the Supplemental Method test without regard to a "plan or arrangement"), the Temporary Regulations provide that the Co-Purchaser thereafter will be treated as a 5% shareholder with respect to any ownership it has in the common parent.

Several observations regarding the potentially overboard application of the Supplemental Method are worth noting. First, neither the increase in a 5% shareholder's ownership in a subsidiary, nor the plan or arrangement with the Co-Purchaser, need have as a principal purpose the avoidance of an ownership change. That approach, which, like the rest of the temporary regulations, is carried over from the original proposed regulations, is reminiscent of the original approach to option attribution adopted in the 1987 Section 382 temporary regulations. Treasury has since recognized, however, that an overly inclusive application of deemed option exercises unduly interferes with legitimate business transactions and, in 1994,

---

[24] Similar principles apply if the increase in the subsidiary is caused by a redemption or similar transaction.

adopted a principal purpose test in the final option attribution regulations.[25] We recommend applying a similar test to the Supplemental Method.

Second, the application of the Supplemental Method is not dependent upon the common parent having actual knowledge of the 5% shareholder's increase in its percentage ownership of the subsidiary, or of the plan or arrangement with the Co-Purchaser. In many cases, the common parent may be totally unaware that such events have occurred, and in particular that a plan or arrangement exists. We therefore recommend that the application of the Supplemental Method be limited to cases in which the common parent of a loss group has actual knowledge of an increase in ownership of subsidiary stock by a 5% shareholder, and that the common parent's duty of inquiry be limited to 5% or greater shareholders of the subsidiary.

Third, the application of the Supplemental Method can result in very artificial ownership change results. For example, where the common parent is highly leveraged, a minority ownership of subsidiary stock would represent a disproportionately large percentage interest of the loss group (by value) compared to an equivalent percentage of parent stock (by share). A second example is where there is a substantial amount of other minority ownership in the subsidiary (and possibly minority ownership in other subsidiaries of the loss group) that is not subject to the Supplemental Method.[26] We recommend limiting deemed increases in parent

---

[25] We observe that the two separate company exceptions to the Parent Change Method in Temp. Treas. Reg. § 1.1502-96T(b) are both directed at specific abuses and apply only if the transaction is undertaken with a principal purpose of circumventing Section 382. In the case of the "more-than-20% option" exception in Temp. Treas. Reg. § 1.1502-96T(b)(1)(i), a "principal purpose" test is incorporated through the option attribution rules in Treas. Reg. § 1.382-4(d).

[26] We recognize that, by taking into account only the stock interest that is the subject of the purported abuse and not other minority ownership -- a flaw it shares with the Parent Change Method -- the Supplemental Method, in effect, substitutes one less than perfect method for another, presumably in the hope of achieving rough justice.

stock ownership attributable to increases in subsidiary stock ownership to a percentage equal to the actual percentage increase in subsidiary stock ownership.

Fourth, based on Example 2 of Temp. Treas. Reg. § 1.1502-92T(c)(5), it appears that once the Supplemental Method has been tripped it continues to apply as a second method for determining an ownership change of the loss group (along with the Parent Change Method) as long as the testing date on which the increase in subsidiary stock occurred is within the relevant Section 382 testing period i.e., for up to 3 years. In that example, the increase in parent stock preceded the increase in subsidiary stock. The regulation provides no guidance as to how long the Supplemental Method should be applied if the facts are reversed. We believe it would be logical and appropriate to no longer apply the Supplemental Method, once the increase in subsidiary stock is outside the current testing period because the increase itself should no longer be counted as an adverse change.

Finally, the Temporary Regulations do not define the scope of the "plan or arrangement" that must exist for a third party to be considered a Co-Purchaser. The only example illustrating the rule simply recites that, "as part of a plan," the sole stockholder of a loss group sold 45% of the stock of the common parent to a single purchaser and a subsidiary in the loss group sold 20% of its stock to the public.[27] This example, although assuming rather than illustrating the existence of a plan, suggests a potentially broad concept of a plan or arrangement, whereby purchasers who presumably are unknown to each other are deemed to have acted pursuant to a plan.

In considering the appropriate scope of a plan or arrangement test, there are substantial commercial and practical limitations that should lessen Treasury's general level of

---

[27] Temp. Reg. § 1.1502-92T(c)(5), Example 2.

concern regarding the use of investments in subsidiary stock to circumvent the application of Section 382. As a threshold matter, it is important to recognize that the issuance of subsidiary stock to the "general" public (whether held in a few hands or by many) imposes significant corporate fiduciary responsibilities and, where applicable, securities law responsibilities on the parent company. In addition, there is often a market disincentive associated with subsidiary stock that represents a minority interest with less liquidity, and for larger investors, generally does not offer a comparable financial and control position in the loss group as a stock investment in the common parent. Thus, the issuance of subsidiary stock to new investors typically occurs only when such issuance is the only practical means available to the loss group to raise capital, such as where the common parent is highly leveraged.

Similar plan-type issues are raised by the definition of an "entity" set forth in Treas. Reg. § 1.382-3(a). There, an entity is defined as "any group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock." The regulation explains that the principal element in determining whether the "understanding" exists is whether the investment decision of each group member is based on the investment decision of one or more other members. That is not to say that each member must, in all circumstances, know the other member's identity. Presumably, however, the absence of knowledge would be rare. An example in the regulation illustrates the situation that apparently was most troubling the Treasury at the time. In that example, the management of the loss corporation meets with select investors friendly to management, each of whom is "aware" that management is meeting with other investors, and convinces the friendly investors to purchase stock of the loss company to ward off a takeover bid. The example concludes the various investors are acting pursuant to an informal understanding to make a coordinated acquisition. The issuances of stock to creditors in

a workout also raise a concern with respect to the potential application of the Supplemental Method, where the workout involves multiple affiliated corporations and requires the issuance of both parent and subsidiary stock, and Treas. Reg. § 1.382-3(a) sensibly provides the participation of creditors in a bankruptcy or insolvency workout will not cause the creditors to be considered an entity.

Letter Ruling 9245012 (August 3, 1992) illustrates the interpretational difficulties posed by the existing "plan or arrangement" concept, and the IRS's recognition that a more refined standard is needed. The ruling involved a highly leveraged parent company of a loss group ("Parent") that recently had acquired a subsidiary ("Subsidiary"). Parent had undergone shifts in ownership, in part related to the issuance of parent stock in connection with amendments to certain debt, the proceeds of which had been used to finance the acquisition of Subsidiary. To incentivize the Subsidiary's employees, Parent proposed to grant stock options for up to 10% of Subsidiary (which, under the option attribution rules as then in effect, generally would be deemed exercised if to do so would result in an ownership change). Prior to receiving his or her options, each employee would certify that he or she was "not acting under any formal or informal understanding with another person who has acquired stock (or options) of Subsidiary or Parent to make a coordinated acquisition of Subsidiary stock (or options)." The IRS ruled that each employee certifying the absence of such an understanding would not be treated as acting pursuant to a "plan or arrangement" with any 5% shareholder of the common parent for purposes of the Supplemental Method. Thus, it appears that the IRS has been willing to employ the "coordinated acquisition" standard of Reg. § 1.382-3(a) as a refinement of the requisite "plan or arrangement" to invoke the Supplemental Method. This makes practical sense, as the object of both provisions is to aggregate certain related acquisitions and treat stock acquired as held by one

person for Section 382 purposes. We recommend this standard be employed in final regulations in lieu of the "plan or arrangement" standard.

A "plan or arrangement" concept is also used in other provisions of the Code relating to stock acquisitions, such as in Section 355(d)(7)(B) (where two or more persons acting "pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing corporation or controlled corporation" are treated as one person), and Section 355(e)(2)(A) (generally treating as one integrated transaction any spin-off and subsequent transactions that are part of a " plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or controlled corporation"). Moreover, it is generally acknowledged that the "plan or arrangement" concept raises difficult issues in these contexts. In each of these cases, the "plan or arrangement" concept has been tailored to the purpose of the respective section. Accordingly, guidance under these sections is unlikely to provide meaningful guidance for Section 382 purposes. It seems to us that little would be gained, other than additional uncertainty and complexity, by incorporating into the Supplemental Method a plan or arrangement concept intended for other purposes instead of the coordinated acquisition approach.

We believe that the Supplemental Method serves a useful purpose as a backstop to the Parent Change Method. To further this purpose without unnecessarily interfering with legitimate business transactions, and to enhance the administerability of the Supplemental Method (both by taxpayers and the IRS), we recommend that:

1. The Supplemental Method apply only where a principal purpose for the increase in the ownership of subsidiary stock is to circumvent the Parent Change Method, and that

determination be based solely on the motivations of the existing 5% shareholder with whom the increase is associated.

2. The Supplemental Method apply only where the common parent has actual knowledge with respect of the increase in the ownership of the subsidiary stock by the 5% shareholder and, where applicable, the arrangement with the Co-Purchaser. Actual knowledge should be taken into account consistent with the rules in Treas. Reg. § 1.382-2T(k)(2), i.e., to the extent the common parent has knowledge on any testing date or acquires knowledge before the date the income tax return is filed for the taxable year in which the testing date occurs.

3. Regardless of whether an actual knowledge standard is adopted, final regulations provide that the common parent's duty of inquiry with respect to changes in the stock ownership of a consolidated subsidiary for purposes of the Supplemental Method is the established duty of inquiry under Temp. Treas. Reg. § 1.382-2T(k)(3), applied on a separate company basis as if the subsidiary were a loss corporation. So treated, the common parent's only affirmative duty of inquiry would be with respect to persons having a 5% or greater direct interest in the subsidiary.

4. Final regulations modify Temp. Treas. Reg. § 1.1502-92T(c)(4)(iii), which currently recasts the increase in the percentage ownership of a subsidiary as an issuance of parent stock of equal value, to provide that the percentage ownership of parent represented by the new issuance cannot exceed the percentage increase in the subsidiary stock (determined on a separate entity basis). This reflects the economic reality that, for example, a 10% interest in a subsidiary cannot represent a greater percentage interest in

the group as a whole, and would avoid the distortive ownership change result described above in the case of a highly leveraged parent company.

5. Final regulations clarify, in text, that the Supplemental Method applies only with respect to a given increase in the ownership of a subsidiary for so long as the testing date on which such increase occurred is within a relevant testing period. Accordingly, once an ownership change occurs or 3 years have passed since the 5% shareholder increased its ownership in the subsidiary, the Supplemental Method should no longer take such increase into account.

6. Final regulations substitute for the current concept of a "plan or arrangement" in transactions involving a Co-Purchaser the "coordinated acquisition" standard employed by Reg. § 1.382-3(a), and expressly incorporate by reference the principles of regulation (including the exclusion for workout and bankruptcy transactions). The coordinated acquisition rule provides a more clearly delineated standard, consistent with a developing body of law.[28]

7. Final regulations delete the special rule in Temp. Treas. Reg. § 1.1502-92T(c)(4)(iii), treating a Co-Purchaser as an independent 5% shareholder of the common parent with respect to any ownership it has in the common parent. Instead, final regulations should include an example illustrating that the application of the "coordinated acquisition" standard of Treas. Reg. § 1.382-3(a) has two consequences: first, it triggers the Supplemental Method and, second, it causes all the 5% shareholder's and Co-Purchaser's

---

[28] The IRS has issued several letter rulings that provide taxpayers with practical guidance. See, e.g., Ltr. Rul. 9533024 (May 19, 1995) (RICs and institutional investors with same investment advisor generally not aggregated); Ltr. Rul. 9610012 (December 5, 1995) (to same effect); Ltr. Rul. 9725039 (March 26, 1997) (similar treatment for employee stock plans).

stock ownership in the loss group (including any ownership the Co-Purchaser has in the common parent) to be treated as held by a single entity, which is considered a 5% shareholder of the common parent.

8. Final regulations clarify that the "supplemental ownership change rules" in Temp. Treas. Reg. § 1.1502-92T(c)(4) apply only for purposes of the Supplemental Method.

4. Treatment Of Departing Members.

One of the areas least developed by the Temporary 382 Regulations, and most in need of revision, is the treatment of members of a loss group (or subgroup) upon departure from the group. The issues presented in those circumstances include:

a. How to apportion the basic Section 382 annual limitation between the departing member and the remaining members of the group, and whether the same apportionment should apply where all or part of the departing member's NOL or capital loss carryforwards are reattributed to the common parent under Treas. Reg. § 1.1502-20(g).

b. How to apportion any previous increase in the Section 382 annual limitation as a result of previously recognized built-in gains among the members.

c. How to apportion any remaining NUBIL or NUBIG among the members.

The Temporary 382 Regulations attempted to address the first two of these questions, and as discussed below, we recommend certain changes be made to the "default" allocation provided in the regulations. Significantly, however, the Temporary 382 Regulations do not address the apportionment of the group's NUBIG or NUBIL to a departing member. It has been widely reported, based on informal discussions with the IRS and Treasury officials, that this omission was intentional and occurred to expedite the original release of the regulations in

proposed form. Unfortunately, this omission has left a significant hole in the framework of the regulations, with the potential for exploitation by both the IRS and taxpayers. A related issue, also discussed below, is the allocation of a separate Section 382 limitation applicable to a departing member.

a. Apportionment of Annual Limitation and Recognized Built-in Gains. Under Temp. Treas. Reg. § 1.1502-95T, any losses of a departing member that are subject to a consolidated (or subgroup) Section 382 limitation will, following the member's departure, remain subject to the member's allocable portion of the limitation. How much, if any, of the Section 382 limitation is to be apportioned to the departing member is left solely within the common parent's discretion (even in the case of a loss subgroup). Absent an express apportionment by the common parent, the member's allocable portion of the Section 382 limitation is deemed to be zero.

Temp. Treas. Reg. § 1.1502-95T(c)(2) provides that the common parent may affirmatively elect to apportion all or part of each "element" of the consolidated (or subgroup) Section 382 limitation. The regulation then provides that, "[f]or this purpose," the limitation consists of the following two elements: the "value" element of the limitation; and the "adjustment" element, which is any current year adjustment to the annual limitation attributable to (i) a carryover of unused prior year limitations or (ii) recognized built-in gains.

If the departure involves the termination of the entire loss group and no express allocation is made, the temporary regulations provide that the full limitation is apportioned to the common parent (or any continuing loss subgroup of which the common parent is a member). Temp. Treas. Reg. § 1.1502-95T(c)(5). Presumably, although not clearly stated in the

regulations, a similar rule applies upon the departure of an entire loss subgroup from the consolidated group without an express allocation.[29]

Although only the common parent may elect to apportion the consolidated or subgroup Section 382 limitation, the apportionment election must be signed by both the common parent and the departing loss member (or, in the case of a departure of multiple members that will comprise a new loss subgroup in its new consolidated group, the new loss subgroup parent). The election statement also must contain certain information set forth in the regulations and be filed with the appropriate tax returns of the common parent and the departing member. Any election is irrevocable, absent the consent of the Commissioner.

b. Alternative to No Apportionment. We recognize that a "default" rule is necessary to address the apportionment of an existing Section 382 limitation in the absence of an express allocation. We have, in our deliberations, identified various alternatives to the "zero" apportionment rule employed by the Temporary 382 Regulations, each having distinct advantages or disadvantages over the other. Each alternative is briefly summarized below, along with the perceived advantages and disadvantages of the zero apportionment rule. Our recommendation then follows.

Each method was evaluated recognizing that a default rule should, to the extent possible, be easily administerable yet work the least injustice in the most situations.

---

[29] Unlike the other portions of Temp. Treas. Reg. § 1.1502-95T(c), paragraph (c)(5) of that Section does not contain the standard parenthetical phrase extending the loss group concept to loss subgroups. Although Temp. Treas. Reg. § 1.1502-95T(b)(3) expresses the general intent that the principles of paragraph (c) are to be applied to loss subgroups, it literally applies only if "two or more former members are included in the same loss subgroup immediately after they cease to be members of the loss group." By its terms, it does not apply where the departure results in the termination of the entire loss subgroup. This issue should be clarified in final regulations.

(i) Zero Apportionment Rule: The zero apportionment rule employed by the Temporary 382 Regulations is administratively simple to apply. In addition, it applies the proper apportionment in those cases where the member leaving the group is either (i) a non-loss member or (ii) a loss member who, upon its departure, is subject to an ownership change that, in any event, would essentially curtail any meaningful use of its NOLs and other tax benefits. In all other cases, however, it would have the extreme effect of rendering unusable any tax attributes that are allocated to the departing member and are subject to the consolidated Section 382 limitation. The zero apportionment method thus fails to recognize the departing loss member's contribution to the Section 382 limitation (in terms of value or recognized built-in gains), or that the departing member may be allocated a meaningful portion of the group's consolidated tax attributes upon its departure.

In addition, the whole process of apportionment, and in particular the zero apportionment rule, is particularly troublesome in the case of intragroup movement of loss subgroup members where apportionment is required because the requisite Section 1504(a)(1) relationship is between the loss subgroup parent and the transferred member is severed.[30] In that instance, although the "departing member" is still within the consolidated group, its NOL carryforwards would, under a zero apportionment rule, generally be subject to a zero limitation and thus rendered effectively unusable, as illustrated by Example 6 below. Moreover, the consolidated group could be doubly penalized, in that upon the ultimate expiration of the losses a negative investment adjustment would be made to the stock of the loss subgroup member (and any upper tier subsidiaries) under Treas. Reg. § 1.1502-32.

---

[30] This result would be avoided if our recommendation to eliminate the required Section 1504(a)(1) relationship is adopted. <u>See</u> Section 1 above.

> Example 6. P is the common parent of a consolidated group in which there is a loss subgroup comprised of S and its wholly-owned subsidiary S1. The S loss subgroup is subject to a separate Section 382 limitation, incurred upon joining the P consolidated group. If S distributes the stock of S1 to P, S1 has departed the loss subgroup (unless P is treated as a successor to S). Unless P affirmatively apportions the S loss subgroup's Section 382 limitation, any NOLs of S1 would thereafter be rendered unusable due to the zero limitation even though S1 is still within the P consolidated group.

(ii) Relative Share of Tax Benefits. As one alternative to the current rule, the Section 382 limitation could be apportioned based on the departing member's relative share of the consolidated NOL of the loss group (with similar principles applying to subgroups).[31] This method would be easily administerable and would avoid allocating any Section 382 limitation to a non-loss member. Moreover, it addresses one of the disadvantages of the zero apportionment rule by attempting to ensure some apportionment of the consolidated Section 382 limitation to a departing loss member absent an express allocation. However, given that a member's allocable share of the consolidated loss has no necessary relationship to the size of the consolidated Section 382 limitation, this method could result in apportioning to the departing member an uneconomically large portion of the Section 382 limitation (such as in the case of a departing member that is essentially a shell loss corporation). Accordingly, if this method is utilized, we believe that any apportionment to the loss member should be limited to the separate Section 382 limitation, if any, that is imposed on the loss member upon its departure from the group. Such a limitation provides a reasonable measurement (utilizing traditional Section 382 concepts and principles) of the portion of the Section 382 limitation that the departing member could have

---

[31] See Temp. Treas. Reg. § 1.1502-21T(a)(2)(iv). In the event no consolidated NOL existed, other tax attributes of the loss group could be substituted. However, it seems to us that any attempt to take into account more than one type of tax attribute at a time would add undue complexity (given the differences between losses and credits and the various limitations that may be imposed on each) and should be avoided.

been expected to utilize had it stayed in the group. We believe that the benefits of such a limitation outweigh the potential for inconsistent reporting by the consolidated group and the departing member (due to valuation and interpretational issues) with respect to any new Section 382 limitation imposed on the departing member.

(iii) Relative Value At Date of Ownership Change. Another method that we considered, but rejected, was to apportion the Section 382 limitation based on the proportionate contribution of the departing member's equity value to the group's Section 382 limitation at the time of the ownership change. This has some conceptual appeal, but generally would require a separate valuation of the departing member on a historical basis, possibly many years prior, producing an administratively unworkable rule. This method also fails, absent special rules, to take into account any change in the location of the group's assets following the ownership change that might have enhanced or reduced the value of the departing member relative to the rest of the group. Those intercompany asset transfers are properly taken into account to the extent the assets also contributed to the value of the loss group at the time of the earlier ownership change.

> Example 7. P is the common parent of a loss group that has several first tier subsidiaries, including L. On January 1, 1999, P undergoes an ownership change, at which time P has a value of $100 and L has a value of $5. During the following year, P contributes $20 in additional assets to L, and L's business prospers. On July 30, 2000, P sell the stock of L for $50.

Under this relative value of ownership change method, L in the above example would be allocated only 5% of the consolidated Section 382 limitation.

(iv) Relative Value At Date of Departure. In addition, we considered and rejected as a possible method the apportionment of the consolidated Section 382 limitation based on the current value of the departing member relative to the current equity value of the common parent. Conceptually, of the methods described, this is the method most consistent with the

neutrality principle of Section 382 and the single entity approach of the consolidated Section 382 regulations. Had the departing member stayed in the group, it seems fair to assume, at least as a general matter, the member would have contributed to the group's income and availed itself of the consolidated Section 382 limitation proportionate to its relative earning potential, which, under Section 382, is assumed to be a fixed percentage of equity value (regardless of the nature of the corporation's business). Accordingly, apportioning the limitation on the basis of value generally should reach an equitable solution. However, unlike the zero apportionment rule or a rule based on the departing member's relative share of tax benefits, this method could result in a substantial allocation of the Section 382 limitation to a departing member with little or no losses. As such, were this method selected, we would recommend that the regulations preclude any apportionment to a non-loss member. However, here also, we believe the dependence of this method on valuations makes it administratively unworkable. Although, in this case, the departing member's value would be more readily ascertainable (as it would generally be established by the transaction pursuant to which the member left the group), the value of the common parent may not be so readily established. For example, in the context of a private company, the departing member typically would not have access to the books and records, or financial statements, of the common parent or the other members of the group.

In short, no single method fully satisfies both the criteria of simplicity and fairness. However, we recommend that the second of the four methods be adopted in lieu of the zero apportionment rule. Under that method, the apportionment would be based on the departing member's proportionate allocation of the consolidated NOL (except where no such NOL exists), but the apportioned amount would be limited to any new separate Section 382 limitation imposed on the member in connection with its departure. We believe this method best mitigates some of

the harshness of the zero apportionment rules, while maintaining an administratively workable, albeit still complex, rule.

c. Allocation Rule Needed for Reattributed Losses. Under the "loss disallowance" rules of the consolidated return regulations, a common parent may, upon a taxable disposition of a member's stock in a transaction that results in a disallowed loss, generally elect to reattribute to itself a portion of the NOL and capital loss carryforwards of the departing member. See Treas. Reg. § 1.1502-20(g). The regulations provide that the common parent succeeds to the reattributed losses as if the losses were transferred in a Section 381(a) transaction, and that any Section 382 event occurring with respect to the member upon its departure does not affect the reattributed losses. Moreover, Examples (1) and (3) of Treas. Reg. § 1.1502-20(g)(3) make clear that, by treating the common parent as a successor to the losses under Section 381, the reattributed losses continue to be subject to any limitations originally applicable to the departing member (including any SRLY taint). However, neither the loss disallowance regulations nor the Temporary 382 Regulations expressly permit the common parent to reattribute to itself any portion of a separate Section 382 limitation to which the reattributed losses may be subject. Absent such an allocation, the common parent arguably could be viewed as having succeeded to losses with a zero Section 382 limitation.

The preamble to the final loss disallowance regulations recognized the need for guidance in this area, stating that guidance would be forthcoming in connection with finalizing the consolidated Section 382 regulations and SRLY regulations. As one illustration, the preamble stated that "it is anticipated that § 1.1502-95 would be modified to provide that the common parent would be permitted to elect to retain all or any part of a Section 382 limitation

that applies to reattributed SRLY losses." We support the express adoption of such an election in connection with the issuance of final regulations.

In connection with permitting a reattribution, it also must be decided whether a common parent succeeding by reattribution to losses of a departing member of a loss subgroup would thereafter be considered part of the departing member's loss subgroup for purposes of any separate Section 382 limitation of that subgroup (as well as for SRLY purposes[32]). This would be important, for example, if another (non-departing) member of the loss subgroup recognizes a built-in gain that increases the subgroup Section 382 limitation. Presumably, if maintenance of a Section 1504(a) relationship continues to be required for Section 382 loss subgroup status, the common parent generally would not be included in the loss subgroup and the requisite allocation for a departing member would have to be made. If, as we recommend, such relationship is no

---

[32] Example (3) of Treas. Reg. § 1.1502-20(g)(3) illustrates the fact that a reattributed loss retains its SRLY status and that the common parent is treated as a successor to such loss, but does not explain how that treatment interfaces with the SRLY subgroup rules in light of Treas. Reg. § 1.1502-21T(f). That regulation provides that, although one member may be treated as a successor to another member (as the context may require), the successor member's income may not be taken into account for purposes of determining a SRLY subgroup's consolidated taxable income unless the successor acquires substantially all the assets and liabilities of its predecessor and the predecessor ceases to exist. In the case of a reattributed loss, the member has neither transferred substantially all its assets to the common parent nor ceased to exist. Thus, it would appear that the common parent's taxable income would not be taken into account in determining the taxable income of any SRLY subgroup in which the departing member was previously included. However, the preamble to the final loss disallowance regulations states that the SRLY limitation applicable to the reattributed losses is based on the contribution of the common parent to consolidated taxable income. See T.D. 8364, 1991-2 C.B. 43. This suggests that in treating the common parent as a successor to the reattributed losses under Section 381(a), the drafters of the regulations may have intended to treat the common parent in the same fashion as if the common parent acquired substantially all of the assets of the departing member in a tax-free reorganization or liquidation. In such event, the common parent's income would be taken into account in the determination of any SRLY subgroup limitation. We recommend that, if SRLY limitations are retained, final SRLY regulations clarify the application of the SRLY rules to reattributed losses in this manner.

longer required by final regulations, final regulations should make clear that the common parent would succeed to the member's status in the loss subgroup.

d. Allocation of NUBIGs and NUBILs. The Temporary 382 Regulations are silent as to how a departing member's "share" of the NUBIL or NUBIG of a loss group (or subgroup) is to be treated upon the member's departure from the group. Guidance is necessary in this area. Although the regulations address the apportionment of the so-called "adjustment" element of a consolidated Section 382 limitation, such element definitionally only includes any current year adjustments to the limitation attributable to (i) recognized built-in gains of the group or (ii) a carryover of unused prior year limitations.

The apportionment of a consolidated NUBIL or NUBIG raises several complex issues, including the following:

1. Should an express apportionment be permitted?

2. Absent an express apportionment, should a departing member's portion of a loss group's remaining NUBIL or NUBIG be determined based on its relative contribution (however determined) to the group's NUBIL or NUBIG? Or should the departing member simply be allocated an amount of NUBIL equal to its remaining net built-in loss, if any, that was taken into account in determining the NUBIL (or, in the case of a consolidated NUBIG, equal to its remaining net built-in gain, if any)?

3. Should a consolidated NUBIL (or NUBIG) be increased to the extent that a departing member had a net built-in gain (or, in the case of a NUBIG, a net built-in loss) that was taken into account in determining the NUBIL (or NUBIG) and had not yet been fully recognized?

4. Should there be different rules for a consolidated NUBIL than for a consolidated NUBIG?

e. Express Apportionment. We recommend the final regulations permit express apportionment for a consolidated (or subgroup) NUBIG, but not for a consolidated (or subgroup) NUBIL. In this regard, we observe that a consolidated NUBIL or NUBIG is directly related to specific assets of individual group members. Only certain assets will, when sold, result in a recognized built-in loss or a recognized built-in gain, as the case may be. Those assets may or may not be among those owned by the departing member. As a result, if express apportionment were permitted with respect to a consolidated (or subgroup) NUBIL, the NUBIL could be apportioned to a departing member that has assets that had little or no built-in losses at the time of the prior ownership change, effectively undermining the NUBIL rules. Accordingly, we do not believe it appropriate to permit an express apportionment of the NUBIL of the loss group (or subgroup).

By contrast, no similar abuse potential exists in the case of a consolidated (or subgroup) NUBIG. In this case, any misapportionment of the NUBIG would hurt, rather than help, the group or the departing member by making it less likely that the group or departing member would achieve the full benefit of the NUBIG in its Section 382 limitation. By contrast, there is no potential for abuse if the loss group apportions a consolidated NUBIG where it will do the most good, such as to a company most likely to sell its assets. Accordingly, consistent with the treatment of the basic Section 382 limitation, the final regulations should permit the common parent to expressly apportion the NUBIG of a loss group (or subgroup).

f. Absent an Express Apportionment. As discussed below, we recommend that, in the absence of express apportionment, a consolidated (or subgroup) NUBIL or NUBIG be apportioned by applying the following rules:

1. *General Rule.*

(a) *NUBIL*: A consolidated (or subgroup) NUBIL will be subject to apportionment only if and when (i) a member that had a net built-in loss that contributed to the group's NUBIL (taking into account the adjustments discussed below) departs the group (a "Former Net Built-in Loss Member") and (ii) the contributed built-in loss has not yet fully been recognized.

(b) *NUBIG*: Similarly, a consolidated (or subgroup) NUBIG will be subject to apportionment only if and when (i) a member that had a net built-in gain that contributed to the group's NUBIG (taking into account the adjustments discussed below) departs the group (a "Former Net Built-in Gain Member") and (ii) the contributed built-in gain has not yet fully been recognized.

> Explanation of Rule: Thus, the basic rule for both NUBILs and NUBIGs would be the same. In each case, no adjustment would be permitted to a group's NUBIL at the time a Former Net Built-in Gain Member leaves the group, and no adjustment would be permitted to a group's NUBIG at the time a Former Net Built-in Loss Member leaves the group. We do not believe it appropriate for a group's NUBIL or NUBIG to be increased by reason of the fact that a member leaves the group. We believe to so permit would significantly undermine the single entity approach of the regulations, increase substantially the degree of complexity of the regulations and introduce considerable potential for abuse.

(c) *Apportionment*: A group's NUBIL will be apportioned to a Former Net Built-in Loss Member, upon its departure from the group, to the extent of the unrecognized portion of the departing member's contributed net built-in loss, and a group's NUBIG will be apportioned to

a Former Net Built-in Gain Member, upon its departure from the group, to the extent of the unrecognized portion of the departing member's contributed net built-in gain (reduced, as discussed below, by any built-in gain recognized by the group with respect to the stock of the departing member).

> Explanation of Rule: In effect, a group's remaining NUBIL (or NUBIG) is split based on the relative amount of net built-in loss (or net built-in gain) that remains to be recognized by the departing member, on the one hand, and the remaining members of the group (treated as if they were a single entity), on the other hand. This rule seeks to preserve, to the greatest extent possible, the single entity approach of the regulations and the matching of built-in losses and built-in gains of the remaining group members.

2. *Adjustments*. For purposes of the foregoing apportionment, three adjustments apply:

(a) *Interim Contributions and Other Carryover Basis Transactions*: In determining the amount of a departing member's contributed net built-in gain or loss (and the unrecognized portion of such net built-in gain or loss), the member should be treated as owning as of the date of the earlier ownership change any assets it subsequently acquired in a carryover basis transaction from another member of the group to the extent such assets were included in the calculation of the consolidated (or subgroup) NUBIL or NUBIG.

(b) *Prior Intercompany Transactions*: The apportionment of any consolidated (or subgroup) NUBIL or NUBIG shall be made only after taking into account any built-in gains or losses (as applicable) that are recognized pursuant to Treas. Reg. § 1.1502-13 (or any predecessor regulation) upon the member's departure.

(c) *Stock Gain*: In determining the unrecognized portion of a departing member's contributed net built-in gain in the case of a consolidated (or subgroup) NUBIG, the portion should be reduced by the amount of any "recognized built-in gain" that the group recognizes

upon a disposition of the member's stock upon, or at any time prior to, the member's departure from the group.

> Explanation of Rule: The Temporary 382 Regulations disregard member stock in determining a consolidated (or subgroup) NUBIL or NUBIG. We agree with that approach, which we believe correctly reflects the single entity approach to the regulations as a whole and the general presumption that any gain or loss inherent in such stock duplicates the net gain or loss in the underlying assets of the member. We also concur in the treatment of any built-in gain or loss subsequently recognized upon a disposition of member stock as recognized built-in gain. That treatment is necessary to account for the fact that the group effectively can recognize the built-in gain attributed to a particular member by selling either the underlying assets or the stock of the member. Consistent with this approach, we believe it appropriate, in the case of a consolidated (or subgroup) NUBIG, to reduce the unrecognized portion of a departing member's contributed net built-in gain by any gain recognized by the group with respect to the member's stock upon, or prior to, such member's departure to the extent the gain is treated as recognized built-in gain for Section 382 purposes. We recognize that in many cases the correlation between the stock gain and the built-in gain in the assets of the departing member may be less than perfect. However, assuming our earlier recommendation is adopted, taxpayers would be permitted to expressly apportion the group's NUBIG between the departing member and the remaining members of the group to rectify any perceived imperfections. We do not believe that a comparable reduction is appropriate in the case of a consolidated (or subgroup) NUBIL where the group incurs a stock loss in connection with a member's departure that is not disallowed under Treas. Reg. § 1.1502-20. By its nature (because of the loss duplication factor), any such loss is necessarily a true economic loss incurred by the remaining members of the group that is not duplicated in the underlying assets of the departing member. As such, no reduction to the unrecognized portion of the departing member's contributed net built-in loss (and thus to the amount of the group's NUBIL to the apportioned to be departing member) appears appropriate.[33]

3. *Departure of Multiple Members in Same Transactions*. If more than one Former Net Built-in Loss Member (or more than one Former Net Built-in Gain Member) departs the group as part of the same transaction, and the departing members are not members of the

---

[33] Similarly, the group's NUBIL should not be reduced in respect of any stock loss that is disallowed under Treas. Reg. § 1.1502-20.

same consolidated group and same loss subgroup immediately after their departure, and the NUBIL (or NUBIG) to be apportioned is less than the aggregate of the unrecognized portions of the members' contributed net built-in losses (or contributed net built-in gains), the NUBIL (or NUBIG) shall be apportioned to the members in proportion to the unrecognized portions of the members' contributed net built-in losses (or contributed net built-in gains).

We believe that the rules proposed above reach a fair accommodation of the competing interests and issues raised by an apportionment of a consolidated (or subgroup) NUBIG or NUBIL. The following series of examples illustrates the application of the proposed rules, and certain benefits of such rules compared to other possible approaches.[34]

> Example 8. HC is the common parent of a loss group that underwent an ownership change on 1/1/98. L, L1 and G are first-tier, wholly-owned subsidiaries of HC. At the time of the ownership change, the HC group had a NUBIL of $100, comprised of the follow separate company net built-in gains and losses:

HC	L (NUBIL)	L1 (NUBIL)	G NUBIG	Group Total
0*	($80)	($240)	$220	($100)

> * excludes stock of L, L1 and G

> On 6/1/98, HC sells 25% of L in a transaction that deconsolidates L, but does not constitute an ownership change of L. At the time of the sale, HC has a tax basis of $200 in the stock of L, the stock of L has a value of $140, and the NUBIG/NUBIL composition of the members of the HC group remains unchanged from the time of the January 1 ownership change.

Under the proposed rules, L would be a Former Net Built-in Loss Member that is required to be apportioned a part of the loss group's NUBIL upon its departure from the group. At the time of the January 1 ownership change, L had a net built-in loss of $80, which

[34] Although the following examples focus on consolidated groups, similar principles apply in the case of subgroups.

contributed to the NUBIL, all of which remained unrecognized at the time of L's departure from the group. Under the proposed rules, because the unrecognized portion of L's $80 contributed net built-in loss is less than the loss group's remaining $100 NUBIL at the time of L's departure, L would be apportioned $80 of the NUBIL. It should be observed that this has the effect of splitting the remaining NUBIL based on the relative amount of net built-in loss that remains to be recognized by L ($80), on the one hand, and remaining members of the group treated as a single entity ($20), on the other hand.

In formulating the proposed rules, we considered and rejected an approach that would apportion a consolidated (or subgroup) NUBIL in proportion to the amount of the departing member's unrecognized contributed net built-in loss relative to the aggregate unrecognized contributed net built-in losses of all other remaining members. Thus, under this alternative, L1's still unrecognized net built-in loss would not be netted against G's contributed net built-in gain for purposes of the apportionment. This would result in L being apportioned $25 (i.e., $80/($80+$240) x $100), rather than $80. Significantly, this would leave the loss group with a remaining NUBIL of $75, unduly limiting the group's ability to utilize subsequently recognized built-in losses against later recognized built-in gains. Ordinarily, the NUBIL rules operate only to limit a corporation's ability to deduct recognized built-in losses in excess of the amount of its built-in gains as determined on the change date -- in effect, allowing a corporation that promptly sells all its assets to utilize its recognized built-in losses to offset any recognized built-in gains. This matching is preserved under our proposed rules, but does not exist under this alternative approach. Thus, under this alternative, were the remaining HC group to sell all its assets, it would be freely permitted to use only $165 of any recognized built-in losses (i.e., $240 - $75) against its potential $220 of recognized built-in gains.

It should be observed that, in the above example, Treas. Reg. § 1.1502-20(a) disallows the entire $15 loss realized by HC on its sale of the L stock. In addition, under Treas. Reg. § 1.1502-20(b), HC is required to reduce its tax basis in its remaining shares of L to fair market value ($105). Because there is no recognized loss, no adjustment to the group's NUBIL is necessary prior to apportionment. Moreover, no adjustment should be made in respect of the reduction in the tax basis of HC's remaining stock in L, because the reduction does not operate to reduce the remaining net built-in loss in the underlying assets.

We recognize that, under the proposed rules, a company may be advantaged by staging the disposition of its subsidiaries, such that the NUBIL (or NUBIG) is allocated to the first member to leave the group, assuming any subsequent departures are not part of the same transaction. However, we believe that the proposed rules preserve to the greatest extent possible the purpose and function of the NUBIL/NUBIG rules while reaching, without undue complexity, an administratively fair result.

> Example 9. The facts are the same as in Example 8 except that HC has a tax basis of $280 (rather than $200) in the stock of L. Thus, there is a built-in loss of $140 in the L stock, compared to a built-in loss of $80 in L's assets.

Under this example, HC has a realized loss of $35 on the sale of its 25% of L stock. Of this amount, only $20 is a "duplicated loss" within the meaning of Treas. Reg. § 1.1502-20(c) (determined on a per share basis). Accordingly, assuming there are no positive investment adjustments and no extraordinary gains, HC would recognize a $15 deductible loss. Under the proposed rules, this loss would reduce the group's NUBIL that is subject to apportionment, but would not reduce the portion allocated to L. This is appropriate because, by its nature, such $15 loss is a true economic loss incurred by HC and is not duplicative of the net

built-in loss in the underlying assets of L. Thus, under this example, L would be allocated $80 of the group's remaining $85 NUBIL (i.e., the original $100 less the $15 recognized stock loss).

> Example 10. HC is the common parent of a loss group which underwent an ownership change on 1/1/98. G, G1 and L are first-tier, wholly-owned subsidiaries of HC. At the time of the ownership change, the HC group had a NUBIG of $100, comprised of the follow separate company net built-in gains and losses:
>
> | HC | G NUBIG | G1 NUBIG | L (NUBIL) | Group Total |
> |---|---|---|---|---|
> | 0* | $80 | $50 | ($30) | $100 |
>
> * excludes stock of G, G1 and L
>
> On 6/1/98, HC sells 25% of G in a transaction that deconsolidates G, but does not constitute an ownership change of G. At the time of the sale, HC has a tax basis of $40 in the stock of G, the stock of G has a value of $120, and the NUBIG/NUBIL composition of the members of the group remains unchanged from the time of the January 1 ownership change.

Under the proposed rules, G would be a Former Net Built-in Gain Member that is required to be apportioned a part of the group's NUBIG upon its departure from the group. At the time of the January 1 ownership change, G had a net built-in gain of $80 which contributed to such NUBIG, all of which remained unrecognized at the time of G's departure from the group. Nevertheless, in determining the unrecognized portion of G's contributed net built-in gain for purposes of apportionment, such portion would be reduced under our proposed rules by the amount of any built-in gain in the G stock recognized by the group upon the disposition of such member's stock. Upon the sale of the G stock, HC recognized a $20 gain. Accordingly, assuming the full amount of such gain is a recognized built-in gain, both the amount of the group's NUBIG subject to apportionment and the unrecognized portion of G's contributed net built-in gain would be reduced by $20. G therefore would be apportioned $60 (i.e., $80 - $20) of the group's remaining NUBIG of $80 (i.e., $100 - $20).

We observe that, to the extent of HC's remaining stock interest in G, both HC and G may now benefit from a subsequent recognition of the same effective economic gain: HC upon a subsequent sale of its G stock, and G upon a subsequent sale of its assets. However, in no event will the combined increases in the Section 382 limitations of the HC group and G ever aggregate more than the HC group's original $100 NUBIG. Accordingly, we do not believe that such potential "duplication" of recognized built-in gain necessitates any modification to the existing NUBIG rules.

> Example 11. The facts are the same as in Example 8 except that on 6/1/98 HC sells 25% of the stock of L and L1 as part of the same transaction, but each to separate unrelated purchasers. Under Treas. Reg. § 1.1502-20, any stock loss realized by HC upon the sale of its stock in L and L1 is disallowed.

Under the proposed rules, both L and L1 would be Former Net Built-in Loss Members that are required to be apportioned a part of the HC group's remaining NUBIL of $100. Although sold in the same transaction, L and L1 were sold to separate purchasers and thus are not part of the same loss subgroup immediately after the sale. Because the HC group's remaining NUBIL of $100 is less than the aggregate of the unrecognized portions of L and L1's contributed net built-in losses -- which total $320 (i.e., L's unrecognized contributed net built-in loss of $80 plus L1's unrecognized contributed net built-in loss of $240) -- the entire NUBIL would be apportioned to L and L1. As between L and L1, the proposed rules would allocate the NUBIL in proportion to the unrecognized portions of their contributed net built-in losses. Accordingly, L would be apportioned $25 of the NUBIL ($80/$320 x $100), and L1 would be apportioned $75 of the NUBIL ($240/$320 x $100).

> Example 12. The facts are the same as in Example 8 except that, on 3/1/98, prior to the sale of L, G merged with and into L in a "D" reorganization (carryover basis) transaction.

Under the proposed rules, in determining the amount of L's contributed net built-in loss for purposes of apportioning the HC group's remaining NUBIL (and the unrecognized portion of such net built-in loss), L would be treated as owning as of the date of the earlier ownership change of the HC group any assets it acquired in the merger with G to the extent such assets were included in the calculation of the HC group NUBIL. Significantly, this would result in L having a contributed net built-in gain of $140 (i.e., the $220 contributed built-in gain of G less the original $80 built-in loss of L), rather than a contributed net built-in loss. Accordingly, at the time of its departure from the group on 6/1/98, L would no longer be considered a Former Net Built-in Loss Member and would not be apportioned any part of the HC group's remaining NUBIL. This same result would occur if G, rather than merging with L, contributed its assets to L in a Section 351 transaction following which L left the group.

5. Treatment of Intercompany Debt Obligations.

The consolidated intercompany transaction regulations generally treat such transactions as occurring between divisions of a single corporation to prevent intercompany transactions from distorting consolidated taxable income.[35] This single entity approach is not universal, however, and a separate entity approach is employed for some purposes. For example, although the timing of gain or loss on an intercompany transaction is generally taken in to account on a single entity basis, the location of such gain or loss is determined on a separate entity basis. We believe the treatment of intercompany debt in the Temporary 382 Regulations does not always appropriately apply single and separate entity concepts.

When a consolidated group (or subgroup) has an ownership change, it must determine whether the group has a NUBIG or NUBIL under Section 382(h)(3). In this regard,

[35] Treas. Reg. § 1.1502-13.

Temp. Treas. Reg. § 1.1502-91T(g)(1) excludes from that determination any unrealized built-in gains or losses attributable to a member's ownership of stock or debt of another member. This treatment of intercompany debt obligations is consistent with single entity principles, because any cancellation of indebtedness ("COD") income realized by the issuer on the satisfaction (or deemed satisfaction under Treas. Reg. § 1.1502-13(g)(3)) of the intercompany debt at a discount generally would be matched by an offsetting bad debt deduction of the holder. Similarly, any bond redemption deduction of the issuer on satisfaction (or deemed satisfaction) of the debt at a premium generally would be matched by an offsetting gain of the holder (which gain would be recharacterized as ordinary income under the single entity attribute redetermination rules).

While the Temporary 382 Regulations, using single entity principles, exclude intercompany obligations from NUBIG and NUBIL calculations in the first instance, Temp. Treas. Reg. § 1.1502-91T(h)(2) treats the gain or loss on the disposition of an intercompany obligation as a recognized built-in gain or loss. The problems created by this treatment of affiliated debt obligations is illustrated through the following example.

> Example 13. L and L1 are members of a consolidated group of which L is the common parent. All of the stock of L is owned by A, an individual. In Year 1, L loans L1 $100. In Year 2, the debt obligation is only worth $90. Also in Year 2, individual B acquires all of the stock of L from A. At the time of the acquisition, the L/L1 group has a NUBIL of $10, determined on a consolidated basis, without regard to gain or loss inherent in the stock or intercompany debt of L1. The NUBIL is attributable to assets held by L that L does not intend to, and does not, sell for at least 5 years after the acquisition. In Year 3, pursuant to a restructuring of the group's corporate structure, L sells the debt obligation to another member of the L group (other than L1) for $90.

Under Treas. Reg. § 1.1502-13(g)(3), L1 recognizes $10 of COD income on the deemed satisfaction of the transferred intercompany debt, and L has an offsetting $10 bad debt

deduction.[36] Under the intercompany transaction rules, the $10 inclusion and the $10 deduction are intended to match, avoiding any net affect on consolidated taxable. This treatment reaches the appropriate single entity result, because there would have been no net income or deduction if L and L1 were divisions of a single corporation.

The single entity result is not reached under the built-in gain and loss rules of the Temporary 382 Regulations. Under Temp. Treas. Reg. § 1.1502-91T(g)(1), when the L group is acquired by B and has an ownership change, the intercompany debt between L and L1 was specifically excluded from the calculation of the L group's $10 NUBIL. To this point, the correct results are reached. However, when L and L1 recognize their offsetting $10 of deduction and income, the system breaks down. Because the $10 bad debt deduction is treated as recognized built-in loss, its use is subject to the Section 382 limitation. Thus, for example, if the L group otherwise has no excess Section 382 limitation available, it appears that the L group effectively cannot offset L's $10 bad debt deduction against L2's $10 COD inclusion. This result frustrates the single entity principles underlying the Temporary 382 Regulations in general, and the consolidated determination of NUBIL.

It should be noted that this treatment of gains and losses with respect to intercompany debt can also benefit taxpayers improperly in circumstances where the group has a NUBIG and the recognition of COD income with respect to intercompany debt is treated as a recognized built-in gain. In such case, the member's gain increases the group's Section 382 limitation even though it is offset by an equal bad debt deduction. Accordingly, we recommend disregarding intercompany debt between members of a loss group or subgroup in determining recognized built-in gain or loss, just as they are disregarded in determining the existence of a

---

[36] The same results would occur if the L/L1 group were acquired by another consolidated group, rather than by individual B.

NUBIG or NUBIL, except to the extent of any net income or gain recognized by the group with respect to the disposition of an intercompany debt.[37] An exception would be applied to the extent that there is any net gain or loss recognized by the members of the loss group or subgroup.

We also observe that this issue does not arise with respect to the disposition of intercompany stock. Because there are no rules requiring the issuer and holder of intercompany stock to recognize offsetting amounts of gain and loss, the Temporary 382 Regulations properly treat gain or loss recognized by the holder as recognized built-in gain or loss.

6. Adjustments to Value Under Section 382(e)(2), (l)(1), and (l)(4).

Temp. Treas. Reg. § 1.1502-93T(b)(1) generally provides that the value of a loss group or subgroup for purposes of calculating the consolidated or subgroup Section 382 limitation is equal to the value of the stock of each member thereof, excluding stock of a member owned directly or indirectly by another member, and Temp. Treas. Reg. § 1.1502-93T(b)(2) provides that the value of the loss group or subgroup, as so calculated, is subject to adjustment under any rule in Section 382 or the regulations thereunder requiring an adjustment of value. These adjustments include Section 382(e)(2) (redemptions and corporate contractions), Section 382(l)(1) (certain capital contributions), and Section 382(l)(4) (ownership of substantial nonbusiness assets) adjustments. The Temporary 382 Regulations provide no guidance as to the proper application of these adjustments in the consolidated context. We recommend that final regulations provide such guidance, in the form described below.

---

[37] This result is consistent with the result reached under Treas. Reg. § 1.1502-13(c)(7), Example 10, which determines the amount of recognized built-in gain taken into account by virtue of an intercompany transaction on a single entity basis. The Committee supports the result reached in this example and believes that the underlying principle should be made explicitly applicable to intercompany debt.

a. <u>Redemptions and Corporate Contractions.</u> Section 382(e)(2) reduces a loss corporation's value by the amount of any redemption or corporate contraction that occurs in connection with an ownership change. As an initial matter, we recommend that final regulations state explicitly what we believe is already implicit: that redemptions or other corporate contractions by members of a loss group or subgroup that do not involve any transfer of value outside the group or subgroup are not taken into account under Section 382(e)(2). Thus, for example, where a subsidiary member redeems stock held by a parent member, the aggregate value of the group or subgroup remains unchanged for Section 382 purposes.

A more difficult issue is posed where the redemption or corporate contraction results in the transfer of value from a loss member or loss subgroup, but not outside the acquiring group. The following example illustrates the potential application of Section 382(e)(2) in that context.

> <u>Example 14.</u> In Year 1, P, a publicly held corporation, owns 49 percent of L, a loss corporation. The remaining 51 percent of L's stock is publicly held. L is the common parent of a consolidated group that consists of L and L1, each of which are operating companies. In Year 2, P acquires the remaining 51 percent of L stock for cash. Immediately following P's acquisition, L distributes the stock of L1 to P as a dividend, and P contributes L1 to another P subsidiary that engages in the same line of business as L1.

Upon P's acquisition of the remaining 51 percent of L stock, L undergoes an ownership change for purposes of Section 382. Under Section 382(b)(1) and Temp. Treas. Reg. § 1.1502-93T(b)(1), the L group's Section 382 limitation is determined by multiplying L's stock value immediately before the ownership change by the long-term tax exempt rate. If, however, it can be shown that L's dividend to P was made in connection with the ownership change, it would appear that the value of the L1 stock (i.e., the amount of the dividend) would be excluded from

L's stock value under Section 382(e)(2), in effect reducing the L group's overall Section 382 limitation.

On the one hand, the above analysis seems entirely appropriate when the redemption or corporate contraction effects a transfer of value outside of the loss group or subgroup. In Example 14, since P is clearly outside of the L-L1 loss group determining the L group's Section 382 limitation by reducing the value of the group by the amount of the dividend seems to follow directly from the statute. On the other hand, the result described above seems inconsistent with the flexibility generally permitted under the consolidated return regulations to rearrange corporate structures to allow businesses to be located within the consolidated group where it makes most sense as a business matter. Moreover, treating the distribution in Example 14 as a corporate contraction under Section 382(e)(2) is inconsistent with the thrust of the intercompany regulations that intercompany transactions should not impact results under Section 382, as illustrated by Treas. Reg. § 1.1502-13(c)(7), Example 10, which determines the amount of recognized built-in gain for Section 382 purposes resulting from an intercompany asset sale by a Section 382-limited member, followed by a later sale of the asset by the buying member on a single entity basis.

On balance, we recommend that redemptions and corporate contractions that transfer value within the acquiring group not reduce the value of a loss member or subgroup for Section 382 purposes. An exception to this rule should be provided for situations in which such redemption or corporate contraction occurs in connection with a redemption or corporate contraction by the acquiring group (or involves the extraction of funds from the target loss member or subgroup to repay financing obtained for the acquisition). Thus, in Example 14,

there would be no reduction in the value of the L/L1 subgroup unless B distributed the stock of L1, directly or indirectly, to B's shareholders.

b. Capital Contributions. The Temporary 382 Regulations also do not specifically address the application of the Section 382(l)(1) "anti-stuffing" rule in determining a group or subgroup's Section 382 limitation. Section 382(l)(1) excludes from the value of a loss corporation amounts attributable to a capital contribution received as part of a plan with a principal purpose of avoiding or increasing the Section 382 limitation. Except as provided in regulations, any capital contribution made within 2 years of an ownership change is presumed to be made for the prohibited purpose.

As an initial matter, we recommend that final regulations clarify that capital contributions between members of a loss group or subgroup are not taken into account under Section 382(l)(1), consistent with treating the loss group or subgroup as a single entity. Another issue that should be clarified in final regulations is that the anti-stuffing rule should not be applied to contributions of the stock of one member to another member prior to their acquisition by another group. This issue is illustrated by the following example.

> Example 15. P is the common parent of a consolidated group that includes its directly owned subsidiaries, L and L1. B, the common parent of another consolidated group, wishes to acquire the stock of L and L1. On leaving the P group, L and L1 would be allocated a portion of the P group's consolidated NOL. Provided that L and L1 are affiliated through a Section 1504(a)(1) relationship through a subgroup parent following the acquisition by B, L and L1 will qualify as a loss subgroup under the Temporary 382 Regulations. Accordingly, P contributes the stock of L1 to L immediately prior to the acquisition, and B acquires the stock of P.[38]

---

[38] We observe that under our proposal, described above, to eliminate the Subgroup Parent Rule, it would not be necessary to contribute the stock of L1 to L to achieve subgroup status. However, there may be other business or regulatory reasons influencing the decision to contribute the stock of L1 to L prior to the acquisition.

Applying the anti-stuffing rule in these circumstances is inappropriate. First, the rule runs counter to the express exception in Temp. Treas. Reg. § 1.1502-91T(d)(4) for restructurings undertaken to achieve the requisite relationship for qualifying for subgroup status. Second, it limits a group's flexibility with regard to locating businesses within a consolidated group, which the consolidated return regulations are generally intended to permit. Accordingly, we would recommend, at a minimum, that the anti-stuffing rule not apply to the contributions of stock of one member to another in connection with an ownership change if and to the extent that the members involved otherwise qualify as a subgroup after the ownership change.

A difficult issue exists where the contributed asset is not stock of another member, but other assets that have been associated with the business. This issue is illustrated by the following example.

> Example 16. Assumes the same facts as in Example 15, except that P contributes to L, in addition to the stock of L1, the land on which the factory owned by L is located and which is currently leased by P to L.

Once again, the language of Section 382(l)(1) is at odds with the flexibility inherent in single entity approach of the consolidated return regulations.[39] On the one hand, it seems inappropriate for the L/L1 Section 382 subgroup limitation to turn on where in the selling consolidated group the assets of the business being sold are located, as the selling group should be entitled to "gather up" the various pieces of the business being sold without running afoul of the anti-stuffing rule. On the other hand, the government has a valid interest in preventing the selling group from using that rationale to disguise a true stuffing transaction. Fortunately, the Temporary 382 Regulations already contain an anti-abuse rule, which, if properly modified, should be sufficient to address the government's concerns without applying the anti-stuffing rule.

---

[39] In some cases, the successor rule under the Temporary 382 Regulations may provide relief regarding this issue.

Temp. Treas. Reg. § 1.1502-91T(g)(3) precludes members of a subgroup from taking into account an asset that is acquired for a principal purpose to increase the Section 382 subgroup limitation by affecting the amount of NUBIG or NUBIG. This regulation could be broadened to cover stuffing transactions with a principal purpose of increasing the Section 382 limitation (e.g., by increasing value).

It is worth noting one further concern in the area of capital contributions. The application of the anti-duplication rules of Temp. Treas. Reg. § 1.382-8T could create the complete loss of stock value when equity is contributed from a nonmember of a subgroup to a member of a subgroup. For instance, if a parent corporation that was not a member of a loss subgroup (e.g., because the subgroup's NOL is SRLY as to the parent corporation) made a capital contribution to a member of the loss subgroup, Section 382(l)(1) would exclude the capital contribution from the loss subgroup's value. Under Temp. Treas. Reg. § 1.382-8T, unless the loss subgroup member makes an affirmative election to restore this value to the parent corporation, the parent's stock value would not reflect this capital contribution for its own Section 382 limitation purposes (e.g., if the parent has an NOL that is SRLY as to the subgroup). We thus propose that final regulations specifically state that if equity is contributed to the capital of a loss subgroup member which is excluded from the loss subgroup's value under Section 382(l)(1), the equity value be automatically restored to the contributor without the need for an affirmative election. This simple clarification would effectively eliminate a trap for the unwary.

c. Substantial Nonbusiness Assets. The last Section 382 value adjustment rule, Section 382(l)(4), also suffers from a lack of clarity in the context of a consolidated loss group or subgroup. Section 382(l)(4) reduces the value of a loss corporation that has substantial nonbusiness assets by the amount of such nonbusiness assets that are held by the loss corporation

immediately after the Section 382 ownership change. For purposes of this limitation, a loss corporation is considered to have substantial nonbusiness assets if such assets comprise one-third of the value of the total loss corporation assets.

Section 382(l)(4) appears to be designed to prevent taxpayers from stuffing loss corporations prior to an anticipated ownership change with large amounts of nonbusiness assets to increase the loss corporation's total value and thus its Section 382 limitation. It is only reasonable to apply the Section 382(l)(4) limitation in a consolidated group context when nonbusiness assets are transferred from a non-subgroup member to a subgroup member. When nonbusiness assets are transferred among subgroup members, there is no economic change in the value of the subgroup as a whole. If the Section 382 limitation is to be determined on a single entity basis among members of a subgroup, we recommend that final regulations provide that the substantial nonbusiness asset test of Section 382(l)(4) is determined on a loss group or subgroup basis. Hence, the subgroup would hold substantial nonbusiness assets immediately after the Section 382 ownership change only if the value of all nonbusiness assets within the subgroup is at least one-third of the value of the total subgroup assets. Intercompany stock and debt would be disregarded for this purpose.