REPORT NO. 1029

New York State Bar Association

Tax Section

Report on Temporary Regulation § 1.337(d) – 2T and Proposed Regulation § 1.1502-35[1]

I. Introduction

This New York State Bar Association Tax Section report comments on possible approaches the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") could adopt to determine whether and to what extent a member of a consolidated group should be allowed a tax loss on the disposition of the stock of a consolidated subsidiary where (i) the loss is attributable to the subsidiary's recognition of built-in gain ("BIG") (the "Son of Mirror Problem" or "Son of Mirror Transaction") or (ii) the loss recognition could result in the consolidated group claiming two tax losses from a single economic loss (the "Loss Duplication Problem").

The Son of Mirror Problem results from positive upward adjustments to subsidiary stock basis under Treas. Reg. § 1.1502-32 on the disposition by the subsidiary of BIG assets if the BIG assets were sold in the interim, resulting in an increase in basis under the consolidated return regulations where that BIG was already reflected in the basis of the subsidiary stock when the subsidiary was acquired by the consolidated group. In that case, if the BIG asset were sold in the interim (resulting in an increase in basis under the consolidated return regulations) the subsequent disposition of the subsidiary

[1] This report was prepared by members of the Committee on Consolidated Returns. The principal drafters of the report are Karen Gilbreath and Jonathan Kushner. Significant contributions were received from Larry Garrett, Irving Salem, Joel Scharfstein, Michael Schler, Elias Tzavelis and Gordon Warnke. Helpful comments were received from Kimberly Blanchard, Noel Brock, Robert A. Jacobs, Brian Peabody and Lewis Steinberg.

stock would result in an artificial loss. The use of this artificial loss is inconsistent with the repeal of the General Utilities doctrine.

In 1991, Treasury and the IRS promulgated Treas. Reg. § 1.1502-20 ("the LDR Rule"), which was designed to be the permanent solution to the Son of Mirror Problem. The LDR Rule generally disallows certain losses recognized by a member of a consolidated group on the disposition of the stock of a consolidated subsidiary. The LDR Rule interdicts Son of Mirror Transactions by disallowing losses on the disposition of subsidiary stock by a consolidated group to the extent upward adjustments in the subsidiary's stock basis reflected gain (or income) from the disposition (or consumption) of the subsidiary's BIG assets. The LDR Rule also addressed the Loss Duplication Problem by preventing a subsidiary's losses from being duplicated as investment losses of its parent when the parent disposes of the subsidiary. In Rite Aid Corp. v. United States,[2] the Court of Appeals for the Federal Circuit held the portion of the LDR Rule that prevented duplicated losses to be invalid.

On March 7, 2002, in response to the Rite Aid decision, the Treasury and IRS issued regulations under Section 337(d) of the Code to disallow artificial tax losses on a sale of subsidiary stock. Instead of the LDR Rule, Temporary Regulation § 1.337(d)-2T (the " -2T Regulations") now govern whether and to the extent a loss on the sale of a consolidated subsidiary's stock will be allowed. In contrast to the LDR Rule, the -2T Regulations deal solely with the Son of Mirror Problem and do not attempt to address the Loss Duplication Problem. The –2T Regulations provide the general rule that no loss will be allowed with respect to the disposition of a consolidated subsidiary, except to the extent the taxpayer establishes the loss is not attributable to the subsidiary's BIG recognition.

Simultaneously with the issuance of the –2T Regulations, the IRS issued Notice 2002-18,[3] which announced that the IRS would continue to attempt to prevent loss duplication within a consolidated group. The Notice announced that regulations would be issued to prevent the same consolidated group from obtaining a loss on both stock and

[2] Rite Aid Corp. v. United States, 225 F.3d 1357 (Fed. Cir. 2001).
[3] 2002-12 I.R.B. 644.

assets where both losses are derived from the same economic loss. On October 18, 2002, the IRS issued proposed regulations[4] (the "-35 Regulations") to implement Notice 2002-18. The – 35 Regulations prevent a consolidated group from duplicating losses via rules that (1) redetermine the tax basis of the stock of a consolidated subsidiary member before certain dispositions and deconsolidations of the subsidiary stock (the "Basis Redetermination Rule") and (2) suspend the time at which certain losses can be recognized on the disposition of stock of a consolidated subsidiary member (the "Loss Suspension Rule"). The Basis Redetermination Rule requires the consolidated group to redetermine the basis of the consolidated subsidiary stock immediately before a disposition or deconsolidation of a share of consolidated subsidiary stock if the tax basis of the transferred share exceeds its value. The Loss Suspension Rule generally defers loss recognized on the disposition of stock of a consolidated subsidiary and disallows the loss if it is later recognized on the consolidated group's tax return on the disposition of the asset.

As our prior reports on this subject when the Treasury and the IRS first began to consider these problems over 15 years ago reveal, the Tax Section recognizes the complex nature of these problems and the difficult choices the Treasury and the IRS face in preventing either the Son of Mirror Problem or the Loss Duplication Problem.[5] These difficult choices involve devising an approach that balances achieving the right result in all cases and at the same time not being unduly burdensome for taxpayers to comply with and for the IRS to administer. If the Treasury and the IRS are unable to devise a precise approach to these problems that is administrable, then, as is often the case, a "compromise" approach must be taken which will be overinclusive in certain instances (e.g., disallowing real economic losses) and underinclusive in others (e.g., allowing artificial losses to shelter economic gains).

[4] 67 F.R. 65,060 (Prop. Treas. Reg. § 1.1502-35).

[5] New York State Bar Association Tax Section, Report on Built-In Gains and the Investment Adjustment Rules in the Consolidated Return Regulations, 90 TNT 30-17 (January 17, 1990) (the "1990 Report"); and New York State Bar Association Tax Section, Comments on Proposed Treasury Regulation § 1.1502-20, 91 TNT 37-21 (January 29, 1991) (the "Peaslee Letter").

Section II of this report sets forth a summary of our conclusions. Section III of the report briefly describes the Son of Mirror Problem and the Loss Duplication Problem and summarizes the prior and current Treasury and IRS attempts to address these problems. Section IV of the report considers whether the -2T Regulations or an alternative approach should be fashioned to address the Son of Mirror Problem. In evaluating the approach to be adopted, the report considers issues such as whether the regulations should treat items of built-in income ("BII") (e.g., income produced from the use of intangible assets) in the same manner as BIG recognized on the disposition of an asset and whether the rules should be limited to losses or should also prevent artificial sheltering of other economic income. The report also discusses several other issues likely to arise in adopting a series of rules to deal with the Son of Mirror Problem. Section V of the report considers how best to achieve the objective of preventing the Loss Duplication Problem within the same consolidated group.

II. Recommendations

We believe that the Son of Mirror Problem and the Loss Duplication Problem are caused by a limited group of transactions, rather than fundamental flaws in the investment adjustment rules. Thus, we agree with the decision by the Treasury and the IRS not to revise the investment adjustment rules. Instead, we recommend that the government adopt specific targeted approaches in addressing each of these problems.

Approach to the Loss Duplication Problem

The Tax Section appreciates the importance of issuing regulatory guidelines in temporary or final form with respect to the loss duplication issue on or before March 15, 2003. Earlier drafts of this report attempted to identify technical problems the with -35 Regulations and make appropriate recommendations. Ultimately, however, we concluded that the proposed -35 Regulations were sufficiently complex and potentially unadministerable that we did not believe satisfactory changes could be made to those regulations prior to March 15. We have doubts about whether the approach taken in the -35 Regulations, even with significant reworking, is the proper way to address the loss duplication problem, although we express no view at this time.

Even assuming the approach taken in the -35 Regulations is determined to be appropriate, we do not believe the -35 Regulations can be fixed by March 15 to work satisfactorily. For that reason, we believe the prudent course at the moment would be to adopt an interim anti-abuse rule that focuses on loss duplication and acceleration. That would solve the March 15 deadline problem and permit a more considered undertaking.

While the government continues to study the scope of the Loss Duplication Problem, we recommend the adoption of an interim rule that focuses on the Loss Duplication Problem as a problem of abuse. The suggested anti-abuse rule would apply if a taxpayer engages in a "stuffing transaction" with a view towards either loss duplication or acceleration. If the prohibited view exists, the results should be based on the principles set forth in the -35 Regulations, namely that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss, and that loss should not be allowed while the asset remains within the group.

As always, we stand ready to assist in any way we can.

<u>Approaches to the Son of Mirror Problem</u>

We considered two alternative approaches to addressing the Son of Mirror Problem. Each approach would be comprised of certain presumptions and certain rules allowing taxpayers to trace in order to rebut the presumptions. One approach, which we term the "Presumptive Approach," relies on the presumptions set forth in Clauses (1) and (2) of the LDR Rule to prevent the Son of Mirror Transactions. If the government were to adopt this Presumptive Approach, we recommend several possible additional rules that likewise should be adopted to alleviate the overbreadth of these presumptions. The alternative approach, the "Modified –2T Regulations," would initially disallow losses on disposition of a consolidated subsidiary subject to taxpayer rebutting this general rule through tracing.

Each of these approaches would contain rules to prevent Son of Mirror Transactions that result from the recognition of BII for a limited period of years, subject to certain anti-abuse rules. Further, while we understand the reasons that the government has limited approaches to the Son of Mirror Problem to the disallowance of losses, we suggest that the government may want to consider a limited approach in addressing the potential for understated gain because BIGs are already reflected in stock basis. Whether or not a limited approach to preventing understated gain is adopted, either of our suggested approaches should provide for certain anti-stuffing rules.

Each of the suggested approaches should prevent artificial losses from Son of Mirror Transactions, but generally should not result in the disallowance of real economic losses. Because both approaches involve certain presumptions and the opportunity to trace to rebut these presumptions, we believe that either approach should be acceptable to the government and taxpayers.

III. Background

In considering the possible approaches the Treasury and the IRS could adopt to address the Son of Mirror Problem and the Loss Duplication Problem, it is necessary to review the scope of both problems and the prior attempts to address the problems. If one determines that the problem is caused by a limited group of transactions, then a specific targeted solution would seem to be the appropriate approach. However, if the problem results from fundamental flaws in how the consolidated return rules work, then a more expansive solution would seem to be necessary and appropriate. Further, given the lengthy history of the LDR rules, we do not want to consider unnecessarily approaches that previously have been rejected for good reason.

A. The Investment Adjustment Rules

The investment adjustment rules of Treas. Reg. § 1.1502-32 are designed to prevent income or loss that has been recognized for income tax purposes by a subsidiary in a consolidated group from again being recognized as investment gain or loss by the subsidiary's parent upon a disposition of the subsidiary's stock. The rules generally accomplish this goal by requiring positive or negative adjustments to the basis of the subsidiary's stock to reflect the increase or decrease resulting from gain or loss recognized by the subsidiary. These adjustments occur regardless of whether the basis of the subsidiary's stock already reflects that gain or loss, thereby introducing the Son of Mirror Problem.

We believe that the Loss Duplication Problem arises from certain assumptions the investment adjustment rules make regarding the shareholder's interests in the subsidiary. One assumption is that the subsidiary's losses are borne by the holders of the common stock before the holders of the preferred stock. Another assumption is that each share within a class of stock should be allocated an equal portion of the subsidiary's items of income and gain, and with respect to common stock, of deduction and loss. In accordance with these assumptions, the investment adjustment rules generally allocate basis adjustments without regard to differences in members' tax bases in their shares of stock in the consolidated subsidiary member and without regard to whether a basis adjustment reflects an item of income, gain, deduction or loss that was built-in with respect to contributed property. By relying on these assumptions, the investment adjustment rules introduce certain potential Loss Duplication Problems.

B. Son of Mirror Problem

In the Tax Reform Act of 1986, Congress repealed the General Utilities doctrine by requiring corporate level gain recognition on a corporation's sale or distribution of appreciated assets, in a liquidating or nonliquidating context.[6] The Tax Reform Act of 1986 also introduced Code Section 337(d), which grants the Treasury authority to promulgate regulations to ensure that the purposes of the repeal of the General Utilities doctrine "may not be circumvented through the use of any provisions of law or regulations (including the consolidated return regulations . . .)." The legislative history of the Tax Reform Act of 1986 reveals that a purpose for the repeal of the General Utilities doctrine was to require the payment of a corporate tax in a transaction that

[6] Pub. L. No. 99-514. Prior to the Tax Reform Act of 1986, the General Utilities doctrine permitted a corporation to distribute appreciated property to its shareholders without recognizing gain at the corporate level. The Tax Reform Act of 1986 repealed the General Utilities doctrine by amending Sections 311(b) and 337 to require that corporations recognize gain on the distribution or sale of appreciated property.

results in a stepped-up tax basis of transferred corporate property for the new owner of corporate assets.[7]

After repeal of the General Utilities doctrine, the operation of the investment adjustment rules permitted a consolidated group to sell assets without paying a corporate tax and for the buyer of the assets to obtain a stepped-up tax basis in those assets. This transaction came to be known as the Son of Mirror Transaction, illustrated by the following example.

> Example 1. Target Subsidiary ("S") has a single capital asset with a basis of $0 and a value of $100. Parent ("P") buys all the S stock for $100. P and S file a consolidated income tax return. S sells its asset for $100, recognizing a gain of $100. Under the investment adjustment rules, P's stock basis in S increases by $100 to $200. P sells the stock of S for $100, recognizing a capital loss of $100.

As the above example illustrates, the Son of Mirror Transaction violates the policy for General Utilities repeal, because the loss on the sale of the consolidated subsidiary's stock offsets the gain on the sale of the BIG asset by the consolidated subsidiary, resulting in the P consolidated group having no net income. The elimination of corporate-level tax on the gain from the disposition of S's asset results from the BIG in S's assets already being reflected in P's cost basis in the stock on the purchase date. Thus, the increase in S's stock basis on the recognition of the BIG from the asset sale results in a double counting of the BIG in stock basis. The consequence of this double counting of BIG allows P an artificial tax loss that can be used to offset S's real economic gain on the asset sale.

The IRS responded to the Son of Mirror Transaction in Notice 87-14,[8] which stated that:

In general, the adjustment to stock basis will not reflect built-in gains that are recognized by target on sales of, or by reason of distribution of, its assets. Thus, in cases

[7] H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-2-2 (1986); Preamble to T.D. 8294 (March 14, 1990).
[8] 1987-1 C.B. 445.

where a target's stock is sold, the regulations will prevent recognition of losses that are attributable to the subsidiary's recognition of built-in gains.

C. LDR Rules

Three years after the publication of Notice 87-14, the Treasury and the IRS issued Temp. Treas. Reg. § 1.1502-20T (the "1990 Temporary Regulations").[9] These temporary regulations adopted a different approach from the one that Notice 87-14 indicated would be forthcoming. Rather than amending the investment adjustment rules to preclude positive basis adjustments for the recognition of BIG that was already reflected in stock basis, the 1990 Temporary Regulations adopted a rule disallowing all losses on the disposition of subsidiary stock.

The preamble to the regulations gave two justifications for this blanket rule. The first, consistent with the intent of Notice 87-14, was to prevent Son of Mirror Transactions. This was accomplished by eliminating the possibility that gain recognized on a disposition of an acquired subsidiary's BIG assets could be offset by a loss at the parent level created by an investment adjustment caused by the subsidiary's recognition of that BIG. The second justification related to a concern that was distinct from the Son of Mirror Problem. The second concern related to the Loss Duplication Problem, in which a loss on the disposition of the stock of a subsidiary reflects an excess of tax attributes over value of the subsidiary's assets, thereby potentially duplicating that loss. This concern extended beyond the situation where the same consolidated group would obtain two deductions with respect to the same economic loss, to situations where the consolidated group and a different taxpayer would obtain a tax benefit from the same loss. For example, if a subsidiary incurs a loss that is not used to reduce its or other group member's taxable income, then the basis of the subsidiary's stock is not reduced. In such case, the parent can recognize a loss on the sale of the subsidiary's stock and, subject to limitation provisions like Section 382, the disposed of subsidiary can use its losses on its separate return or in its new consolidated group. The Loss Duplication

[9] 55 Fed. Reg. 9,426 (1990).

Problem involving two unrelated taxpayers benefiting from the same unrealized loss is illustrated by the following example.

> Example 2. Parent ("P") forms a subsidiary ("S") with a contribution of $100, and P and S file a consolidated income tax return. S's assets decline in value to $40. Because the loss is unrealized, P's basis in its S stock is not reduced. If P sells all the S stock for $40, P would recognize a $60 loss. S can sell its assets for $40, likewise recognizing a $60 loss.

In justifying its opposition to the duplicated loss created in the example, the preamble to the temporary regulations indicated that taxpayers could always use self-help to avoid duplication of gain (e.g., by asset sales or stock sales with a section 338(h)(10) election). However, taxpayers could preserve duplicated losses where they disposed of a subsidiary.[10]

The preamble to the 1990 Temporary Regulations is very instructive because therein the Treasury and the IRS set forth their rationale for not adopting certain approaches. The preamble noted that the most accurate approach for preventing the Son of Mirror Problem would be a tracing regime to eliminate positive investment adjustments to the extent such adjustments are attributable to the recognition of BIG. This approach was rejected as administratively burdensome to both taxpayers and the IRS.[11] Implementing a tracing approach would require appraisals at the time the subsidiary was acquired and tracing of each asset with BIG to determine the extent to which the BIG was recognized (either by sale of the asset or by consumption of the asset in the subsidiary's business) while the subsidiary was a member of the consolidated group. The preamble also discussed the difficulties of applying a tracing approach to the disposition of an asset through its consumption in the business, i.e., "wasting assets" that are used up in the process of earning income. A second approach that was rejected was to create a presumption concerning the extent to which a subsidiary's recognized gain is

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[10] The IRS adopted this view even though several other provisions potentially could limit the purchaser's use of the subsidiary's attributes or high tax basis. See, e.g., Sections 269, 382 and 384.

[11] For a discussion of many of the issues that would have to be addressed to successfully implement a tracing approach, see Schler, Consolidated Return Loss Disallowance: Conceptual Issues, 95 Tax Notes 899 (May 6, 2002) ("Schler on Loss Disallowance").

BIG and to eliminate positive basis adjustments to that extent. To illustrate, the presumption could apply to disallow positive adjustments for 50 percent of the subsidiary's post-acquisition income, up to the amount of its BIG. The Treasury and the IRS recognized that adopting this presumptive approach produces correct or equitable results only if the actual facts correlate with the facts presumed, and therefore ultimately rejected this approach as imposing harsh results in some cases while failing to prevent the elimination of corporate-level tax in other cases. Finally, the Treasury and the IRS rejected a loss limitation approach that would have disallowed a loss on disposition of subsidiary stock unless the taxpayer could establish that the loss was not attributable to the recognition of BIG. The Treasury and the IRS reasoned that this approach had all the complexities and administrative burdens of tracing.[12]

In addition, the preamble to the 1990 Temporary Regulations justified a blanket loss disallowance rule by citing the situations that the rules did not reach that could be advantageous to taxpayers. For example, the new rules did not apply to situations where basis increases resulting from the recognition of BIG do not create a loss on disposition of the subsidiary; therefore, the recognition of BIG could shelter post acquisition appreciation in a subsidiary.

> Example 3. A subsidiary ("S") has two assets, one with a basis of $0 and a value of $100 and the other with a basis and value of $0. Parent ("P") purchases the S stock for $100. S sells the first asset for $100, resulting in an increase in P's basis in the S stock to $200. The remaining asset appreciates in value to $100, and P sells its S stock for $200, reflecting the economic gain of $100 and recognizing no gain or loss for federal income tax purposes. Because of the post-acquisition appreciation of the second asset, there is no loss on disposition of the subsidiary to which the LDR Rule could apply. In that case, P's basis increase shelters the gain from appreciation of the second asset.

The package that included the temporary regulations also published another set of rules under the authority of Section 337(d) to cover the period from the issuance of Notice 87-14 to the issuance of the 1990 Temporary Regulations. These rules are set

[12] Although most of the burden under this approach would be on the taxpayer, the IRS would have to examine the taxpayer's valuations.

forth in Treas. Reg. § 1.337(d)-1 and 2 (the "1990 Transition Rules"). Under the 1990 Transition Rules, a loss on the sale of subsidiary stock was disallowed unless (1) the parent disposed of all its stock in the subsidiary in a single transaction to an unrelated party, and (2) the selling parent established that the loss was not attributable to the subsidiary's recognition of BIG on the disposition of an asset, where that BIG was already reflected directly or indirectly in the stock basis of the subsidiary. The approach of the 1990 Transition Rules placed the burden on taxpayers to appraise and trace assets so to overcome the loss disallowance rule. Apparently, the IRS was willing to adopt a loss limitation approach that would involve tracing where tracing would be required for a limited period of time.

The difference between the approach of the 1990 Temporary Regulations and the approach suggested by Notice 87-14 generated an extensive amount of commentary.[13] In particular, the comments questioned the validity of a blanket loss disallowance rule that would deny a deduction for true economic losses. The public reaction to the 1990 Temporary Regulations caused the Treasury and the IRS to withdraw these regulations and to reconsider their approach to loss disallowance.

In 1991, the Treasury and the IRS finalized the LDR Rule, which attempted to deal with both the Son of Mirror Problem and the Loss Duplication Problem.[14] The LDR

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[13] See, e.g., American Bar Association, Section of Taxation Committee on Affiliated and Related Corporations, Comments Re: Temp. and Prop. Treas. Reg. §§ 1.1502-20T and 1.337 (d)-1T (October 2, 1990), 90 TNT 213-32; Philadelphia Bar Tax Section Letter to Fred T. Goldberg Jr. (June 27, 1990), 90 TNT 145-37; Paul Zagortz, Hallmark Cards, Inc., Letter to Robert Boyer (June 12, 1990), 90 TNT 129-33; New York State Bar Association Tax Section Outline of Presentation by Tax Section of New York State Bar Association Re: Treasury Regulation §1.1502-20T (June 7, 1990), 90 TNT 126-43; Tax Executives Institute, Outline of Oral Comments of Michael A. DeLuca, Household International, Inc., (June 1, 1990), 90 TNT 135-27; and New York State Bar Association Tax Section Letter to Kenneth W. Gideon (April 17, 1990), 90 TNT 83-16.

[14] In November 1990, the IRS withdrew the 1990 Temporary Regulations and reproposed new regulations in their place. 55 Fed. Reg. 49,075 (1990). These reproposed regulations were more taxpayer friendly than the 1990 Temporary Regulations and the approach of these regulations was largely adopted in the LDR Rule. The reproposed regulation continued to reflect the government's attempt to prevent the Loss Duplication Problem. The justifications given for not permitting Loss Duplication in the consolidated return context are that: such a result is inconsistent with the single entity treatment of consolidated groups; the Supreme Court decision in Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934), supports attempting to preclude loss

Rule, as revised, addressed the concerns expressed in the commentary by limiting the amount of loss that could be disallowed. Under the LDR Rule, losses on a disposition of subsidiary stock were disallowed to the extent of the sum (without duplication) of:

Clause (1) - the subsidiary's income or gain from extraordinary asset dispositions;

Clause (2) - the amount of positive investment adjustments with respect to subsidiary stock; and

Clause (3) - the amount of duplicated loss with respect to subsidiary stock.[15]

Clauses (1) and (2) were specifically aimed at Son of Mirror Transactions. Clause (1) is targeted toward the transaction described in Example 1. Clause (1) is overbroad because it is premised on the presumption that all extraordinary asset dispositions and exchanges producing gain are attributable to BIG. Clause (2) is aimed at preventing Son of Mirror Transactions that result from BII[16] generated by an appreciated asset that is consumed through its use in the business. This clause also is overbroad because it assumes all income earned by the subsidiary post-acquisition is BII. The positive investment adjustment factor did not allow netting of negative investment adjustments for a year with positive investment adjustments for another year; however, netting of positive and negative adjustments within the same year are permitted. This netting could be overbroad in that built-in loss ("BIL") recognized in one year was not permitted to be netted against BII recognized in another year and under inclusive in that loss from operations recognized in one year was permitted to be netted against BII recognized in the same year. Clause (3) was intended to prevent the Loss Duplication Problem, which arises where losses attributable to an affiliated subsidiary's unrecognized, or recognized but unused, losses are preserved for use outside the consolidated group.

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duplication; and statutory provisions like Sections 269, 382 and 384 may not significantly limit duplicated loss.

[15] The duplicated loss is determined by a formula that attempts to compute the excess of the subsidiary's tax assets (e.g., the aggregate tax bases of assets, loss carryovers and deferred deductions) over the gross value of the subsidiary's assets. Treas. Reg. § 1.1502-20(c)(2)(vi) provides a specific formula for determining whether a duplicated loss exists.

[16] Built-in income generally includes income attributable to periods prior to the date on which the subsidiary became a member of the consolidated group but which is collected, and therefore taken into account, after the subsidiary became a member of the consolidated group.

Recognizing that the LDR Rule potentially could disallow certain stock losses that represented real economic losses, where the subsidiary whose stock was being disposed of had an NOL or capital loss carryover, Treas. Reg. § 1.1502-20(g) allowed the common parent of the consolidated group to reattribute the subsidiary's loss to the common parent. This reattribution election was available only to the extent a stock loss otherwise would have been disallowed. The reattribution election permitted a parent company to replace a disallowed loss on the stock sale with a loss that it could carry forward and potentially use in the future.

D. Rite Aid

In Rite Aid,[17] the Court of Appeals for the Federal Circuit held that the loss duplication factor of the LDR Rule was invalid. In reaching its holding, the Federal Circuit reasoned that the duplicated loss on the sale of a consolidated subsidiary's stock is not solely a consolidated return issue and, therefore, the IRS did not have the authority in the consolidated return regulations to disallow the loss. In this regard, the potential for duplicating losses exists outside of the consolidated return context; for example, where a taxpayer transfers built-in loss assets to a corporation in a transaction qualifying under Section 351. The court specifically stated "in the absence of a problem created from filing consolidated returns, the Secretary is without authority to change the application of other tax code provisions to a group of corporations filing a consolidated return."

The IRS petitioned for a rehearing en banc, and the petition was denied. The Solicitor General's office determined not to petition for certiorari to the Supreme Court.

The Rite Aid decision raised the possibility that taxpayers could challenge the validity of other consolidated return regulations where the regulation required a different result from the result required under statutory provisions governing taxpayers filing separate tax returns. To prevent potential protracted litigation over the validity of these rules, legislation has been proposed that would affirm the power of the Treasury

[17] Rite Aid Corp v. United States, 255 F. 3d 1357 (Fed Cir 2001), reh'g denied, 2001 U.S. App. LEXIS 2307 (Fed Cir 10/03/2001). This decision reversed the decision of the Court of Federal Claims upholding the validity of the loss duplication prong of the LDR Rule. 46 Fed. Cir. 500 (April 21, 2000).

Department to prescribe consolidated return regulations that differ from the rules applicable to separate returns.[18] This proposal would not overrule the decision in Rite Aid. However, the legislative history clearly indicates that the legislation is intended to overrule the reasoning of Rite Aid that the consolidated returns cannot prescribe a rule different from the rules applying to taxpayers filing separate returns.[19]

E. IRS Reaction to Rite Aid

In Notice 2002-11, the IRS conceded the invalidity of the loss duplication factor. The Notice states that "in the interests of sound tax administration the government would not continue to litigate the validity of the loss duplication factor." The Notice further provides that because of the interrelationship in the operation of all the loss disallowance factors, new rules would be implemented on a prospective basis that would be an amended version of the 1990 Transition Rules.

Shortly after Notice 2002-11, the IRS issued the -2T Regulations. The rule of the -2T Regulations, rather than the LDR Rule, governs the allowability of losses on all sales (or other dispositions) of stock of a consolidated subsidiary on or after March 7, 2002.[20] The basic rule of the -2T Regulations is that no loss is allowed for any loss recognized on disposition of a consolidated subsidiary. However, unlike the LDR Rule, to the extent the taxpayer establishes that the loss is not attributable to recognition of BIG from the disposition of an asset, the loss would be allowed.[21] The -2T Regulations are generally identical to the 1990 Transition Rules, except that the -2T Regulations removed the condition of the 1990 Transition Rules that all the stock of the subsidiary must be sold for the selling parent to recognize a loss.

[18] Section 631 of the Care Act of 2002, H.R. 7, as amended.
[19] S. Rep. No. 107-211, 107th Cong., 2nd Sess. (July 16, 2002) and JCT-61-2002 (June 12, 2002).
[20] For sales of subsidiary stock prior to March 7, 2002, taxpayers can elect to apply the -2T Regulations. This election applies to all open years and would apply to a loss from a closed year if the application of the -2T Regulations would result in a new loss carryover to an open year.
[21] The taxpayer also has to satisfy a procedural requirement and file a procedural statement, which is entitled Treas. Reg. § 1.337(d)-2T statement, with its tax return for the year of disposition.

On May 31, 2002, the IRS amended the -2T Regulations to, among other changes, add a netting rule, which is similar to the netting rule set forth in Treas. Reg. § 1.1502-20(a)(4). The netting rule is an exception to the general loss disallowance rule, providing that loss with respect to a disposition of stock of an affiliated subsidiary can offset gain if such gain results from the disposition of stock with the same material terms of such subsidiary and the gains and losses from the disposition of the subsidiary stock are taken into account as a consequence of the same plan or arrangement. The netting rule similarly applies on deconsolidation of an affiliated subsidiary.

The hearing notice with respect to the –2T Regulations suggests that the -2T Regulations may only be a stopgap measure while the IRS considers how to address other aspects of loss disallowance. In this regard, the IRS and Treasury are continuing to consider how to deal with BIG (or BII) assets that are consumed in the subsidiary's business rather than disposed of by the subsidiary. Further, the hearing notice indicates that the IRS may no longer limit itself solely to loss situations.

F. Loss Duplication Within A Consolidated Group

Simultaneously with the issuance of the -2T Regulations, the IRS issued Notice 2002-18, announcing its intention to issue regulations that would prevent a consolidated group from recognizing a loss on both stock and asset sales where both losses reflect the same economic loss. The Notice is based on the long-standing principle that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss.[22] Thus, the government does not want a taxpayer filing a consolidated return to obtain a deduction on the sale of a subsidiary's stock, while retaining the opportunity to obtain deductions inside the subsidiary that were already reflected in the

[22] This principle was first expressed in Charles Ilfeld Co. v. Commissioner, 292 U.S. 62 (1934), where the Supreme Court disallowed a worthless stock deduction recognized on a liquidation of a subsidiary member because the group had already obtained the tax benefit from the operating losses that gave rise to the deduction.

outside loss (the classic Loss Duplication Problem). The Notice states that these regulations would be effective from March 7, 2002 (the date of the Notice).[23]

Notice 2002-18 was prompted by the Treasury and the IRS becoming aware of a transaction that permitted loss duplication within a consolidated group. This transaction is illustrated by the following example.[24]

> Example 4. Parent ("P") has an asset with a basis of $100 and a value of $20. P contributes the asset to a pre-existing subsidiary ("S") in exchange for perpetual preferred stock with a face amount and value of $20. P and S have filed a consolidated income tax return. The exchange qualifies for tax free treatment under Section 351 and P's tax basis in the S preferred stock is $100. P sells the preferred stock to an unrelated party for $20, recognizing a taxable loss of $80. Because the preferred stock is described in Section 1504(a)(4), P and S continue to file a consolidated return, thereby allowing the P consolidated group to recognize a second loss of $80 if S were to sell the asset for $20.[25]

In contrast to the LDR Rule and the 1990 Transition Regulations, the -2T Regulations would permit the recognition of the loss on the sale of the preferred stock. The LDR Rule would have disallowed the loss under the loss duplication factor. Likewise, the 1990 Transition Regulations would have disallowed the loss since P did not sell all of its S stock. The -2T Regulations eliminate the requirement that the parent sell all of its subsidiary stock so to recognize a loss on the sale. Applying the -2T Regulations to the above example, the loss on the sale of the preferred stock would not be precluded because the basis of that stock did not reflect any BIG.

As discussed in the preamble to the –35 Regulations, the Treasury and the IRS are also concerned about the ineffectiveness of the investment adjustment regime in

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[23] In order to hold the March 7 effective date, the Treasury and IRS must have guidance in place by March 15, 2003. See Section 1503(a).

[24] This transaction is commonly referred to as the "Bank of America Transaction" as it has been reported that Bank of America engaged in a similar transaction. See Sheppard, "Bank of America" 53 Tax Notes 686 (Feb. 11, 2002); Mollenkamp and McKinnon "Bank of America's Tax Strategy is unlikely to Help Profit Again," Wall St. Journal at C3 (April 15, 2002). We have no independent knowledge of whether the transaction was ever entered into or, if the transaction was entered into, whether it involved a consolidated subsidiary.

[25] The same result can be achieved if S sells the asset first and P then sells the preferred stock.

allocating negative basis adjustments appropriately to "match" deductions inside the subsidiary with the related subsidiary shares (the "Investment Adjustment Problem"). This Investment Adjustment Problem permits a consolidated group to sell the related subsidiary shares at a loss, while the remaining subsidiary shares would have gain (or a lesser loss). We assume the government finds this aspect of Investment Adjustment Problem troubling because of the potential for acceleration of losses.

For example:

> Example 5 - In Year 1, Parent ("P") forms a subsidiary ("S") with a cash contribution of $80 in exchange for 80 shares of S stock. In Year 2, P contributes a depreciated asset ("Asset A") with a tax basis of $ 70 and a value of $20 to S in exchange for an additional 20 shares of S common stock. In Year 3, S sells Asset A for $20, recognizing a $50 loss. This loss is used to offset income of P on the P group consolidated tax return. In accordance with Treas. Reg. § 1.1502-32, P's basis in each share of S common stock it holds is reduced on a pro rata basis by the $50 loss, with the result that the shares acquired in Year 1 have a tax basis of $40 and the shares acquired in Year 2 have a basis of $60. In Year 4, P sells the 20 shares of S stock acquired in Year 2 for $20, thereby recognizing a $40 loss which can be used to offset taxable income of the P group.

On October 18, 2002, the IRS issued the -35 Regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss. The -35 Regulations have two primary rules — the Basis Redetermination Rule and the Loss Suspension Rule. The preamble to these regulations indicates that the IRS expects these rules to apply infrequently.

The Basis Redetermination Rule attempts to equalize members' tax bases in subsidiary stock on the occurrence of certain events. Generally, the Basis Redetermination Rule requires the redetermination of the basis of a consolidated subsidiary's stock held by group members immediately before a disposition or deconsolidation of a share of subsidiary member stock when the basis of such stock exceeds its value. If a subsidiary remains a member of the consolidated group, the Basis

Redetermination Rule requires that all members' tax bases in the subsidiary are aggregated and then reallocated – first, to preferred stock up to the fair market value of the stock, and then to shares of common stock in proportion to their relative value. If a subsidiary leaves the consolidated group, then the basis reallocation amount is limited to the lesser of the loss on the disposed of/deconsolidated shares or negative items in the computation of basis adjustments with respect to the shares retained. If the subsidiary leaves the group, the basis in the shares of the subsidiary member stock disposed of or deconsolidated is reduced by the amount of basis subject to reallocation. With respect to the shares of subsidiary stock retained, the amount of basis subject to reallocation is reallocated first to preferred stock up to its fair market value and then to the shares of common stock of the subsidiary in a manner that would, to the extent possible, cause the ratio of basis to the value of each such share to be the same. The Basis Redetermination Rule does not apply if the consolidated group disposes of all its stock of a consolidated subsidiary within a single taxable year in one or more fully taxable transactions or is allowed a worthless stock deduction with respect to all of a consolidated subsidiary's stock.

The Loss Suspension Rule applies if a consolidated group recognizes a loss on the disposition/deconsolidation of shares of a consolidated subsidiary and the subsidiary remains a member of the group. In that case, the duplicated loss is suspended while the subsidiary remains in the group. The Loss Suspension Rule adopts a definition of duplicated loss that is substantially identical to the one in the LDR Rule, except that securities of other subsidiary members of the group are not excluded from the computation of the subsidiary's aggregate asset basis. Pursuant to the Loss Suspension Rule, the suspended loss is reduced as deductions and losses of the subsidiary are taken into account in determining the consolidated group's taxable income. The Loss Suspension Rule operates to allow the consolidated group to take into account a loss incurred by a subsidiary with respect to its assets, but to disallow the loss on the disposition of the affiliated subsidiary's stock. However, under the Loss Suspension Rule, if a loss remains when a subsidiary leaves the consolidated group, that suspended loss may be allowed. The Loss Suspension Rule presumes that all deductions and losses are attributable first to the duplicated loss, subject to the taxpayer rebutting this presumption by tracing.

The –35 Regulations have two additional rules. One rule applies if either the subsidiary becomes worthless under the standard of Treas. Reg. § 1.1502-80(c) or an insolvent subsidiary is liquidated, thereby ceasing to be a member of the consolidated group. If either of those events occur, the –35 Regulations treat the portion of the consolidated net operating loss allocable to the subsidiary as absorbed by the consolidated group, resulting in a downward basis adjustment in the stock of the subsidiary.[26] The –35 Regulations also contain various anti-abuse rules. The anti-abuse rules, among other things, are designed to prevent a consolidated group from recognizing a loss on a subsidiary stock when the subsidiary leaves the group and, within the next 10 years, the consolidated group "reimports" the inside deductions or losses of the subsidiary.

Both the Son of Mirror Problem and the Loss Duplication Problem arise from the investment basis adjustment rules. By adopting the -2T Regulations and proposing the -35 Regulations, the Treasury and the IRS chose again not to revise the investment basis adjustment rules. Instead, the Treasury and the IRS dealt with both the Son of Mirror Problem and the Loss Duplication Problem as distinct problems that could be addressed by additional rules targeted to the specific problems. We agree that there is no need to once again substantially revise the investment basis adjustment rules. Accordingly, this report separately addresses each of the perceived problems and proposes solutions to each. To the extent possible, we hope that each of the solutions ultimately adopted would be consistent in approach.

IV. Suggested Approach To the Son of Mirror Problem

As discussed in the preamble to the 1990 Temporary Regulations, there are a number of possible approaches to thwart the Son of Mirror Transaction. An approach that traces the recognition of BIG and eliminates that gain from positive basis adjustments is the most accurate and all encompassing method to implement Notice 87-

[26] Prop. Treas. Reg. § 1.1502-35(f).

14. The Treasury and the IRS have never adopted a tracing approach.[27] As discussed in the preamble to the 1990 Temporary Regulations, there are significant and perhaps unsolvable administrative burdens that would be imposed on taxpayers and the government to implement a tracing regime.[28]

Perhaps, an even more compelling reason for not adopting a tracing approach that would preclude all positive basis adjustments for recognized BIGs that are already reflected in tax basis is that adjustment regime would require substantial revisions to the investment basis adjustment rules under Treas. Reg. § 1.1502-32. In 1994, the latest version of the investment basis adjustment rules were adopted to conform basis adjustments to taxable income of the subsidiary, rather than earning and profits of the subsidiary. This new system for basis adjustments was viewed positively by taxpayers as simplifying the rules by eliminating many discontinuities that resulted from "linking" basis adjustments to earnings and profits. Adopting a "full" tracing regime would introduce new and greater complexity to the investment basis regime because it would effectively require compliance with a second regime separate from the investment basis regime. We believe this approach inappropriate where the separate regime is for the

[27] However, it is interesting to note that both Congress and the Treasury and the IRS previously have used tracing regimes in similar situations, one of which is contained in the consolidated return regulations that are the subject of the loss disallowance regulations. See Section 382(h) (providing a presumption that any gain from the sale of any asset is not BIG where the selling corporation has undergone an ownership change in the five-year period immediately preceding the sale unless the loss corporation can rebut the presumption by tracing the asset disposed of and prove that it held the asset on the change date and that the gain recognized is not larger than the BIG inherent in the asset on the change date); Section 1374(d) (providing the exact opposite presumption in the S corporation regime governing conversions of C corporations to S corporations); Section 704(c) (requiring partners and the partnership to track and specially allocate to the contributing partner any appreciation or depreciation built into any asset on the date it was contributed to a partnership by a partner); Treas. Reg. § 1.1502-15 (the separate return limitation year limitation on BIL adopts the Section 382(h) concept and therefore a presumption that the taxpayer may rebut if it has sufficient evidence -- any such evidence would involve tracing assets). Sections 382 and 1374 were enacted at the same time as Section 337(d) and both provisions were enacted to address, at least in part, the repeal of General Utilities (the same purpose that the IRS and the Treasury gave for the LDR Rule). Further, the -35 Regulations apply principles very similar to the regulations under Section 704(c).

[28] See Axlerod and Torosyan, Loss Disallowance After Rite Aid: Deconstructing "-20," (article to be published in the March 2003 issue of Taxes); Schler on Loss Disallowance. For an excellent summary of the rules needed to implement this type of tracing approach see Schler on Loss Disallowance at pages 902 - 903.

limited purpose of preventing non-economic losses (or understated gains) where the subsidiary was acquired in only certain types of transactions (e.g., the subsidiary is purchased without a Code Section 338(h)(10) election). Accordingly, we concur with the decision by the Treasury and the IRS not to adopt a "full" tracing approach.

Instead, the report discusses two alternative approaches for preventing the Son of Mirror Problem. One approach, like the LDR Rule, would rely on a series of BIG presumptions. As discussed below, this suggested approach (the "Presumptive Approach") attempts to narrow the overbreadth of Clauses (1) and (2) of the LDR Rule. The alternative "Modified -2T Regulations" approach, like the -2T Regulations, would initially disallow losses on disposition of a consolidated subsidiary stock, but would allow taxpayers to establish that the loss is not attributable to the recognition of BIG (i.e., rebut the presumption); however, as discussed, the Modified -2T Regulations may apply in limited circumstances to increase gains that have been understated because of the recognition of BIG that is reflected in stock basis. As discussed in greater detail below, while the approach of the Modified -2T Regulations is not intended to be a full tracing approach, it has many of the elements of tracing. Accordingly, this approach needs to achieve the balance of reaching the cases the government deems appropriate, but not being unduly burdensome for taxpayers to comply with and the IRS to administer.

Regardless of which approach is adopted, two major policy issues must be addressed. The first is whether the approach adopted should deal with BII where appreciated assets are consumed through their use in the subsidiary's business rather than sold at a gain. The second policy issue is whether the approach should be limited to disallowing losses or should also apply to affect the determination of the amount of gain on the sale.

A. Built-In Income From Wasting Assets

The –2T Regulations are more narrow than the LDR Rule as the –2T Regulations apply only to an asset "disposition". The term "disposition" does not appear to apply to assets (tangible assets like equipment or intangible assets like goodwill) that are consumed in the business. As illustrated by the following example, the Son of Mirror

Problem can arise where assets are not disposed of in the traditional sense, but instead are consumed in the business.

> Example 6. A company ("S") has a single asset, a right to receive a taxable recovery in a pending litigation. The claim has a basis of $0 and a value of $100. Parent ("P") buys the stock of S for $100. Subsequently, S collects the $100 from the litigation, resulting in P's basis in the S stock increasing from $100 to $200. Upon collection, the right of recovery in litigation becomes worthless. If P subsequently sells the stock for $100,(the cash in S's bank account) P would recognize a $100 noneconomic loss that the –2T Regulations would not apply to.

Like a Son of Mirror Transaction involving a disposition of an asset, the value of the recovery right in Example 6 had been included in P's purchase price and for determining P's tax basis in the S stock. Thus, the collection of the claim sets up a noneconomic loss because stock basis is increased for an item that already has been reflected in basis. Thus, BII has the same potential to cause the Son of Mirror Problem as BIG.

The problem raised by BII is best illustrated by intangible assets. The similarity between the consumption of an intangible asset through its continued use in a trade or business and the actual disposition of the asset exists where the intangible has a specified useful life. In that case, the value of the intangible (e.g., a patent) will decline over time; that is, the intangible asset is a "wasting asset." All or a portion of the income earned from the wasting asset is economically a return of investment, even though it is fully taxable. Accordingly, if the stock of a company that owns wasting assets is purchased in a stock acquisition without a Section 338(h)(10) election, the income generated from the consumption of the target's assets that is economically a return of investment (i.e., the payment for the projected earnings stream from the intangible asset) is already reflected in the stock basis of the acquired company.

As described above, the potential for Son of Mirror Transactions exists with respect to BII from tangible and intangible assets. A difficult question in devising rules to address BII is whether the rules should be limited to tangible assets and intangible assets with definite useful lives like a patent or should the rules also cover intangible assets, such as goodwill, that do not have a definite useful life. Any approach that attempts to deal with nonwasting assets like goodwill would have to rely on presumptions as to the life of this type asset. In light of rules such as Code Section 197, which assign a definite tax life to all intangible assets, we recommend the rules cover all intangible assets. Accordingly, we recommend that either of our suggested approaches for preventing Son of Mirror Transactions contain rules to prevent positive basis adjustments for BII with respect to all assets.[29]

A. Should the Recognition of BIG Be Allowed To Shelter Post-Acquisition Appreciation?

Unlike the full tracing of BIG approach suggested by Notice 87-14, both the LDR Rule and the -2T Regulations disallow losses, but do not increase the amount of gain recognized. Thus, the LDR Rule and the -2T Regulations are more limited in scope then a full tracing approach that would not increase stock basis for BIGs that are recognized by a consolidated subsidiary, where such basis already reflects this BIG.

The decision to limit the approach to loss disallowance reflects an historic compromise in the approach of the Treasury and the IRS. In adopting the LDR Rule, the government apparently was concerned that it would be unacceptable to taxpayers if the broad presumptions of Clauses (1) and (2) of the LDR rule caused tax basis to be artificially lowered for all purposes, resulting in overstating the gain on the sale of every consolidated subsidiary. Because Clauses (1) and (2) were overbroad on the loss side, the government apparently chose not to extend this overbreadth to the gain side.[30] While not explicitly stated in the preamble to the –2T Regulations, these regulations likewise adopt a compromise approach. The general rule of the –2T Regulations, disallowing all losses recognized on disposition of a consolidated subsidiary, is even more overbroad than the presumptions underlying Clauses (1) and (2) of the LDR Rule. The overbreadth of this rule is mitigated by allowing taxpayers to establish that the loss is not attributable to the

[29] The issue of how to treat BII applies under a number of analogous provisions. One analogous provision is Section 382(h). From a simplicity and administerability standpoint, the government should attempt to resolve the treatment of BII in these contexts on a consistent basis.
[30] Preamble to T.D. 8294, 55 Fed. Reg. 9426 (March 9, 1990).

recognition of BIG from the disposition of an asset. Thus, the burdens of tracing are placed on taxpayers to overcome the overbreadth of the general rule. The Treasury and the IRS apparently chose not to extend this broad approach, limited by the complexities of tracing, to the gain side.

Further, to adopt an approach that would be equitable on both the loss and gain side, the government may have to revise substantially the investment adjustment rules to preclude positive adjustments for the recognized BIG and BII already reflected in stock basis. As discussed above, the government has always chosen not to revise the investment basis adjustment regulations in this manner and we agree with the decision.

The Treasury and the IRS are faced with a very difficult decision whether to adopt an approach that extends to situations where gain is understated due to BIG or BII recognition. Because precise rules that are easily administrable cannot be devised to address the potential for understated gain, we understand why the Treasury and the IRS would choose to maintain the historic compromise in this area and not extend the rules to the gain side.[31]

We recognize that any approach that is limited to the loss side may present sheltering opportunities on the gain side for taxpayers. For example, if a consolidated group purchases all the stock of a subsidiary and the subsidiary subsequently recognizes BIG or BII, the tax basis of the stock of that subsidiary will be artificially high. Thus, if the group is patient and willing to wait for other assets of the subsidiary to appreciate in value, then the artificially high tax basis can shelter full recognition of that economic gain for tax purposes.

An issue that should be addressed is the possibility for taxpayers to attempt self-help by stuffing the acquired subsidiary with appreciated assets. The following example illustrates the potential for stuffing.

[31] The 1990 Report provided a possible justification for this result. As noted in the Report, the appreciated assets remain in corporate solution and there would be a tax on the appreciation when the asset is ultimately disposed of. From that perspective, the compromise can be viewed as permitting deferral of tax, rather than elimination of tax.

> Example 7. A subsidiary ("S") has a single asset with a tax basis of $0 and a value of $100. Parent ("P") buys the S stock for $100 and S joins the P consolidated group. S sells the asset for $100, resulting in P's basis in the S stock increasing to $200. P contributes an existing appreciated asset to S with a basis of $0 and a value of $100, thereby increasing the value of S from $100 to $200. P sells the S stock for $200 and reports no taxable gain.

The example illustrates that P can shelter the gain on its existing appreciated asset by contributing the asset to S and selling the S stock. An anti-stuffing rule is needed to restrict such transactions. The LDR Rule had a specific anti-stuffing rule, which applied if (1) an asset was transferred to a consolidated subsidiary within two years preceding the sale of that subsidiary and (2) the transfer to the subsidiary was with a view to avoiding loss disallowance on the stock or gain recognition on the asset.[32] We believe that a similar anti-stuffing rule is necessary under either of the approaches discussed below. The two-year period provides an effective deterrent to a stuffing transaction because most taxpayers that want to dispose of an asset are unwilling to wait for two years.

The government may prefer to adopt a limited approach to address the potential for understated gain. This limited approach, discussed below, would apply only with respect to an actual disposition of an asset with BIG and not to an Effective Disposition of an asset with BII, because of the additional complexities in addressing BII. Further, to alleviate burdens of tracing that would be placed on taxpayers and the government, the approach adopted would apply for a limited period of time, such as 5 years. While we believe it is appropriate for the government to revisit whether any approach ultimately adopted should be extended to reach understated gain, we strongly recommend any attempt to do so be in a very limited manner such that it would not be unduly burdensome. We believe that any rules applying to the gain side should be limited because taxpayers cannot plan as to the exact amount of gain or the timing of such gain.

[32] Treas. Reg. §1.1502-20(e)(2). The LDR Rule provided for a general anti-avoidance rule that states the LDR Rule must be applied in a manner that is consistent with and reasonably carries out its purposes such that if a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments must be made as necessary to carry out their purposes. Treas. Reg. §1.1502-20(e)(1). The –2T Regulations incorporate both anti-abuse rules.

If a limited approach to the gain side is adopted, the anti-stuffing rules discussed above should also apply.

B. Presumptive Approach

The LDR Rule prevents the Son of Mirror Transaction described in Example (1) because either Clause (1) or Clause (2) of the LDR Rule will disallow the $100 loss on P's sale of the S stock. Further, Clause (2) would address a situation like the one described in Example (6) where the potential for a Son of Mirror Transaction result exists because the affiliated subsidiary earns BII. However, the LDR Rule potentially disallows many real economic losses because Clauses (1) and (2) rely on some unrealistic presumptions that all extraordinary gains recognized post-acquisition are attributable to BIGs and all post-acquisition income is attributable to BII. Thus, one potential approach would be to revise the LDR Rule to eliminate the loss duplication factor and to modify Clauses (1) and (2) to alleviate their overbreadth. As discussed above, we term this approach the Presumptive Approach. If this Presumptive Approach is extended to the gain side, then Clauses (1) and (2) would apply if the subsidiary stock is sold for a loss, but only Clause (1) would apply for a limited period of time if the subsidiary stock is sold for a gain.

Several possible changes could alleviate the unrealistic and unfair results of Clauses (1) and (2). First, Clauses (1) and (2) should not apply to subsidiaries that were acquired in specified acquisitions where inside asset basis of the subsidiary equals the stock basis of that subsidiary. Those acquisitions would include a stock purchase for which a Code Section 338 election has been made, as long as the election is made down the chain of acquired subsidiaries, or a tax-free asset reorganization such as under Code Sections 368(a)(1)(A), where there is stock and asset basis conformity before and after the reorganization for the target corporation and its subsidiaries. In each of these cases, BIG is not reflected in stock basis because inside and outside basis are equal when the subsidiary joins the consolidated group. Similarly, the loss disallowance regime should not apply to the formation of a new consolidated subsidiary where inside and outside basis are equal, and therefore, would not reflect any BIG. The clearest example of this is when the subsidiary is formed by a contribution of cash or cash equivalents.

Second, Clauses (1) and (2) should be rebuttable presumptions providing that gains are BIGs (and income is BII) except where taxpayers establish that post-acquisition gains (or income) is attributable to assets acquired after the date the affiliated subsidiary became a member of the consolidated group. Gain (or income) with respect to after-acquired assets cannot be considered attributable to BIGs. Thus, Clauses (1) and (2) should not apply to the extent a taxpayer can show that (i) a capital gain or Section 1231 gain is attributable to the disposition of an appreciated asset acquired after the subsidiary became a member of the group, (ii) operating income of the subsidiary from the disposition of assets (e.g., inventory) is attributable to assets that the subsidiary did not own when it became a member of the consolidated group, and (iii) income of the subsidiary resulting from the cancellation of debt is attributable to after acquired indebtedness.[33] If Clause (1) is to be applied with respect to stock dispositions at a gain, we strongly believe taxpayers should be permitted to rebut the presumption of Clause (1).

Under the LDR Rule, a taxpayer can net profits and losses incurred in the same taxable year (other than income from an extraordinary gain disposition), but the taxpayer is not permitted to net profits and losses arising in different taxable years. We recommend that Clause (2) be amended to allow for a netting of operating income and losses. We believe it unfair for the ultimate tax consequences to differ depending on the timing of when certain events occur where those events are very often outside of the taxpayer's control. For example, a particular business may sustain a loss in a taxable year because of damages to property, a work stoppage or some other unforeseen event.

The Presumptive Approach should provide a ceiling as to the amount of losses that can be disallowed; that is, the aggregate amount of losses that would be disallowed

[33] In our 1991 report, we initially suggested an after-acquired asset exception. in response to the proposed LDR Rule. See Peaslee Letter. However, the IRS rejected this suggestion because it would impose many of the administrative burdens of a tracing regime. Preamble to T.D. 8364, 1991-2 C.B. 43, 46. Given that the IRS is willing to place the burden on taxpayers to trace under the –2T Regulations, the IRS likewise should allow taxpayers the ability to overcome the broad presumptions of Clauses (1) and (2) through tracing.

under Clauses (1) and (2) should not exceed the purchase price of the subsidiary's stock plus the amount of the liabilities of the subsidiary at the time of its acquisition. This ceiling rule does not raise additional difficulties in valuation and limits loss disallowance to the absolute maximum potential BIG of the subsidiary. This ceiling rule also would backstop two of the changes we suggested above - allowing taxpayers to show the gain is attributable to assets acquired after the date of acquisition, and the rule for post-acquisition appreciation.

Finally, the Treasury Department and IRS should consider that the positive investment adjustment factor of Clause (2) be disregarded after the subsidiary stock has been held for a specified period of years. [34] Where the subsidiary is an affiliate for an extended period of time, it is likely the acquirer of that subsidiary did not intend to engage in a Son of Mirror Transaction. Under this rule, Clause (2) would apply to basis adjustments during the minimum holding period, but would no longer be viable apply after the holding period has been satisfied. If the government adopts such a rule, it may be appropriate to consider certain anti-abuse provisions. In that regard, it may be appropriate to deny positive investment adjustments attributable to specifically identifiable assets even where the positive adjustment factor of Clause (2) ceases to apply. For example, Clause (2) may have to continue to apply to a narrow group of specified assets (such as a patent or the litigation claim in Example (6)) for the entire life of that asset.

In adopting the Presumptive Approach, certain rules that are part of the LDR regime would no longer be needed to address the Son of Mirror Problem and other rules should continue to apply. In that regard –

- if the Presumptive Approach is solely aimed at preventing Son of Mirror Transactions, there is no need for a rule allowing taxpayers to elect to reattribute losses; [35]

[34] There are many analogies in the Code that establish a time period during which the presumptions apply, e.g., Section 707 (7 years) or Section 1374 (10 years). For this purpose the most appropriate guidepost may be Section 382(h), adopting a 5-year time frame.

[35] Under the LDR Rule, the reattribution election was available regardless of the reason for the disallowed loss. However, permitting such an election only made sense where a net operating

- as discussed above, the anti-stuffing rules of the LDR Rule should be retained; and

- to prevent the loss disallowance rules from being circumvented, a basic deconsolidation rule is necessary; however, we recommend that consideration be given to permitting the parent to maintain a shadow basis account that would operate to restore tax basis if there is a subsequent disposition of the retained shares for consideration in excess of the reduced basis of the stock.[36]

B. Modified –2T Regulations

Our other recommended approach proposes certain modifications to the -2T Regulations. The -2T Regulations adopt a loss limitation approach that disallows loss on a stock sale of an affiliated subsidiary, unless taxpayers can prove that a positive basis adjustment is not attributable to the recognition of BIG on the disposition of an asset where the BIG is already reflected in stock basis. Because the burden is placed on taxpayers to establish that a noneconomic loss does not result from the recognition of BIGs that are already reflected in stock basis of an affiliated subsidiary, this approach has most of the elements of a tracing regime.

In considering whether the Modified -2T Regulations should be a permanent attempt to prevent the Son of Mirror Problem, we initially focus on (1) devising rules for preventing Son of Mirror Transactions resulting from BII from tangible and intangible assets and (2) how the Modified -2T Regulations possibly could be extended to deal with gain being understated because of BIG recognition.

1. Built-In Income

The difficult question with respect to incorporating rules for tracing BII in the regime of the –2T Regulations is how to properly measure the amount of BII earned on

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loss of the subsidiary increased the amount of the disallowed loss to the parent company. In that case, it was reasonable that the parent not be placed in a worse position because the parent, rather than its subsidiary, recognized the losses. However, if the approach is solely limited to the Son of Mirror Transactions, a reattribution election could be a windfall for the corporate parent.

[36] We previously discussed the rationale for such an amendment in the Peaslee Letter. This basis account would operate similarly to the basis reduction account of Treas. Reg. §1.1502-32(a).

an annual basis.[37] As a conceptual matter, the best measure of this amount is the actual income earned for that year up to an amount equal to the decline in value of the asset during that year. To illustrate, assume the acquired subsidiary has a single wasting asset (e.g., equipment) with a zero tax basis, a value of $100 and a ten-year life. If the asset declines in value on a ratable basis of $10 per year, then the first $10 of income each year should be considered BII. However, where the future decline in value of the existing asset cannot be determined on the date the subsidiary is acquired, this approach would require taxpayers to appraise annually the wasting assets. As discussed above, the difficulties of measuring the decline in value of assets becomes even more difficult when dealing with assets like goodwill.

In developing an administrable regime for tracing BII, the first-step would be to value the BIG (or BII) with respect to the assets. This is the same step required to determine whether BIG (or BII) items are reflected in stock basis. Next, the regime would have to determine the amount of BII that is attributable to the wasting asset each year. With respect to an asset like equipment or a patent that has a determinable useful life, the asset would be treated as declining in value on a pro rata basis over its remaining life. For goodwill, the –2T rules would have to assign a useful life. The Section 197 regime provides a life of 15 years for goodwill and going concern value and, as a matter of consistency, a life of 15 years could be established by the -2T Regulations. Thus, if a consolidated group purchases a subsidiary for a premium price representing goodwill, the income representing a return on that premium would be traced over a 15 year period. To illustrate, assuming a premium of $150, then $10 per year would be BII representing the consumption of that asset. We recommend that the calculation of BII representing a return of investment be done on a cumulative basis over the assigned tax life of the intangibles. To illustrate, assume there is a $150 premium for the purchase of the affiliated subsidiary. In that case, the BII representing an annual return of investment would be $10 per year. If the subsidiary has only $5 of income in Year 1, then up to $15 of income for Year 2 would be BII income. On the other hand, if the subsidiary earns

[37] For a discussion of administrable ways to trace BII under Section 382(h), see Noel Brock, The Forthcoming Built-In Item Regulations: Issues For the Government to Address, 95 Tax Notes 97 (April 1, 2002).

$15 of income in Year 1, we would treat $10 as BII and $5 as economic profit that increases stock basis in the subsidiary. This result should not change if in a subsequent given year the subsidiary earns only $5. Thus, we suggest that a deficit amount of BII, as compared to earned income, could be carried forward, but an excess of income over BII not be treated as a carryover to subsequent years.

If the intangible asset has a tax basis, then the tax basis of that asset should be treated as an offset to BII. Using our example, if the goodwill had a tax basis of $75, then the asset has a BIG of $75. In that case, the BII with respect to the asset is really $5 per year over the tax life of 15 years. Assuming the $5 of basis is amortized otherwise, in determining the amount of BII, the first $5 is BII that should reduce loss recognized on disposition of subsidiary stock.

As suggested for our Presumptive Approach, the rules governing BII likewise would apply for a limited period (e.g., 5 years). Under our suggested Modified –2T Regulations, positive basis adjustments for BII items that are already reflected in subsidiary stock basis per the tax presumptions as to the life of the asset would be permanently precluded for this limited period of time, but after this period positive basis adjustments would be allowed. In addition, it would be appropriate to adopt certain anti-abuse type rules that apply to specified assets (e.g., the litigation claim in Example (6)) for the life of the asset.

2. Understated Gain

If Treasury and IRS decide to extend the Modified –2T Regulations to situations where gain is understated because of BIG or BII recognition, then two sets of rules would be needed -- one for losses and one for gains. The general rule of the Modified –2T Regulations, that loss on disposition of an affiliated subsidiary's stock is disallowed, clearly is intended to deal solely with uneconomic losses. Further, it seems inappropriate to place the burdens of tracing on taxpayers to prove their gain is not understated. Accordingly, if the government decides to extend the rules to the gain side, the rule should be that the taxpayer has reported the proper amount of gain unless the IRS establishes the gain has been overstated because of the BIG recognition. We believe that with respect to the gain side the burden of tracing should be on the IRS. Further, the IRS's ability to prove that gain is understated should be limited to the recognition of BIG from an actual disposition of assets during a fixed period of time (e.g., 5 years).

3. Additional Modifications to the –2T Regulations

While the Treasury and the IRS have the latitude to adopt our suggested Presumptive Approach as an approach to preventing the Son of Mirror Problem, the government has indicated it has abandoned the presumptions underlying the LDR Rule.[38] Thus, the Treasury and the IRS appear committed to moving forward with the approach of the –2T Regulations, which involves many of the elements of tracing. Regardless of the ultimate resolution of the major policy issues discussed, the Modified –2T Regulations will have many of the complexities and burdens of tracing. This portion of the report discusses several of the complexities that the government should address and possible rules to include in the Modified –2T Regulations.

a. Regulations Apply Where No Net Appreciation in Subsidiary Assets

The –2T Regulations apply where a consolidated group acquires a subsidiary and any asset of that subsidiary has BIG; that is, the –2T Regulations apply on a "gross" basis rather than a "net" basis. We agree that applying the loss limitation approach of the –2T Regulations to "gross" BIG as opposed to net BIG of all the assets is appropriate because the potential for Son of Mirror Transactions exist as long as there exists gross unrealized appreciation in the acquired subsidiary's assets. This is illustrated by the example set forth in Treas. Reg. §1.337(d)-2T(c)(4). In that example, P purchases for $50 all of the stock of T, which does not have any net unrealized appreciation with respect to both of its assets. One of T's assets has a tax basis of $0 and a value of $ 50 and the other asset has a tax basis of $50 and a value of $0. S sells its appreciated asset for $50 and then P sells its S stock for $50, P would recognize a $50 loss on the sale of the stock that could be

[38] Notice 2002-11 states that the IRS would not apply the entire LDR Rule going forward "because of the interrelationship of all the loss disallowance factors." See also, Schler on Loss Disallowance, 95 Tax Notes at 923.

used to offset the gain on the sale of the appreciated asset. Thus, the Son of Mirror Problem is caused by gross unrealized appreciation in a single S asset.

The example also deals with the situation where the appreciated asset is sold for a gain and then the depreciated asset is sold for a loss. The example reasons that the BIG and the BIL are both reflected in P's stock basis in S and, therefore, the example concludes that the recognized BIG should increase the stock basis of S. The example further provides for the same result if S had an NOL carryover rather than a depreciated asset. This example properly allows for an offset of losses against the recognized BIG as T has not had an overall economic profit.

b. "Reflected in Subsidiary Stock Basis"

A key question under the –2T Regulations is how taxpayers determine whether, or the extent to which, gain or loss from asset dispositions by a subsidiary has been "reflected in the subsidiary's stock basis" before the disposition. In that regard, while the -2T Regulations are similar to the 1990 Transition Rules, there is little judicial or administrative authority interpreting the 1990 Transition Rules as they were in effect for only a few months during 1990 and 1991. Thus, there is little guidance to clarify the question of whether BIG (or BIL) is reflected in stock basis.[39]

The determination of whether BIG (or BIL) is reflected in subsidiary stock basis requires two measurement dates. The first measurement date is when the subsidiary becomes a member of the consolidated group. On that date, the taxpayer would have to value each of the subsidiary's assets (including stock of lower-tier subsidiaries and the assets of these lower tier subsidiaries). To the extent the appraised value of an asset exceeds (or less than) the tax basis of an asset, then that asset has BIG (or BIL). The

[39] TAM 200138005 (May 4, 2002) attempts to make this determination. In the TAM a subsidiary's stock basis was increased by both recognized BIG and post acquisition appreciation. Thereafter, the value of the subsidiary declined, and the subsidiary's stock was sold at a loss. The TAM concludes the selling consolidated group should be allowed to claim the loss on the subsidiary's stock a sale because the loss did not exceed the loss that would have resulted if the BIG had not been recognized.

price paid for the subsidiary stock grossed up for the subsidiary's liabilities[40] establishes the maximum BIG that could be reflected in subsidiary stock basis and could be recognized as BIG on asset dispositions.

The second measurement date occurs when an asset is sold or otherwise disposed of by the subsidiary. At that time, the taxpayer must determine the amount by which the basis of the subsidiary stock immediately after the asset disposition is greater (or less) than the basis that stock would have had absent the asset disposition resulting in recognition of BIG (or BIL). If the subsidiary stock basis is greater or less than the basis the subsidiary stock would have taken absent the asset disposition, then the amount of gain (or loss) treated as BIG (or BIL) " reflected in stock basis" prior to the asset disposition is the lesser of (i) the amount determined as of the first measurement date or (ii) the amount determined as of the second measurement date. The Treasury and the IRS should include an example to illustrate this methodology. Set forth below, is an example based on the fact pattern and conclusion of TAM 200138005 that could be added to the – 2T Regulations.

> Example 8. A parent company ("P") purchases the stock of a subsidiary ("S") for $45, S had no liabilities. S owns two assets, Asset 1 with a tax basis of zero and a value of $20, and Asset 2 with a tax basis and value of $25. S sells Asset 1 for $20, resulting in the recognized BIG increasing P's stock basis in S to $65. After Asset 2 has appreciated in value to $70, S sells Asset 2 for that amount. The sale of the asset results in a $45 gain and an increase in P's stock basis from $65 to $110. S reinvests the $90 of sales proceeds from the asset sales in new assets that decline in value from $90 to $50. P sells the S stock for $50, recognizing a loss of $60 ($110-$50). P should be allowed to claim $40 of the $60 loss and $20 of the loss should be disallowed. P should be able to claim the $40 loss because it should be able to demonstrate that it would have had a loss on the S stock sale whether or not it sold Asset 1. That is, if S had not disposed of Asset 1, then S would have recognized gain of $45 from post-acquisition appreciation and P would have a $90 tax basis in the S stock. In that

[40] As discussed further below, the amount of liabilities for this purpose should be the lower of the issue price or the fair market value of the liabilities.

case, the sale of S stock would result in an allowable loss of $40; the recognition of BIG should not change that result.

c. Safe Harbors

As discussed with respect to the Presumptive Approach, there are several instances where taxpayers acquire a subsidiary in a manner where a Son of Mirror Transaction is not possible. In those instances, to reduce the burdens tracing imposes, the Modified –2T Regulations should provide safe harbors permitting taxpayers to claim losses on a subsequent disposition of a subsidiary without having to comply with all aspects of tracing. Safe harbors could include: (1) stock purchases for which a Code Section 338(h)(10) election is effected for the target and all its subsidiaries, (2) tax-free asset reorganizations, such as under Code Sections 368(a)(1)(A), and (3) newly formed subsidiaries where inside and outside basis are equal.

d. Creeping Acquisitions

A corporation may acquire stock of a subsidiary at different times. Presently the –2T Regulations require P to determine the BIG reflected in the basis of its subsidiary stock based on a valuation of the subsidiary's assets on each acquisition date of stock. Depending on the duration between purchase dates and the fluctuations in value of the subsidiary's assets, there may be considerable variations in the amount of BIG reflected in each purchase of stock. This necessarily complex tracing of values for each purchase date would present a formidable task for taxpayers in applying the –2T Regulations. Rather than requiring taxpayers to trace on each acquisition date of subsidiary stock with multiple acquisitions, a potential solution may involve an averaging of the various values from each purchase date and coming to an averaged BIG or BIL as of the date of consolidation for purposes of the Modified –2T Regulations. While this approach would still require that the BIG (or BII) be determined for each acquisition date, the taxpayer would not need to maintain the different asset values and BIG (or BII) for each purchase date.

e. Multiple Acquisitions of Target Subsidiaries

The complexities of tracing are compounded when a consolidated group purchases all the stock of a target and the target itself has multiple subsidiaries that have been previously acquired. The amount of BIG reflected in the target stock and any other subsidiaries of target must be determined for each acquisition date of target and its previously acquired subsidiaries. Accordingly, the acquiring consolidated group's valuation date for the assets of target and its subsidiaries' assets would differ from the valuation date of target, resulting in multiple calculations concerning the amount of BIG reflected in stock basis. The complexity of multiple calculations would become daunting if target has multiple subsidiaries purchased on different dates, or if those subsidiaries themselves have purchased their own subsidiaries on various dates. To reduce the complexities of multiple calculations and alleviate the burdens this would place on taxpayers, the government should consider adopting simplifying conventions. For example, if there are multiple acquisitions through a chain of corporations and if the difference in value does not exceed a certain threshold, then the value of the highest tier company that has been most recently acquired could be used and allocated among all the companies in that tier. After a specified period of time (e.g., 5 years), only the values as of the acquisition date of the top tier target should be used for the target and its subsidiaries.

f. Acquisition of Stock in a Tax-Free Reorganization

An acquiring consolidated group may acquire the subsidiary stock in a "B" reorganization where the acquirer member takes a tax basis in the stock that is neither fair market value nor equal to the underlying net asset basis. Where the stock of a target company is subject to significant arbitrage after the announcement of its acquisition, an acquirer in a "B" reorganization of a publicly traded target may obtain a tax basis in the target stock that is close to the trading price of the target stock immediately prior to the acquisition by taking advantage of a statistical sampling procedure.[41] In that case, the stock basis of the acquired target already would reflect BIG in the target assets. To

[41] See Treas. Reg. §1.358-6, and Rev. Proc 81-70, 1981-2 C.B. 79.

prevent Son of Mirror Transaction results in this situation, the Modified –2T Regulations should apply to this type of acquisition. If an acquirer in a type "B" reorganization relies on a statistical sampling procedure, then it is stepping into the shoes of the recent purchasers of the stock, and the Modified –2T Regulations should treat the acquirer in this manner. For example, if the acquirer in a "B" reorganization relies on a statistical sampling to establish stock basis in the target subsidiary, and if within a three month period prior to the close of the acquisition more than 50% of the stock is traded, then the acquirer's stock basis in the target should be viewed as the net fair market value of the target for purposes of determining the extent to which BIG is reflected in stock basis.

g. Impact of Liabilities

Finally, consideration should be given to the effect of the liabilities of the acquired subsidiary for the –2T Regulations. A threshold issue is the impact of subsidiary liabilities in determining the extent to which recognized asset gain or loss has been "reflected" in subsidiary stock basis. Similar to the issuance by a corporation of its own stock in exchange for a capital contribution, the liabilities of the corporation (that generated prior deductions, asset basis, or non-capital, nondeductible expenses) have had an effect on the inside basis of the corporation and, thus, should be treated as reflecting any BIG or BIL attributable to target liabilities in a parent's basis of subsidiary stock prior to the asset disposition. As has been suggested by some commentators, the simplest means of a achieving a proper reflection of BIG or BIL would be to treat the lesser of the issue price of the liability or its fair market value on the date of the subsidiary stock acquisition as additional consideration paid for the subsidiary stock for purposes of determining the amount of built-in gain or loss reflected in P's basis in the S stock prior to the asset disposition. For example, assume that P, the common parent of a consolidated group, desires to acquire S, also a parent of a consolidated group. P contributes $25 cash to a newly formed acquisition subsidiary, Newco, and Newco borrows $75 from an unrelated third party and merges into S. Pursuant to the merger of Newco into S, the shareholders of S receive $100 cash and P acquires all of the stock of S. For federal income tax purposes, the transaction is treated as if P purchased 25% of the S stock for $25 cash and S redeemed 75% of its own stock for $75 cash.[42] At the time of the merger, the S group had a $100 built-in gain in its sole asset. Although the adjusted basis of the S stock in the hands of P is $25, the full $100 built-in gain should be treated as being reflected in P's basis of S stock. For purposes of the –2T Regulations, the $75 indebtedness incurred to acquire S should be viewed as additional consideration paid by P for the S stock. The indebtedness has given rise to a nondeductible, non-capitalized expense of S that is reflected in the inside basis of its assets at the time of the acquisition.[43]

E. Comparison of Presumptive Approach Rules with Modified –2T Regulations

In the context of disallowing an artificial tax loss to prevent a Son of Mirror Transaction, a comparison of the Presumptive Approach, which applies two presumptions subject to limited rebuttal by taxpayers through tracing, and the approach of the Modified –2T Regulations leads to the conclusion that the approaches are more similar to each other, than dissimilar. For loss disallowance to extend to situations involving an uneconomic loss caused by the recognition of BII, any approach will have to rely on certain artificial presumptions (e.g., the tax life of various intangible assets). Further, to narrow the overbreadth of the presumptions relied on for the Presumptive Approach, taxpayers should be given the opportunity to trace assets (e.g., the after-acquired-asset exception). Thus, in creating an approach to loss disallowance that covers situations involving BIG and BII and that does not have overbroad rules that would too often deny real economic losses, any approach would be comprised of certain presumptions and instances where taxpayers are allowed to trace so as to rebut a general loss disallowance rule or BIG presumptions.

Where the approaches would materially differ is if the Treasury and the IRS decide to extend the rules to the gain side. Under our Presumptive Approach, Clause (1) could apply to prevent both uneconomic losses and understated gains. By contrast, the Modified –2T Regulations would require two rules; one for the loss side and one for the

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[42] Rev. Rul. 2001-26, 2001-23 I.R.B. 1.
[43] For a discussion of this issue and other indebtedness issues, see Dubroff et. al., The Federal Taxation of Corporations Filing Consolidated Returns, Section 72.02[4][b][iii] (2nd ed. 2002).

gain side. In addition, the burden of proof should shift from taxpayers to the IRS with respect to situations involving understated gain. Ultimately, the government's choice of which approach to adopt may depend on whether the government decides to extend the rules to the gain side.

The following table compares both approaches:

	Presumptive Approach	Modified –2T Regulations
1) Disallows any loss	Yes, disallow losses to the extent of positive post-acquisition basis adjustments	Yes, subject to taxpayer rebuttal
2) Increase gain	Yes, to the extent of positive post-acquisition basis adjustments from extraordinary dispositions	No, subject to IRS rebuttal
3) BII	Clause (2) would apply to preclude positive basis adjustments for BII, but only for a limited period	Adopt presumptive rules to address BII, but rules only apply for a limited period
4) Tracing **a) Loss Side**	Taxpayers permitted to trace for purposes of after acquired asset exception	With respect to loss, taxpayers can trace to establish loss is not attributable to BIG or BII reflected in stock basis
b) Gain Side	Taxpayers permitted to trace for purposes of after-acquired asset exception	With respect to gain, IRS can trace to establish gain is understated due to recognition of BIG
5) Presumptions **a) Loss Side**	Clauses (1) and (2) are presumptions	Presumptions for recognition of BII for tax life of certain assets (e.g. goodwill)
b) Gain Side	Clause (1) but not Clause (2)	No presumption needed, since rules would apply to recognition of BIG from an actual disposition
6) Safe Harbors	Yes, for limited transactions where there is inside and outside basis conformity	Yes, for limited transactions where there is inside and outside basis conformity

V. Suggested Approach to the Loss Duplication Problem

While agreeing that addressing the Loss Duplication Problem is necessary, we are concerned by the –35 Regulations approach. At the forefront of our concerns is the complexity of the proposed rules. We believe it an appropriate goal to limit the opportunities for one or more members of a consolidated group to claim more than one deduction from a single economic loss. However, we believe that this goal is best achieved by viewing the problem largely as one of abuse[44] with the goal of introducing minimal complication to the current consolidated return rules, rather than attempting to eradicate any possibility of loss duplication through precise and comprehensive rules. Prop. Treas. Regs. Section 1.1502-35, by adopting the latter approach, does not appear to

[44] The –35 Regulations, as illustrated and explained in the preamble and the examples, focus on "stuffing" transactions in which BIL assets are contributed to the subsidiary prior to the recognition of losses, suggesting that the basic concern is to prevent tax planning to obtain a duplicated loss. "Stuffing" transactions historically have been addressed by anti-abuse rules. See, e.g., Section 336(d) (precluding loss recognition on the liquidating distribution of certain property acquired prior to the liquidation); Section 382(l)(1)(A) (reducing the value of a loss corporation for certain pre-ownership change capital contributions); Treas. Reg. §1.269-3(b)(3) (providing that the contribution of high earning assets to a newly-formed corporation with other assets producing net operating losses ordinarily is indicative that the principal purpose for acquiring control was evasion or avoidance of Federal income tax); Treas. Reg. §1.269-3(c)(2) (similar, but dealing with the acquisition of assets rather than the acquisition of control); Treas. Reg. §1.338-4(h)(7) (determining the gain or loss recognized on the deemed sale of target affiliate stock without consideration to loss assets transferred thereto where such transfer was made with a purpose to reduce gain (or increase loss) recognized on such sale); Treas. Reg. §1.1502-13(h)(2), Example 3 (where one member contributes cash and another member contributes appreciated property to a newly formed member, after which the newly formed corporation liquidates under Sections 332 and 337 in an unrelated transaction with only cash going to the member that contributed the appreciated asset, such member will nevertheless be required to recognize the asset gain when the other distributee member is sold outside the group); Treas. Reg. §1.1502-13(h)(2), Example 4 (where one member contributes property with a basis equal to value and another member contributes appreciated amortizable property to a newly formed partnership, after which the partnership distributes the amortizable asset to the member contributing the non-appreciated asset in an unrelated liquidation such that the member takes a stepped-up basis therein under Section 732, appropriate adjustments must be made); Treas. Reg. §1.1502-20(e)(2) (reducing stock basis in a subsidiary where an asset is transferred thereto with a view to avoiding (i) the disallowance of loss on the disposition or the basis reduction on the deconsolidation of the subsidiary's stock; or (ii) the recognition of unrealized gain following the transfer); Treas. Reg. §1.1502-32(e), Example 2 (where appreciated property is contributed to eliminate gain on the sale of subsidiary stock, the basis adjustments are allocated to the contributing member's stock to avoid the planned result); Treas. Reg. §1.1502-91(g)(4) (excluding from the separately computed NUBIG/NUBIL amount any assets acquired with a principal purpose to affect such amount).

adequately consider the administrability and complexity concerns that most definitely should be considered in the resolution of this problem.[45]

In particular, we do not believe it appropriate to have one investment adjustment regime that applies in cases involving stock sold at a loss (the Basis Redetermination Rule of –35) and a different regime that applies when stock is sold at a gain.[46] Further, we do not believe it is appropriate to have one Basis Redetermination Rule that applies if the subsidiary remains part of the consolidated group after the sale of shares and another Basis Redetermination Rule that applies if the subsidiary is deconsolidated. While the preamble rationalizes the creation of a new regime as one that should not apply frequently (in the absence of tax incentives), we are not convinced that this assertion is correct.[47] Moreover, we do not believe that such complexity should be added to the law to address a limited group of transactions where a much simpler rule would suffice.[48] While it may be true that well advised taxpayers will be able to plan to avoid the application of the –35 Regulations, it will equally be true that those taxpayers will plan to use the Basis Redetermination Rules to their advantage. The basis shifting mechanism in the –35 Regulations could be used to eliminate excess loss accounts and, by invoking their application at a lower tier subsidiary, could enable tiering up of adjustments to eliminate gain recognition.

Ultimate adoption of the –35 Regulations would require significant additional rules to reduce the inadequacies, and the devotion of significant additional government resources. Significantly, to overcome the presumption of loss duplication in the –35 Regulations, taxpayers must understand what information will be required to support the valuation and tracing components of the required rebuttals. Because of the myriad of fact patterns that can exist, however, we are concerned that even with additional effort, the

[45] See Preamble to T.D. 8364 (September 19, 1991).
[46] As discussed above, we do not believe it desirable to rewrite Treas. Reg. Section 1.1502-32 and do not believe such a rewrite is necessary to address the apparent concerns of the government.
[47] For example, the –35 Regulations would apply to any intercompany taxable transfers of subsidiary stock that result in a loss.
[48] Regardless of the type of transaction resulting in a stock loss, taxpayers will need to assess the impact of the regulations for planning purposes, and the IRS will need to be able to apply the rules in the examination of returns.

apparent goal of the –35 Regulations to precisely eliminate loss duplication in all situations could not be reached.[49]

A. <u>Interim Guidance to Address the Loss Duplication Problem</u>

We appreciate the government must issue guidance in temporary or final regulations form by March 15, 2003, to have rules in place to address the Loss Duplication Problem for transactions occurring after March 7, 2002 (the date of Notice 2002-18).[50] We agree guidance should be issued for transactions in this 2002 period. Because we believe that additional time is necessary to study the Loss Duplication Problem and the issues raised by the –35 Regulations, however, we recommend not making these regulations effective by March 15, 2003. Issuing the –35 Regulations as temporary regulations without a satisfactory opportunity to study the complex issues inherent in them will result in confusion and significant additional work by taxpayers, their advisors and the government. Despite the possibility that the current –35 Regulations may only be effective for an interim period and may be significantly modified for future tax years, the government and taxpayers will still need to have the guidance necessary to transact business during this period.

Instead, we recommend the adoption of an interim rule that focuses on loss duplication and acceleration as a problem of abuse, designed to thwart taxpayer plans to benefit from loss duplication or acceleration in the consolidated group. For this purpose, we would define loss duplication in a manner similar to Notice 2002-18: a consolidated group obtaining a tax benefit from both the utilization of a loss from the disposition of stock (or another asset that reflects the basis of stock) and the utilization of a loss or deduction with respect to one or more other assets (or net operating or capital losses) that reflect the same economic loss. We would define loss acceleration as a consolidated group obtaining a tax benefit from the utilization of a loss from the disposition of stock

[49] For a detailed analysis of the –35 Regulations, see American Bar Association Tax Section, Comments Concerning Proposed Regulations on REG-131478-02, Consolidated Group Basis Redetermination and Loss Suspension, 2003 TNT 36-61 (February 24, 2003).
[50] <u>See</u> Section 1503(a). As with the Son of Mirror Problem, we believe it is appropriate for the government to issue interim guidance to address the Loss Duplication Problem while it evaluates the extent of the problem and the comments received.

(or another asset that reflects the basis of stock) while retaining ownership within the group of one or more other assets the basis of which reflects (or net operating or capital losses which reflect) the same economic loss.

In addition, we recommend that the anti-abuse rule would apply only to the specific transactions that currently form the basis for concern in the area: "stuffing transactions." The –35 Regulations illustrate these problems through fact patterns that involve the contribution of a BIL asset to the subsidiary whose stock would be later sold. The issuance of preferred stock in exchange for the stuffed asset appears especially problematic. However, beyond transactions involving stuffing undertaken with a view to achieving loss duplication or acceleration, we are not convinced that loss duplication or acceleration warrants broader rules, at least on an interim basis. While we recognize that loss duplication or acceleration may be objectionable even if unplanned, we do not believe that it is possible prior to the March 15, 2003 deadline to write comprehensive, objective rules without adding considerable complexity to the consolidated return regulations and the administration thereof. Further, hastily adopting a complex set of rules could result in improperly denying economic loss in some cases, or providing additional abuse opportunities in other cases. Thus, at least for purposes of this interim guidance, we would recommend narrowing the concerns with the Loss Duplication Problem to transactions in which there has been "planning" to achieve the duplication of a single economic loss through a "stuffing" transaction.

Utilizing the anti-abuse concepts and framework of the former LDR Rule, as adopted by the –2T Regulations, seems appropriate for addressing the problem created by "stuffing transactions" and for accomplishing the difficult charge of issuing effective guidance in a contracted time frame.[51] Similar to the anti-abuse rules in Treas. Reg. Section 1.1502-20(e), we recommend a rule that would apply if a taxpayer engages in a stuffing transaction with a view towards either loss duplication or acceleration (as defined above).

[51] See Treas. Reg. §1.1502-20(e).

If the stock or the asset were sold within a certain period after the stuffing transaction (other than in an intercompany transaction to which Treas. Reg. § 1.1502-13(c) applied), there would be a strong presumption that the prohibited view existed.[52] Two years could be considered an appropriate time frame for such a presumption.[53] If the stock or asset were sold more than two years after the stuffing transaction, there would generally not be a presumption for or against the prohibited view.

However, even for sales after the two-year period, the transfer of the stuffed asset in exchange for preferred stock would be evidence that such a view had existed at the time of the exchange. We agree with the suggestion in the preamble and examples in the –35 Regulations that the issuance of preferred stock in a stuffing transaction is indicative of planning. The basis in preferred stock is not allocated any negative basis adjustments under Treas. Reg. Section 1.1502-32 if the stuffed asset is sold first, and, in the case of preferred stock, such stock can be sold without disposing of any of the economics of the underlying assets. As a result, preferred stock can be used to maximize the loss duplication effects of a stuffing transaction. Moreover, there may be no economic disadvantage to the taxpayer to waiting for any requisite period of time to recognize the loss on the preferred stock.

If the prohibited view exists, the results should be based on the principles set forth in the -35 Regulations, namely that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss, and that loss should not be allowed while the asset remains within the group. If the stuffed asset is disposed of outside the group first, the loss would be recognized, but the basis adjustments required under Treas. Reg. Section 1.1502-32 should be allocated to the stock whose basis reflects the BIL of the asset.[54] The required basis adjustments could be illustrated by a separate

[52] However, the loss duplication or acceleration rule potentially would apply to a stock or asset loss taken into account after the intercompany transaction.
[53] For example, Sections 269(b), 336(d)(2), 355(e), 382(c), 382(l), 1059 and Treas. Reg. §§1.1502-20(e), 1.1502-32(e), and 1.1504-4(c)(2) look at the two-year period as indicative of a plan.
[54] The basis adjustments would be made under the principles of Section 704(c). If the stock loss were previously recognized as a result of an intercompany transaction, but not taken into account

example in the existing anti-abuse regime of Treas. Reg. Section 1.1502-32(e), or it could be made clear that existing Example 2 of the Treas. Reg. Section 1.1502-32(e) regulations is on point.

> Example 9. In year 1, P, the common parent of a consolidated group, forms S with cash in exchange for common stock. In year 2, P transfers Asset A with a basis of $100 and a value of $10 to S in exchange for additional shares of common stock ("Block 2"). In year 3, P sells Asset A, recognizing a $90 loss. Under the proposed anti-abuse rule, unless P could overcome the strong presumption, when the $90 loss is absorbed, the basis in Block 2 would be reduced by $90, leaving a basis in Block 2 of $10. The basis reduction in the Block 2 shares will eliminate the loss duplication potential created by the stuffing transaction. [55]

If the prohibited view exists and the subsidiary stock is disposed of outside the group before the asset is disposed of (or the stock is disposed of after the asset is disposed of but before the resulting asset loss has been utilized by the group), the stock loss would be suspended under a rule similar to the Suspended Loss Rule of the –35 Regulations, but with no adjustments to the basis of the subsidiary stock. Generally, any loss recognized with respect to the stock of a subsidiary would be deferred to the extent of the portion of any duplicated loss[56] attributable to the stuffing transaction until such time as it could be determined that such portion will not be utilized by the consolidated group. Upon deconsolidation of the subsidiary, the deferred loss would be allowed to the extent that the group can demonstrate that the duplicated loss in the assets (or net operating or capital losses) has not already been taken into account by the group and will

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under Treas. Reg. § 1.1502-13, the stock loss would be recharacterized as a nondeductible, noncapital expense.

[55] This basis tracking approach necessarily requires limited tracing of stuffed assets and the stock acquired in exchange therefor. The existing Example 2 in Treas. Reg. §1.1502-32(e) reaches the same result.

[56] The definition of "duplicated loss" in the –35 Regulations (i.e., the excess of (1) the sum of the aggregate basis of the subsidiary member's assets (excluding stock in other subsidiary members of the group), the subsidiary member's losses that are carried to its first taxable year after the disposition and the subsidiary member's deductions that have been recognized but deferred under another provision, over (2) the sum of the value of stock of the subsidiary member and the subsidiary member's liabilities that have been taken into account for tax purposes) is appropriate for this purpose.

not be retained by the group. Alternatively, if the taxpayer can demonstrate that there is no possibility of utilizing the inside loss (e.g., the stock loss duplicated net operating losses of the subsidiary that subsequently expired or that are subject to a zero Section 382 limitation pursuant to Section 382(g)(4)(D)), the deferred stock loss would be allowed. [57]

B. Beyond Interim Guidance

We believe the anti-abuse approach described above accomplishes the government's goal of preventing problematic loss duplication and acceleration while the issues continue to be studied. In formulating the ultimate guidance in this area, it will be important to consider some of the fundamental policy questions raised by loss duplication and acceleration generally, as implicit in the –35 Regulations, and as interpreted by the courts that have rendered decisions in the area.

Significantly, in order to determine whether an anti-avoidance regime will be adequate in the long-term, the government must identify whether or not loss duplication arising in fact patterns other than stuffing transactions is acceptable. For example, suppose there is no stuffing, but preexisting assets of a wholly owned subsidiary decline in value, and the parent sells 20% of the stock of the subsidiary at a loss. Should the loss be disallowed or deferred because the assets remain within the group? We question whether the prohibition on loss duplication should go this far. In any event, if the government decides that a more expansive approach is necessary to attempt to address all possible loss duplication, further explanation of the problem and additional rules and complexities would be necessary.

[57] The requirement that the group demonstrate that the duplicated loss not be retained by the group notwithstanding the deconsolidation of the subsidiary would preclude a taxpayer from planning into a taxable liquidation of the subsidiary (because its liabilities exceed the value of its assets), and arguing that it is entitled to the stock loss and the subsidiary's portion of the consolidated net operating or capital loss pursuant to United Dominion Industries, Inc. v. U.S., 532 U.S. 822 (2001). It should be noted that we believe that the correct result under current law is that the subsidiary's portion of any consolidated net operating or capital losses are eliminated in a taxable liquidation. Similarly, the requirement that the stock loss be deferred until the group can demonstrate that it cannot utilize the inside loss would preclude the group from planning into a worthless stock deduction and arguing that the group also retains the subsidiary's portion of the consolidated net operating or net capital loss without a zero Section 382 limitation under Section 382(g)(4)(D).

Additionally, in studying the Loss Duplication Problem, a determination must be made as to whether a consolidated group should have the opportunity to accelerate a loss, namely to recognize the loss on the stock sale after a stuffing transaction while utilization of the inside loss by the group is limited or precluded through one mechanism or another. The -35 Regulations clearly have the effect of precluding such acceleration, although the preamble does not expressly articulate whether the government is troubled by the acceleration possibilities in a consolidated group.[58]

In the separate return context, a taxpayer generally is able to accelerate losses.[59] We recognize, however, that the rules governing the taxation of the consolidated group is necessarily a blend of separate and single entity concepts. In particular, the use of preferred stock in the consolidated group context may allow unlimited opportunity for acceleration while the group retains all the economics of the subsidiary. As a result, we believe that restrictions on acceleration are appropriate. However, if the government determines that acceleration is acceptable in some contexts, one approach would be to allow a taxpayer to recognize the stock loss provided the taxpayer agrees (pursuant to a closing agreement) to a permanent corresponding reduction in asset basis or the subsidiary's portion of the consolidated net operating or capital losses. We would note that such an approach is likely to involve a number of ordering rules that may entail a good deal of complexity.

Finally, it is necessary to examine further the proper scope of Rite Aid in light of the Ilfeld decision – i.e., whether Rite Aid provides any limitation on the government's ability to write regulations consistent with Ilfeld to prevent a consolidated group from obtaining two benefits in respect of a single economic loss.

We do not believe that the three issues discussed above need be resolved for purposes of the interim guidance and we fully recognize that time does not permit proper

[58] Notice 2002-18 leaves open the possibility of addressing the duplication problem by limiting the inside losses and does not articulate a problem with acceleration.
[59] But see, Section 358(h) (a stock basis adjustment regime that disallows acceleration of loss in the case of liabilities that are not yet recognized by the tax system).

consideration of them. However, we believe that they should be resolved ultimately in determining the proper scope of final regulations.