NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON

CLAIMING WORTHLESSNESS FOR A FAILED SUBSIDIARY WITHIN A CONSOLIDATED GROUP

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New York State Bar Association Tax Section

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Claiming Worthlessness for a Failed Subsidiary within a Consolidated Group

I. Introduction

This report of the Tax Section of the New York State Bar Association (the "Tax Section") addresses how consolidated groups should account for failed subsidiaries for U.S. federal income tax purposes.[1] We addressed this topic in a prior report (the "2003 Report").[2] Since then, the Internal Revenue Service (the "Service") and the Treasury Department (the "Treasury") have proposed guidance attempting to address in a comprehensive fashion the treatment of insolvent company restructurings under general subchapter C rules and issued other guidance addressing selected consolidated return aspects. No comprehensive guidance addressing accounting for failed subsidiaries by consolidated groups has been issued, or even proposed. Instead, consolidated return guidance has been provided on a piecemeal basis through regulations and published and private rulings to address specific issues.

The impetus for the current report is the continued development of the rules governing the timing and availability of a worthlessness deduction with respect to stock of a consolidated subsidiary. The current report discusses three paradigms for whether and when a consolidated group can claim worthlessness on the stock of an insolvent subsidiary (or on the stock of a subsidiary whose asset value is not in excess of the liquidation preference on its outstanding preferred stock) by consummation of an upstream or sideways restructuring. The three paradigms described herein include determining the timing and availability of a worthless stock deduction by (i) generally applying subchapter C rules applicable to separate entities, although adjustments are made as necessary to coordinate with the consolidated return regulations (i.e., the approach taken under current law); (ii) adopting the approach described in the 2003 Report, which generally took a single entity approach where the consolidated group continues the insolvent subsidiary's business, thereby denying a worthless stock deduction upon an upstream or sideways restructuring of the subsidiary; and (iii) providing an alternative, hybrid approach that

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For purposes of this report, an upstream restructuring is an actual or deemed transfer of the assets of a subsidiary to its parent corporation through merger, liquidation, or conversion into an entity that is disregarded pursuant to Treas. Reg. § 301.7701-3. A sideways restructuring is a transfer of the assets of a subsidiary to a sister corporation (the "acquiring subsidiary") through merger or otherwise.

[2] *See* Report No. 1043, New York State Bar Association Section on Taxation, Report on Reorganizations Involving Insolvent Subsidiaries (Nov. 7, 2003), reprinted at 2003 TNT 218-50.

defers the worthless stock deduction that would otherwise result under current law until a later appropriate triggering event (the "Suspended Loss Approach").

II. Summary of Recommendations

We continue to believe that the government should provide specific rules in a consolidated return regulation to determine whether a worthless stock deduction can be recognized as a result of an upstream or sideways restructuring of an insolvent subsidiary. The interactions between the consolidated return regulations and Code-based rules for worthless stock deductions have increased and become more complex since our 2003 Report. Consolidated return regulations now have a pervasive impact on the timing, character, allowable amount, and collateral consequences of a worthless stock deduction with respect to the stock of a consolidated subsidiary. The trend generally has been to impose single entity adjustments on the Code's separate company framework with respect to stock worthlessness. For example, in 2007, the government reaffirmed the deferral rule of Treas. Reg. § 1.1502-80(c) ("-80(c)"),[3] making it clear that the foundation for the rule is single entity treatment. However, the government has been unwilling to adopt a special rule in consolidation applying a single entity approach to determining qualification for nonrecognition treatment under subchapter C provisions and, in fact, specifically rejected this approach in connection with the issuance of the proposed net value regulations in 2005 (the "PNV Regulations").[4] While adopting such an approach would be a significant step beyond where the government has been willing to go under current law, the pervasive influence of single entity oriented rules under the consolidated return regulations with respect to worthless stock deductions for insolvent subsidiaries, as well as the complexity of the interaction between single entity and separate company rules, argue persuasively, in our view, for a single entity determination of whether an upstream or sideways restructuring can generate a worthless stock deduction.

We continue to believe that the proposals made in the 2003 Report are appropriate because they represent a unified approach to the treatment of stock of an insolvent subsidiary (or subsidiary whose asset value is not in excess of the liquidation preference on its outstanding preferred stock) by generally eliminating the worthless stock deduction where the subsidiary's business remains in the group. Many of the developments in the law since then are not incompatible with the recommendations in the 2003 Report. Adoption of these proposals will not eliminate the complexities and uncertainties associated with the interaction of the consolidated return regulations and the Code-based worthless stock provisions in all cases. However, the adoption of the proposals should resolve issues associated with an important category of cases and produce results that facilitate business-motivated restructurings while limiting opportunities for artificial acceleration of worthless stock deductions. We therefore suggest that the proposals described in the 2003 Report be considered anew.

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[3] Unless otherwise specified, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations (the "Regulations") promulgated thereunder.

[4] *See* REG-163314-03, 70 FR 11903 (Mar. 10, 2005).

Should the government still determine not to issue a consolidated return regulation modifying the application of the tax-free reorganization provisions of section 368 to upstream and sideways restructurings of insolvent subsidiaries, we recommend that consideration be given to the Suspended Loss Approach. This approach is essentially a hybrid of single entity and separate company treatment that does not eliminate or disallow a worthless stock deduction with respect to the subsidiary but instead defers such deduction until the subsidiary's shareholder (i.e., its parent corporation[5]) leaves the consolidated group or potentially another triggering event occurs. We also suggest for consideration an election by which the common parent of the group can "push down" the portion of the subsidiary stock basis that does not represent a duplicated loss to the assets of the subsidiary that remain within the consolidated group immediately after the restructuring, subject to certain requirements (including the requirement that such election will only be available where the worthless stock loss otherwise would have been ordinary under section 165(g)(3)).

III. Paradigm One: Summary of Current Law Addressing Worthless Stock Deductions and the Proposed Net Value Regulations

The timing and availability of a worthless stock deduction for an insolvent subsidiary depends in the first instance on generally-applicable rules of the Code (e.g., sections 165(g), 332, and 368). The consequences of applying these rules are modified by the consolidated return regulations, which impact the timing, character, allowable amount, and collateral consequences of any worthless stock deduction (e.g., -80(c), Treas. Reg. §§ 1.1502-19(c)(1)(iii), 1.1502-35(f), 1.1502-36). Thus, under current law, a determination must be made as to whether an insolvent subsidiary's stock is worthless and if so, whether a deduction is permitted more generally under the Code.[6] Then, adjustments must be made to take into account how the consolidated return regulations alter the Code-based results.

A. The Application of Section 165 Outside of Consolidation

Section 165(a) broadly provides that "[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Section 165(g)(1) generally treats a loss arising from the worthlessness of corporate stock held as a capital asset as a loss from a sale or exchange occurring on the last day of the taxable year if the stock becomes worthless during such taxable year.[7] An ordinary worthless stock loss is permitted in certain circumstances, provided the taxpayer directly owns stock meeting the requirements of section

[5] References to "parent" and "parent corporation" throughout this report refer to the member of the group directly owning stock in the "subsidiary".

[6] Treas. Reg. § 1.1502-80(a) ("The Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. To the extent not excluded, other rules operate in addition to, and may be modified by, these regulations.").

[7] Section 165(g) applies more generally to a "security," which is defined as (i) a share of stock in a corporation, (ii) a right to subscribe for, or to receive, a share of stock in a corporation, or (iii) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation of by a government or political subdivision thereof, with interest coupons or in registered form. Section 165(g)(2). This report focuses on worthless stock losses; therefore further discussion of the other categories of securities is not included herein.

1504(a)(2) and the gross receipts test under section 165(g)(3)(B) is satisfied.[8] Thus, to fall within the scope of these provisions, the following requirements must be met.

1. Identifiable Event Establishing Worthlessness

Section 165(a) does not apply to a stock investment that becomes partially worthless due to a decline in value during the year.[9] Instead, there must be one or more identifiable events evidencing complete worthlessness before a section 165 deduction is allowed.[10] Specifically, there must be an event that forecloses a recovery of any value with respect to the stock. Events that have been held to indicate worthlessness are (i) bankruptcy (or substantial insolvency),[11] (ii) termination of business operations,[12] (iii) liquidation, and (iv) receivership.[13]

In many instances, insolvency is the initial step for establishing worthlessness. But insolvency alone does not establish worthlessness unless there is another event or fact indicating that there is no chance for recovery.[14] The complete liquidation of a corporation is likely the most widely accepted indicator of worthlessness by the courts and the Service. In fact, a liquidation in and of itself generally establishes worthlessness because it forecloses any chance that the stock may later become valuable.[15] The stock of an insolvent corporation might not be viewed as worthless if it is considered to have future value; but the liquidation of the insolvent corporation generally will forestall any allegation of remaining value, if only because the liquidated corporation's stock is cancelled in exchange for no consideration.[16]

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[8] Section 165(g)(3).

[9] *See* Treas. Reg. § 1.165-4(a); *875 Park Avenue Co. v. Comm'r*, 217 F.2d 699 (2d Cir. 1954), *aff'g*, 12 T.C.M. 1157 (1953).

[10] *See Chandless v. Comm'r*, 2 T.C.M. 296 (1943).

[11] Typically, bankruptcy and insolvency must be combined with another event in order for stock/securities to be considered worthless. *See, e.g., Mahler v. Comm'r*, 119 F.2d 869 (2d Cir. 1941), *cert. denied*, 314 U.S. 660 (1941); *Young v. Comm'r*, 123 F.2d 597 (2d Cir. 1941); *Textron, Inc. v. U.S.*, 561 F.2d 1023 (1st Cir. 1977); *Jessup v. Comm'r*, 36 T.C.M. 1145 (1977).

[12] *See The Austin Co., Inc. v. Comm'r*, 71 T.C. 955 (1979).

[13] *Morton v. Comm'r*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

[14] *Id*. ("[I]t is apparent that a loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss is sustained, that stock may not be considered worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time, and that such hope and expectation may be foreclosed by the happening of certain events such as bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver for it. Such events are called 'identifiable' in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock.").

[15] *See Gould Securities Co., Inc. v. Comm'r*, 96 F.2d 780 (2d Cir. 1938); *Burnet v. Imperial Elevator Co*., 66 F.2d 643 (8th Cir. 1933); *Dittmar v. Comm'r*, 23 T.C. 789 (1955), *acq*., 1955-2 C.B. 5.

[16] *See Comm'r v. Spaulding Bakeries, Inc*., 252 F.2d 693 (2d Cir. 1958), *nonacq*., 1957-2 C.B. 8, and *H.K. Porter Co. v. Comm'r*, 87 T.C. 689 (1986) (complete liquidation of a subsidiary that had common and preferred stock outstanding resulted in a worthless stock deduction with respect to the subsidiary's common stock where the liquidated corporation's net asset value was less that the preference on the outstanding preferred stock resulting in no distribution with respect to its common stock). *See also* Prop. Treas. Reg. § 1.332-2(b) (for a complete

In addition, the availability of a worthless stock deduction is not precluded even if the parent corporation (or another entity) continues the liquidated corporation's business operations.[17] For example, in Rev. Rul. 2003-125,[18] a subsidiary corporation made an election under Treas. Reg. § 301.7701-3 (a "check-the-box" election) resulting in its dissolution for U.S. federal income tax purposes. Although the subsidiary's business continued to operate in the disregarded entity, the Service ruled that a worthless stock deduction under section 165(g) was available, provided the amount of the subsidiary's liabilities were in excess of the value of all of its assets (tangible or intangible),[19] because no distribution was made with respect to the subsidiary's stock. Moreover, the Service stated that the deemed liquidation resulting from the entity's change in classification is an identifiable event that fixes the shareholder's loss with respect to the subsidiary corporation's stock because it destroys the potential for the shareholder, in its capacity as such, to obtain any future value from its stock investment.

2. Sustained During the Taxable Year

A loss must be "actually sustained during the taxable year" in order for a deduction to be allowed.[20] A loss is treated as sustained in the taxable year in which the loss occurs, evidenced by closed and completed transactions and as fixed by identifiable events.[21] As discussed above, a loss is generally treated as sustained when stock is proven worthless (i.e., devoid of present and potential value) by the occurrence of an identifiable event.

3. Ownership Requirement

Under section 165(g)(3), stock in a corporation is not treated as a capital asset and a worthless stock deduction is ordinary, if (i) the shareholder owns the requisite amount of such stock and (ii) the corporation is active as determined by reference to its gross receipts. Under section 165(g)(3)(A), the shareholder must directly own stock meeting the requirements of section 1504(a)(2) (i.e., stock possessing at least 80 percent of the total voting power and at least 80

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liquidation to qualify under section 332, P must receive "at least partial payment for each class of stock it owns" in S).

[17] *See, e.g.*, Rev. Rul. 70-489, 1970-2 C.B. 53, modified by Rev. Rul. 2003-125, 2003-2 C.B. 1243 (Service ruled that taxpayer was entitled to a worthless stock loss notwithstanding that the taxpayer continued the insolvent subsidiary's operations as a branch); PLR 8528067 (Apr. 17, 1985); PLR 8824040 (Mar. 21, 1988); PLR 9425024 (Mar. 25, 1994); PLR 9610030 (Dec. 12, 1995). *But see* FSA 200226004 (June 28, 2002) (Service concluded that the shareholders of an insolvent subsidiary that terminated its existence via a check-the-box election under Treas. Reg. § 301.7701-3 were precluded from claiming a worthless stock deduction because the insolvent subsidiary's business continued). Presumably, as discussed below, this conclusion has no continuing validity in light of Rev. Rul. 2003-125.

[18] 2003-2 C.B. 1243.

[19] For purposes of this fair market value determination, all of the corporation's assets, including tangible and intangible assets and assets not appearing on the corporation's balance sheet, are taken into account.

[20] Treas. Reg. § 1.165-1(b).

[21] Treas. Reg. § 1.165-1(d)(1).

percent of the total value of such corporation). This determination is made at the time the stock of the issuing corporation becomes worthless.

4. Gross Receipts Requirement

In addition to the ownership requirement described above, an ordinary loss is available only if more than 90 percent of the subsidiary's aggregate gross receipts for all taxable years has been from sources other than royalties, certain rents, dividends, certain interest, annuities, and gains from sales or exchanges of stock and securities.[22] The term "gross receipts" is defined as the total gross receipts without any deduction for cost of goods sold.[23] Additionally, with respect to gross receipts from the sale or exchange of stock and securities, only gains are included (i.e., loss from the disposition of stock and securities are not netted against gains for purposes of applying the gross receipts test).[24]

Although section 165(g)(3)(B) appears clear on its face, there is a meaningful body of administrative precedent holding that rental and interest income realized in connection with the active conduct of a trade or business does not constitute "bad" receipts for purposes of the gross receipts test provided the issuing corporation performs significant services in connection with the generation of such income. For example, in Rev. Rul. 88-65,[25] the Service ruled that rental income generated by a corporation that was actively engaged in renting motor vehicles and performed significant services with respect to the leased property was not "rents" for purposes of section 165(g)(3).[26]

The Service also has ruled that a target corporation's gross receipts history is an attribute to which section 381 applies and must be taken into account by an acquiring corporation for purposes of analyzing whether the gross receipts requirement is satisfied. For example, in PLR 200710004,[27] the historic gross receipts of certain target corporations acquired in section 381 transactions were required to be taken into account for purposes of determining whether the acquiring corporation satisfied the gross receipts test under section 165(g)(3)(B).[28]

B. Application of Sections 332 and 368 to Upstream and Sideways Reorganizations Outside of Consolidation

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[22] Section 165(g)(3); Treas. Reg. § 1.165-5(d)(2)(iii). As described in Rev. Rul. 75-186, 1975-1 C.B. 72, the appropriate methodology for determining whether the 90 percent gross receipts test is satisfied is to aggregate receipts for all taxable years (i.e., the test is not applied to each taxable year).

[23] Treas. Reg. § 1.165-5(d)(2)(iii).

[24] *Id*.

[25] 1988-2 C.B. 32.

[26] *See also* PLR 200003039 (Jan. 21, 2000) (income from short-term vehicle rentals, long-term vehicle leases, and fees paid by franchisees were not "bad" gross receipts for section 165(g)(3) purposes because the corporation provided significant services with respect to the three types of income); PLR 9218038 (Jan. 29, 1992) (interest income received by a federal savings bank with respect to its lending activities was not "bad" gross receipts for section 165(g)(3) purposes).

[27] Dec. 5, 2006.

[28] *See also* PLR 200932018 (Apr. 14, 2009).

1. Case Law and Other Currently-Operative Guidance

The 2003 Report noted that:

> Current law regarding upstream and sideways restructurings of insolvent subsidiaries is uneven. There is a fair degree of clarity in existing case law and IRS rulings with respect to a number of critical issues relating to the qualification of upstream restructurings for tax-free treatment, although recent developments call in to question whether older precedents still control. In contrast, substantial uncertainty remains about whether sideways restructurings of insolvent subsidiaries can qualify for tax-free reorganization treatment.

a. Developments Relating to Upstream Restructurings

Today, as when we submitted the 2003 Report, an upstream restructuring of an insolvent subsidiary cannot qualify as a tax-free liquidation under section 332 or as a tax-free reorganization under section 368. The authorities cited in the 2003 Report remain intact. For example, we noted that, in *H.G. Hill Stores, Inc. v. Commissioner,*[29] because of the subsidiary's insolvency, the court held that the parent received no property upon the cancellation of its stock and, therefore, did not qualify for section 332 nonrecognition treatment.[30] Shortly after the release of the 2003 Report, the Service confirmed this analysis in Rev. Rul. 2003-125.

The Service's position today remains that an upstream restructuring of an insolvent corporation cannot qualify as a tax-free reorganization. In Rev. Rul. 59-296,[31] the Service held that a merger of an insolvent subsidiary into its creditor-parent failed to qualify as a tax-free "A" Reorganization. The Service reasoned that:

> the transfer of all the debtor-subsidiary's assets to the creditor-parent in a transaction which is a merger or consolidation under the applicable state statutes is a transfer made in satisfaction of indebtedness. Since all of the property of the subsidiary is worth less than the debt, no part of the transfer is attributable to the stock interest of the parent. The transaction is therefore neither a nontaxable distribution under section 332 of the [Code] nor a tax-free "reorganization" under section 368(a)(1)(A) of the Code.

While Rev. Rul. 2003-125 did not explicitly confirm this result, the same analysis implicitly underlies the holding in that revenue ruling. [32]

[29] 44 B.T.A. 1182 (1941) (applying section 112(b)(6) of the Revenue Act of 1936, the predecessor of section 332).

[30] *Id.* at 1183. In *Hill*, the parent was permitted to claim a worthless stock deduction on the liquidation of its insolvent subsidiary. *Id.*

[31] 1959-2 C.B. 87.

[32] As indicated in our prior report on the PNV Regulations, absent the adoption of our recommendations in the 2003 Report, we agree that an upstream restructuring of an insolvent corporation generally constitutes a repayment of debt and cannot qualify as a tax-free reorganization, *See* Report No. 1102, New York State Bar Association Section on Taxation (Jan. 20, 2006), reprinted at 2006 TNT 15-10.

In addition, it remains the case that a capital contribution made by a parent corporation in order to render its subsidiary solvent in anticipation of the upstream restructuring will not be respected. In Rev. Rul. 68-602,[33] the corporate shareholder of a subsidiary could not make its subsidiary solvent by contributing debt owed by the subsidiary to it. The Service disregarded the cancellation of debt immediately before the liquidation because it was an integral part of the liquidation and had no independent significance. The Service continues to adhere to this analysis. In two instances since 2003, the Service has applied Rev. Rul. 68-602 to preclude section 332 from applying to the deemed liquidation of a subsidiary following a sale of its stock that the parties elected to treat as a sale of its assets pursuant to section 338(h)(10).[34]

The issuance of Rev. Rul. 2003-125 has removed an uncertainty that we noted in the 2003 Report. In FSA 200226004, a U.S. holding corporation elected to treat two foreign subsidiaries as disregarded and claimed a worthless stock loss on the common stock of both entities. Despite the fact that the foreign entities were insolvent, the Service asserted that no worthless stock deduction could be taken based on several factors: (1) the fact that the businesses continued to operate as before; (2) the foreign entities had been unaware of the change in form; (3) it was unclear whether the U.S. corporation had written the stock off as worthless on its books; (4) it was unclear if the stock had been cancelled; and (5) the beneficial ownership of the U.S. corporation had not changed. In the 2003 Report, we noted with concern that, if the Service's position in the FSA was based on the theory that a subsidiary's insolvency does not assure that its stockholders would not receive any value in a restructuring, and the Service was signaling that the distribution requirement for a section 332 liquidation can be satisfied where as a practical matter a shareholder would have been able to extract value in a workout, greater uncertainty would be injected into the law governing upstream restructurings. Rev. Rul. 2003-125 clarified that, contrary to this potential interpretation of the FSA, the Service will treat liquidating proceeds as first being used to repay debt (or preferred stock) in accordance with its priority position and the residual class of stock will be treated as worthless if it would receive nothing based on the applicable priorities.

Other uncertainties regarding the treatment of upstream restructurings have not been fully addressed. The principal uncertainty is the proper characterization for federal income tax purposes of intercompany debt, a matter on which there has been little guidance since the 2003 Report.

As noted in the 2003 Report, if a subsidiary is potentially insolvent due to intercompany advances from its parent, considerable uncertainty may exist as to whether such advances constitute debt or equity for federal income tax purposes. The characterization of such interests often will impact whether the upstream restructuring can qualify as a tax-free reorganization. For example, if the intercompany advance were recharacterized as preferred equity for federal

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[33] 1968-2 C.B. 135.

[34] PLR 201011003 (Nov. 30, 2009); CCA 200818005 (Jan. 29, 2008). In PLR 201011003, the parent corporation was entitled to a worthless stock loss deduction. It is not clear in CCA 200818005 whether the parent corporation was entitled to a worthless stock deduction or whether the parent corporation was required to recognize income from the recapture of an excess loss account pursuant to Treas. Reg. § 1.1502-19 (an "ELA").

income tax purposes, section 332 still would not apply to an upstream restructuring of the subsidiary based on the holding in *Spaulding Bakeries Inc. v. Commissioner*.[35] In this case, the parent corporation owned both common and preferred stock in an insolvent subsidiary, and the subsidiary liquidated, distributing assets to the parent that were worth less than the liquidation preference on the preferred stock. The Second Circuit held, under a predecessor to section 332, that a partial payment on preferred stock did not constitute a liquidation because no assets were distributed with respect to the common stock.[36]

As noted in the 2003 Report, an upstream restructuring where intercompany debt is recharacterized as preferred stock may qualify as a tax-free reorganization – a fact that remains true today. However, characterization as an upstream reorganization potentially creates its own uncertainties. In Rev. Rul. 74-515,[37] the Service addressed a reorganization of a solvent company in which a shareholder held both preferred and common stock of the target corporation. The shareholder received solely cash with respect to the target preferred stock and acquiring corporation stock with respect to the target common stock. The Service ruled that the shareholder's treatment was governed solely by sections 354 and 356 and, consequently, the shareholder could not recognize a loss on the preferred stock under section 1001. Applying a similar analysis, it could be argued that, under section 356(c),[38] a parent corporation cannot recognize a worthless stock deduction on a subsidiary's common stock in an upstream (or sideways) restructuring that qualifies as a tax-free reorganization where the parent receives consideration only on the subsidiary's preferred stock. We believe that this ought not be the result and that a parent corporation should be able to recognize a worthless stock deduction in this fact pattern for two reasons: (1) there is no exchange with respect to the subsidiary's common stock, which thus should not be viewed as being part of the section 354 exchange with respect to the preferred stock, and (2) no "boot" is received in the transaction to which section 356 applies and thus section 356(c) is not operative. This position is supported by the PNV Regulations described below.[39]

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[35] 27 T.C. 684 (1957), *nonacq.*, 1957-2 C.B. 8, *aff'd*, 252 F.2d 693 (2d Cir. 1958).

[36] *See also H.K. Porter Co. v. Comm'r,* 87 T.C. 689 (1986).

[37] 1974-2 C.B. 118.

[38] Section 356(c) prohibits a shareholder from taking a loss in an exchange to which section 356 applies.

[39] *See* Prop. Treas. Reg. § 1.332-2(e), Ex. 2, published after the 2003 Report, which would not apply section 356(c) to deny a worthless stock deduction in this case. Treas. Reg. § 1.1502-36(d)(7)(iii), Ex. (iii), which is currently operative, avoids the issue by positing that there are two different holders of the subsidiary's common and preferred shares.

b. Developments Relating to Sideways Restructurings

The 2003 Report noted that the treatment of sideways restructurings is less certain than the treatment of upstream restructurings, which remains true today. The 2003 Report noted that sideways restructurings have two potential pathways to tax-free treatment: (1) under the doctrine underlying the *Norman Scott* case,[40] which holds that the continuity of interest ("COI") requirement for tax-free reorganization status is satisfied where there is substantial identity in the shareholder and creditor interests, or (2) as a "D" Reorganization (section 368(a)(1)(D)), with respect to which the control requirement appears to supercede the COI requirement.

The *Norman* Scott case was discussed extensively in the 2003 Report.[41] In brief, it involved a merger of two insolvent sister corporations into a third sister corporation. The Tax Court held that the mergers constituted valid tax-free reorganizations. The court rejected the Service's challenge to tax-free status, finding that the COI requirement was satisfied because the insolvent target corporations' shareholders received a proprietary interest in the acquiring corporation *either* as shareholders or as creditors. The Service ultimately acquiesced in the result reached in *Norman Scott*, although it rejected the broad sweep of the Tax Court's reasoning. In the Service's view, COI was satisfied, but only because there was a virtual identity of shareholder and creditor interests.[42]

Since 2003, there have been no cases or rulings citing *Norman Scott* or addressing a similar fact pattern. As discussed further below, the Service has addressed the analysis in *Norman Scott* in proposed regulations issued in 2005 (restating its position that a sideways reorganization of an insolvent subsidiary cannot qualify as a tax-free reorganization); however, these proposed regulations are not currently operative.

With respect to the potential application of the "D" Reorganization provisions to sideways restructurings, the 2003 Report noted that there were two critical aspects to the analysis: the application of the COI requirement and the distribution requirement under section 354(a)(2)(B). As noted in the 2003 Report, where the control requirement is satisfied, it appears to supercede the COI requirement, at least where there is virtual identity of ownership between the acquiring and target corporations. There appears to be no meaningful change in the state of the law in this regard.

In the interim, the Service has issued regulations addressing the application of the distribution requirement where such identity of ownership exists.[43] In general, these regulations effectively deem the distribution requirement to be met through the mechanism of treating the acquiring corporation as issuing a nominal share and the target corporation as distributing the nominal share to its shareholders. These regulations do not explicitly exclude insolvent target

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[40] 48 T.C. 598 (1967), *action on dec.*, 1967 AOD LEXIS104 (Dec. 7 1967) (the Service acquiesced in result only).

[41] *See also United States v. Adkins-Phelps, Inc.*, 400 F.2d 737 (8th Cir. 1968) (disregarding whether a shareholder/creditor received her stock as a shareholder or as a creditor).

[42] 1967 AOD LEXIS104 (Dec. 7, 1967).

[43] Treas. Reg. § 1.368-2(l).

corporations from the application of this nominal share approach. In promulgating the initial version of the nominal share regulations, the Service and the Treasury noted that:

> [T]hese temporary regulations do not expressly implement Prop. Reg. § 1.368-1(f)(4) (FR 70, 11903-11912), which provides that there must be an exchange of net value except in the case of a transaction that would otherwise qualify as a reorganization described in section 368(a)(1)(D), provided that the fair market value of the property transferred to the acquiring corporation by the target corporation exceeds the amount of liabilities of the target corporation immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the fair market value of the assets of the acquiring corporation equals or exceeds the amount of its liabilities immediately after the exchange. The solvency requirement remains the IRS's and Treasury Department's proposal but the IRS and Treasury Department continue to consider whether this solvency requirement should be applied to the transactions described in these temporary regulations.

In absence of any express limitation of the nominal share approach, it appears to apply even in the case of an insolvent target and results in satisfaction of the distribution requirement. However, the "D" Reorganization Regulations continue to leave open the question as to whether there is an overriding requirement that the target corporation be solvent prior to the reorganization.

In any event, as noted in the 2003 Report, an insolvent subsidiary apparently can be made solvent prior to a sideways restructuring through a parent corporation's contribution of intercompany debt or other value to such subsidiary. In Rev. Rul. 78-330,[44] the Service ruled that the cancellation of debt by a parent corporation in order to avoid section 357(c) gain on a subsequent "D" Reorganization should be respected. The Service reasoned that such contribution has independent economic significance because it results "in a genuine alteration of a previous bona fide business relationship." Accordingly, the 2003 Report noted that a capital contribution prior to a sideways reorganization, to which Rev. Rul. 78-330 may apply, differed materially from a capital contribution prior to an upstream reorganization, to which Rev. Rul. 68-602 applies. Since 2003, the Service has confirmed this distinction. For example, in PLR 200934001,[45] the Service ruled that each of a series of sideways mergers will qualify as a reorganization under section 368(a)(1)(A) (an "A" Reorganization) where the target corporations were rendered solvent prior to the merger as a result of contributions of intercompany debt to capital.

2. Proposed Net Value Regulations

The government issued the PNV Regulations in 2005, which require the exchange (or in the case of section 332, a distribution) of net value for the nonrecognition rules of subchapter C to apply (e.g., sections 332, 351, and 368).[46] The PNV Regulations attempt to provide a comprehensive

[44] 1978-2 C.B. 147.

[45] May 12, 2009.

[46] *See* REG-163314-03 (Mar. 10, 2005).

set of rules addressing the application of nonrecognition provisions of subchapter C to insolvent corporations. The PNV Regulations are not currently operative as they apply to transactions occurring after finalization. But the Service generally appears to be following the principles of the PNV Regulations in its private letter ruling practice.[47] The Tax Section previously submitted extensive comments on the PNV Regulations[48] and a thorough review of them is beyond the scope of this report. However, the PNV Regulations are summarized briefly below.

In general, the PNV Regulations are consistent with the authorities described above that support claiming a worthless stock loss under section 165 due to insolvency or where there is no distribution with respect to common stock because the value of the subsidiary's assets do not exceed the liquidation preference of its outstanding preferred stock. In such case, under the PNV Regulations, an upstream or sideways restructuring of an insolvent subsidiary generally cannot qualify under section 332 or 368 because there is no exchange or distribution of net value.[49]

As described above, section 332 applies only where the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation.[50] The PNV Regulations clarify that section 332 applies only where the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation, which is consistent with the Second Circuit's holding in *Spaulding Bakeries* and the Tax Court's holding in *H.K. Porter*. As stated in the preamble to the PNV Regulations, the government believes that the recognition of loss is appropriate where a distribution with respect to each class of stock is not received by the liquidating corporation's shareholder.[51] This is the case even if the distribution qualified as a reorganization under section 368.[52]

With respect to sideways asset reorganizations, the PNV Regulations require both a surrender and receipt of net value. In a potential asset reorganization, the target corporation generally surrenders net value if the fair market value of the property transferred by it to the acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation and the amount of any money and the fair market value of any property (other than stock permitted to be received under section 361(a)) received by the target corporation. This rule ensures that the target corporation transfers property in exchange for stock. A target corporation receives net value if the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. This rule ensures that the target corporation receives (or is deemed to receive) stock having value.

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[47] *See, e.g.*, PLR 200934001.

[48] Report No. 1102, New York State Bar Association Section on Taxation (Jan. 20, 2006), reprinted at 2006 TNT 15-10.

[49] *See, e.g.*, Rev. Rul. 2003-125.

[50] Treas. Reg. § 1.332-2(b).

[51] *See* REG-163314-03 (Mar. 10, 2005).

[52] The PNV Regulations confirm that, if section 332 does not apply because the recipient corporation did not receive at least partial payment for each class of stock, but did receive at least partial payment for at least one class of stock, the transaction may nevertheless qualify as a reorganization under section 368.

C. Consolidated Return Interactions

The consolidated return regulations interact in numerous and complicated ways with the separate return rules of section 165. These rules can impact the timing, character, allowable amount, and certain collateral effects of a worthless stock deduction for an insolvent subsidiary.[53]

1. Timing

Outside consolidation, a worthless stock deduction may (and effectively must) be taken into account in the taxable year in which the subsidiary stock becomes worthless.[54] In the context of the consolidated return regulations, the timing of the deduction may be deferred pursuant to -80(c). Under -80(c), subsidiary stock is not treated as worthless under section 165 until immediately before the earlier of the time (i) the stock is worthless within the meaning of Treas. Reg. § 1.1502-19(c)(1)(iii), or (ii) the subsidiary for any reason ceases to be a member of the group.

By deferring the timing of a worthless stock deduction for a consolidated subsidiary, -80(c) seeks to avoid certain interactions with other consolidated return or Code rules that were thought to be inappropriate. Treas. Reg. § 1.1502-80(c) was promulgated in 1994, at a time when Treas. Reg. § 1.1502-20 was still in effect. Under then Treas. Reg. § 1.1502-20, deductions were disallowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary (other than certain true economic losses).[55] For example, even though parent may be entitled to a worthless stock deduction under general tax principles with respect to an insolvent subsidiary, such deduction would be disallowed while nevertheless reducing parent's tax basis in the subsidiary to zero. Subsequently, when the subsidiary incurs an NOL that is absorbed elsewhere in the group, the tax basis in the subsidiary stock would be driven negative resulting in an ELA that would likely be triggered in the future.[56] The Service acknowledged that the reattribution election then available under Treas. Reg. § 1.1502-20(a)(1) might mitigate this result, but expressed concern that, in the context of a subsidiary in bankruptcy, the reattribution of the subsidiary's attributes might not be allowed. The Service also noted claiming a worthless stock deduction could potentially trigger a section 382 ownership change of the subsidiary due to the application of section 382(g)(4)(D). As such, the Service concluded that the allowance of a worthless stock deduction, pending a worthlessness event under Treas. Reg. § 1.1502-19(c)(1)(iii) or (as -80(c) was subsequently amended[57]) the subsidiary otherwise ceasing to be a member of the consolidated group, was inconsistent with the single entity principle of the consolidated return regulations.

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[53] *See* Treas. Reg. § 1.1502-80(a).

[54] Section 165(g)(1).

[55] Former Treas. Reg. § 1.1502-20(a)(1) (2000).

[56] Preamble to Proposed Rules, 57 FR 53634, 53645-53646 (1992).

[57] Preamble to Proposed Rules, 72 FR 2964, 2986 (2007). See also the discussion below relating to this amendment in Section IV, B, 2.

Under Treas. Reg. § 1.1502-19(c)(1)(iii), worthlessness of stock held by a parent corporation ("P") occurs when (i) all of a subsidiary member's ("S") assets (other than its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence) are treated as disposed of, abandoned, or destroyed for U.S. federal income tax purposes;[58] (ii) an indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Treas. Reg. § 1.1502-32(b)(3)(ii)(C); or (iii) a member takes into account a deduction or loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.

A subsidiary ceases to be a member of the group when, for example, it has a separate return year.[59] This would occur if S's third party creditors exchange their claims for S stock and P's stock in S is cancelled. In such case, under -80(c), P may claim a worthless stock deduction under section 165(g) notwithstanding that S has not disposed of its assets.

It also seems clear that -80(c) is satisfied where a subsidiary ceases to be member and has no successor. This should occur where an insolvent subsidiary terminates its existence through an upstream or sideways restructuring that is fully taxable, even though another member acquires its business or assets. For example, in PLR 201006003,[60] the Service ruled that P was entitled to a worthless stock deduction for S where S's liabilities owed to P exceeded the value of its assets and S merged into P, effectively transferring its assets to P in partial satisfaction of the intercompany liabilities. The Service specifically referenced -80(c) in its conclusions. Although not explicitly addressing the question of whether P should be treated as a successor to S, or whether successor status is relevant for -80(c) purposes, P's acquisition of S's assets was not, by itself, an obstacle to terminating deferral under -80(c).[61]

Where an upstream or sideways restructuring qualifies as a reorganization, a more serious question exists as to whether -80(c) mandates continued deferral of a worthless stock deduction on the basis that the acquiring member is a successor to the insolvent subsidiary. In general, an acquiror in a transaction to which section 381 applies is treated as a successor to the target for consolidated return purposes, by specific regulatory inclusion.[62]

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[58] An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S under section 332 or is in exchange for consideration (other than relief from indebtedness). Treas. Reg. § 1.1502-19(c)(1)(iii).

[59] The term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group. Treas. Reg. § 1.1502-1(e).

[60] Oct. 28, 2009.

[61] *See also* PLR 200932018 (April 14, 2009) (a conversion of an insolvent subsidiary into a disregarded limited liability company in connection with partial satisfaction of intercompany debt owed to another member held to give rise to a worthless stock deduction, citing -80(c); Service ruled that the subsidiary ceased to be a member of the group and no other member would be treated as its successor, citing Treas. Reg. § 1.1502-1(f)(4)).

[62] *See, e.g.*, Treas. Reg. §§ 1.1502-1(f)(4)(i); 1.1502-13(j)(2)(i)(A); 1.1502-19(f); 1.1502-35(d)(5)(i); 1.1502-80(d); 1.1502-91(j).

Treas. Reg. § 1.1502-80(c), unlike Treas. Reg. § 1.1502-19 and other provisions in the consolidated return regulations, does not contain or seemingly incorporate a predecessor-successor provision.[63] As such, it would seem that an upstream or sideways restructuring would technically satisfy the conditions of -80(c) for the allowance of the worthless stock deduction. Notably, however, Treas. Reg. § 1.1502-36(d) contains an example apparently to the contrary. Treas. Reg. § 1.1502-36(d)(7) provides for the extinguishment of a worthless subsidiary's NOL carryforwards, capital loss carryforwards, and deferred deductions (including its allocable share of consolidated items) depending on whether the subsidiary continues to be a member of the group.[64] One of the examples involves an insolvent subsidiary whose common stock is cancelled in connection with a tax-free "D" Reorganization into another member of the group.[65] The example views -80(c) as deferring the worthless stock deduction with respect to the cancelled stock since there is a successor member under section 381. The technical basis for this assumption is questionable given the lack of any successor rule in -80(c), and it does not seem necessary to reach the conclusion in the example with respect to the application of Treas Reg. § 1.1502-36(d)(7) in light of the successor rule in Treas. Reg. § 1.1502-36(e)(1), which assures that the subsidiary is not treated as leaving the group for purposes of Treas Reg. § 1.1502-36(d)(7)(ii)(B).[66]

Assuming that a worthless stock deduction is not deferred under -80(c) with respect to an upstream or sideways restructuring, the potential application of the intercompany transaction rules of Treas. Reg. § 1.1502-13 must still be addressed. Treas. Reg. § 1.1502-13 provides a system of rules for taking into account items generated from transactions between members of a consolidated group (*i.e.*, intercompany transactions). These rules generally are designed to produce results as to timing and attributes consistent with the results that would have been generated if the parties to the intercompany transaction were divisions of a single corporation. The two basic rules are the matching rule and the attribute redetermination rule. Under the matching rule, the timing of the items of the members generally is matched to assure symmetry. Under the attribute redetermination rule, attributes of items generally are redetermined consistent with single entity principles.

In the context of upstream and sideways restructurings of insolvent subsidiaries, two fundamental issues are raised. First, does the attribute redetermination rule require that any worthless stock deduction be recharacterized as a noncapital, nondeductible expense? Second,

[63] *Cf*. Treas. Reg. § 1.1502-19(f); Treas. Reg. § 1.1502-32(f).

[64] See Section III, C, 4 below for further discussion of Treas. Reg. § 1.1502-36(d)(7).

[65] Treas. Reg. § 1.1502-36(d)(7)(iii), Ex. (iii).

[66] *See* Elliot, *Continuity of Interest May be Preserved in Upstream Transactions, IRS Says*, 2009 TNT 100-2 (May 28, 2009) (reporting that Theresa Abell, senior counsel in the IRS Office of Chief Counsel (Corporate), commenting on Treas. Reg. § 1.1502-36(d)(7)(iii), Ex. (iii) stated that "[t]he text of -80(c) can't be trumped by an example in another reg section," and adding that the Service plans to "fix" the example and that practitioners should not read more into it:); TAM 200843031 (July 16, 2008) ("examples incorporated into Treasury Regulations are generally considered illustrative only and are not to be considered as dispositive"); *Tennessee Baptist Children's Homes, Inc v. U.S.*, 790 F.2d 534 (6th Cir. 1986).

does the broader successor concepts of Treas. Reg. § 1.1502-13(j)(2) apply to defer a worthless stock deduction even when -80(c) does not?[67]

It can be argued that the attribute redetermination rule of Treas. Reg. § 1.1502-13(c)(1) requires that any worthless stock deduction be recharacterized as a noncapital, nondeductible expense. The source of the concern is an example providing that loss recognized by a member on redemption of "hook" stock (*i.e.*, parent stock held by a subsidiary) is so recharacterized.[68] A broad reading of the example might suggest that a stock loss resulting from any intercompany transaction is recharacterized as a noncapital, nondeductible expense. Such a reading, however, seems inconsistent with the clear reflection principles that underlie the intercompany transaction rules. Treas. Reg. § 1.1502-13(a)(1) states that the purpose of the intercompany transaction regulations is to provide rules to clearly reflect the taxable income and tax liability of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income or consolidated tax liability. Absent taking a broader single entity approach, as discussed below, subsidiary stock should be viewed as inherently a separate entity attribute because it cannot exist between divisions of a single corporation. Recharacterizing worthless stock deductions resulting from intercompany transactions such as upstream or sideways restructurings would distort consolidated taxable income by permanently disallowing economic loss. For example, parent buys stock of subsidiary, which holds an asset with a basis of zero and a fair market value of $100. The value of subsidiary's asset subsequently declines to zero and subsidiary merges into parent. Recharacterizing parent's worthless stock deduction as a noncapital, nondeductible expense would permanently disallow the $100 economic loss, which will not be realized when the asset is sold. Consistent with this analysis, the Service appears not to have asserted that the attribute redetermination rule precludes a worthless stock deduction.

Another significant question is whether the timing of a worthless stock deduction can be further deferred by Treas. Reg. § 1.1502-13. As an initial matter, it would appear that a worthless stock deduction must be taken into account under the matching rule because the issuer of the stock (i.e., the insolvent subsidiary) does not recognize a corresponding item to which the timing of the worthless stock deduction can be matched. However, unlike -80(c), the intercompany transaction regulations do have a broad successor rule, which applies "as the context may require." Thus, where a member acquires the assets of the subsidiary in an upstream or sideways restructuring, it potentially is a successor to the insolvent subsidiary. As such, it can be argued that single entity principles require continued deferral where there is a successor under Treas. Reg. § 1.1502-13(j) so as to prevent an intercompany transaction from accelerating the timing of a worthless stock deduction.

Nevertheless, there are no mechanics in the intercompany transaction rules to determine when to take into account a worthless stock deduction assuming deferral beyond the time when the -80(c)

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[67] For example, under Treas. Reg. § 1.1502-13(j)(2), as the context may require, a successor can be a transferee in a transaction: (i) to which section 381 applies; or (ii) in which substantially all the assets of the transferor are transferred to members in complete liquidation.

[68] *See* Treas. Reg. § 1.1502-13(f)(7)(i), Ex. 5(d), pursuant to which the loss recognized by one member of the group was permanently disallowed when such member's stock interest in its parent company was redeemed.

requirements are satisfied – that is, the intercompany transaction regulations rely on the existence of a corresponding item in the hands of the counterparty to the transaction and, in the absence of one, the intercompany item should be taken into account immediately because matching is not possible.[69] As a result, a mechanic would have to be invented, with no obvious candidates. Moreover, it would seem that -80(c) already provides a deferral regime and, given its specific mandate, the "context" would not seem to require that the intercompany transaction rules step in to create a supplemental deferral regime.

2. Character

As described above, in the circumstances specified in section 165(g)(3), a parent corporation is entitled to an ordinary loss on the worthlessness of its subsidiary's stock. The consolidated return regulations overlay the separate rules of the Code in this regard, potentially altering their application.

As an initial mater, in order to claim an ordinary loss on the stock of a subsidiary, section 165(g)(3) requires that the subsidiary be affiliated, as defined in section 1504(a)(2). In consolidation, the direct ownership requirement of section 165(g)(3)(A) can be satisfied by treating the parent as directly owning shares of the issuer's stock held by other members of the group.[70] Thus, the consolidated return regime provides for an aggregation rule for purposes of satisfying the ownership requirement by group members.

In addition, although there are no specific rules under the consolidated return regulations modifying the general gross receipts test under section 165(g)(3)(B), the intercompany transaction regulations (Treas. Reg. § 1.1502-13), as interpreted by the Service in private letter rulings, do impact the determination of whether the test is met with respect to a consolidated subsidiary. Initially, the Service applied a "look through" approach only for purposes of characterizing gross receipts from intercompany distributions. The scope of this "look through" approach has continued to expand and has been applied to intercompany transactions more generally, and the Service has consistently indicated that its rationale for the "look through" approach is rooted in the attribute redetermination rules of Treas. Reg. § 1.1502-13.

With respect to intercompany distributions, the Service has essentially treated what is otherwise passive income (e.g., dividends) as active gross receipts for purposes of section 165(g)(3)(B) to the extent such dividends were received from another consolidated group member that was an operating company and had income from active sources. For example, in PLR 200710004,[71] the common parent owned all of the stock of an insolvent holding company ("Holding") that it wanted to treat as worthless under section 165(g). Holding had received dividends from subsidiaries that had to be evaluated under the gross receipts test of section 165(g)(3)(B). Citing Treas. Reg. § 1.1502-13(c), the Service applied attribute redetermination to conclude that

[69] *See* Treas. Reg. § 1.1502-13(d).

[70] *See* Treas. Reg. §§ 1.1502-34 and 1.165-5(j), *Ex. 1*. *See also* PLR 199951011 (Sept. 17, 1999); PLR 9425024 (Mar. 25, 1994); PLR 8528067 (Apr. 17, 1985).

[71] Dec. 5, 2006. For a thorough discussion of issues raised by PLR 200710004 under section 165(g)(3)(B), see Brian Peabody, "Continuing Questions regarding Worthless Securities", 2008 TNT 219-29 (Nov. 10, 1998).

"Holding will include in its aggregate gross receipts all dividends received from lower-tier subsidiary members of its consolidated group, and such dividends will be treated as 'gross receipts from passive sources' [only] to the extent they are attributable to the respective distributing member's 'gross receipts from passive sources.' . . . Only dividends that are attributable to 'gross receipts from passive sources,' as defined herein, are counted as dividends for purposes of computing the 'more than 90 percent gross receipts' test under section 165(g)(3)(B)." It is unclear why attribute redetermination applied to convert any of the dividend income into favorable active income based on looking through to the distributing subsidiary's active income. Simply excluding intercompany dividends from the gross receipts calculation (i.e., not including such dividends in the numerator or the denominator) would have been more consistent with the exclusion of intercompany distributions from gross income under Treas. Reg. § 1.1502-13(f)(2).[72] It appears that the Service has adopted a more general single entity approach than might be explained solely from the application of Treas. Reg. § 1.1502-13 principles.[73]

As indicated above, the Service recently expanded the "look through" approach for purposes of the gross receipts test under section 165(g)(2)(B) to all amounts received in intercompany transactions. This expansion essentially requires tracing of all gross receipts to the ultimate counterparty for purposes of determining whether such amounts are active or passive. For example, in PLR 201011003,[74] Parent sold all of its equity interests in LossCo, a limited liability company that was treated as a corporation for U.S. federal income tax purposes, to Purchaser, an unrelated third party, and a section 338(h)(10) election was made with respect to the sale transaction. The Service ruled that Parent could claim a worthless stock deduction under section 165(g)(3) with respect to LossCo as a result of its deemed liquidation, provided that the applicable requirements were met. For purposes of computing LossCo's gross receipts under section 165(g)(3)(B), the Service ruled that "LossCo will include in its aggregate gross receipts all amounts received in intercompany transactions that are described in § 1.1502-13 (as effective/applicable on or after July 12, 1995) ("Intercompany Transactions"), and such amounts from Intercompany Transactions will be treated as 'gross receipts from passive sources' to the extent they are attributable to the Intercompany Transactions' counterparty's 'gross receipts from passive sources.'" The Service further ruled that, for purposes of computing the "gross receipts from passive sources" with respect to LossCo's counterparty in an Intercompany Transaction or any other counterparties in Intercompany Transactions, "the counterparty will include in its aggregate gross receipts all amounts it received in Intercompany Transactions, and such amounts from Intercompany Transactions will be treated as 'gross receipts from passive sources' to the extent they are attributable to its counterparty's 'gross receipts from passive sources.' In other words, LossCo's 'gross receipts from passive sources' is determined by looking at all of LossCo's gross receipts from Intercompany Transactions (even if on its face the Intercompany

[72] *See* Treas. Reg. § 1.1502-13(f)(2) (An intercompany distribution is not included in the gross income of the distributee member to the extent there is a corresponding negative adjustment reflected under Treas. Reg. § 1.1502-32 in the distributee member's basis in the stock of the distributing member.).

[73] *See also* PLR 200932018 (Apr. 14, 2009) (similar approach to intercompany distributions for purposes of the gross receipts test of section 165(g)(3)(B)); PLR 201006003 (Oct. 28, 2009) (similar approach to intercompany distributions for purposes of the gross receipts test of section 165(g)(3)(B), but distributions under former Treas. Reg. § 1.1502-14 (1994) distinguished).

[74] Nov. 30, 2009.

Transaction appears not to be 'gross receipts from passive sources') and sourcing the gross receipts based on LossCo's counterparty's 'gross receipts from passive sources.' Furthermore, LossCo's counterparty in Intercompany Transactions (and LossCo's counterparty's counterparty, and so on until it reaches the ultimate counterparty) will apply a similar rule." Thus, the Service has expanded the "look through" approach to all intercompany transactions, which has the potential to redetermine gross receipts as passive, notwithstanding that such amounts are active on their face.

The application of the "look through" approach for purposes of section 165(g)(3)(B) essentially appears to be available only through the private letter ruling process. Given the lack of any specific rule or example in Treas. Reg. § 1.1502-13 applying the attribute redetermination rule for section 165(g)(3)(B) purposes, practitioners are unlikely to be comfortable proceeding in the absence of a private letter ruling. Moreover, it has been reported that Service representatives have informally indicated that a "look through" approach is elective and taxpayers can alternatively apply the Code's separate return principles.[75]

3. Amount of Allowable Loss

The consolidated return regime can also impact the allowable amount of a taxpayer's worthless stock deduction with respect to a consolidated group member in a number of ways. As an initial matter, a member's basis in its subsidiary stock is adjusted by investment adjustments under Treas. Reg. § 1.1502-32. These positive and negative adjustments literally determine the amount of loss that may be recognized under section 165(g).

Moreover, other provisions of the consolidated return regulations interact with the investment adjustment system to impact stock basis in important ways with regard to worthless stock deductions. As one example, Treas. Reg. § 1.1502-13(g) provides rules for the deemed satisfaction and reissuance of intercompany debt in certain circumstances, thereby generating items of income and loss that often are reflected in stock basis through the investment adjustment system.[76] In general, Treas. Reg. § 1.1502-13(g)(3)(ii)(A) provides that, if there is a triggering transaction with respect to an intercompany obligation,[77] immediately before the transaction the debtor member is deemed to satisfy the obligation for an amount of cash equal to its fair market

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[75] *See* Elliott, *Look-Through Rule Must Trace All Intercompany Transactions*, 125 Tax Notes 44 (Oct. 5, 2009) (In describing a possible new approach that would require either a separate return approach or a single entity approach that conforms the treatment of all intercompany items for purposes of section 165(g)(3)(B), Marie Milnez-Vasquez, Senior Technical Reviewer, Office of Associate Chief Counsel (Corporate), is reported to have stated that: "If you're going to use single entity treatment for a specific kind of intercompany item, you've got to use it for all of your intercompany items ... You're going to look at all of the intercompany transactions that that entity has entered into and all of the income it's gotten from those intercompany transactions, whether they're dividends, interest, rents, royalties, or even active income. ... If you choose to look through on the dividends, you're going to have to look through on everything ... That's a huge job because if you're in a big group, you're going to have thousands and thousands of intercompany transactions. ... If a taxpayer came to us and said, 'This is a huge job and we can't do it,' and they just want to take the items on their face, they can do that as long as they do that on all of their items ...").

[76] For further background on Treas. Reg. § 1.1502-13(g), *see* IV. B. 3. below.

[77] Treas. Reg. § 1.1502-13(g)(2)(ii) defines an intercompany obligation as an obligation between members, but only for the period during which both parties are members. Treas. Reg. § 1.1502-13(g)(2)(i) provides that an obligation of a member is a debt or security of a member.

value, and then to reissue a new obligation for the same amount of cash. The deemed satisfaction and reissuance of the intercompany obligation is treated as separate from the triggering transaction.[78] To the extent that the intercompany obligation is deemed to be satisfied at a discount to its adjusted basis and adjusted issue price ("AIP"), such deemed satisfaction generally will result in the recognition of offsetting amounts of ordinary cancellation of debt ("COD") income and ordinary loss by the debtor and creditor members, respectively.[79] Such COD income and ordinary loss are recognized by the members notwithstanding that section 108(a) or 354 otherwise would be applicable in a separate return context.[80]

In relevant part, a triggering transaction is any intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation. However, the regulations provide certain exceptions from the definition of a triggering transaction in cases where applying the deemed satisfaction and reissuance model is not necessary to carry out the purposes of Treas. Reg. § 1.1502-13(g) or where the burdens associated with valuing the obligation or applying the mechanics of the deemed satisfaction and reissuance model outweigh the benefits achieved by applying Treas. Reg. § 1.1502-13(g).[81] The exceptions include transfers and assumptions of intercompany obligations in intragroup exchanges to which section 332 or 361 apply (if neither the creditor nor the debtor recognizes an amount of income, gain, deduction, or loss in the transaction) and certain extinguishments of intercompany debt.[82]

An intercompany extinguishment transaction generally is not a triggering transaction if all or part of the rights and obligations under the intercompany obligation are extinguished (other than an exchange or deemed exchange of the intercompany obligation for a newly-issued intercompany obligation), the AIP of the obligation is equal to the creditor's basis in the obligation, and the debtor's corresponding item and the creditor's intercompany item with respect to the obligation offset in amount.[83] In such cases, it is not necessary to apply deemed satisfaction and reissuance constructs because, taking into account the special rules in Treas. Reg. § 1.1502-13(g)(4)(i)(C), the applicable Code rules and general principles of tax law will ensure that consolidated taxable income is not distorted. Accordingly, pursuant to the extinguishment exception, the contribution of intercompany debt by a parent corporation to the capital of its insolvent subsidiary potentially will be excepted from the deemed satisfaction and reissuance rules and section 108(e)(6) will apply to the contribution.

The rules under Treas. Reg. § 1.1502-13(g), whether resulting in an actual or deemed satisfaction of debt, play a crucial role in determining the allowable amount of a worthless stock deduction for an insolvent subsidiary in an upstream or sideways restructuring. If the restructuring is a triggering event (or even if the extinguishment exception applies), the net effect is often to shift

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[78] Treas. Reg. § 1.1502-13(g)(3)(ii)(B).

[79] Treas. Reg. §§ 1.1502-13(c)(1)(i); 1.1502-13(g)(4)(i).

[80] Treas. Reg. § 1.1502-13(g)(4)(i)(C).

[81] Preamble to T.D. 9442 (December 24, 2008).

[82] Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1), (5), and (6).

[83] Treas. Reg. § 1.1502-13(g)(3)(i)(B)(*5*).

basis from intercompany debt to intercompany equity. As such, these rules may increase the amount of a worthless stock deduction that is recognized, subject to the basis rules under Treas. Reg. § 1.1502-36 (the "ULR").

The ULR is primarily designed to prevent a group from (i) reducing its income through the creation and recognition of non-economic losses and (ii) recognizing a tax benefit in the form of a stock loss while preserving a potential duplicate benefit in the form of attributes of the subsidiary.[84] The ULR is implicated when a member of a consolidated group transfers a "loss share," which is a share of subsidiary stock that has a basis in excess of its fair market value.[85] For this purpose, a transfer includes, among other things, when a parent corporation takes a worthless stock deduction with respect to a share of its subsidiary's stock.[86] The determination of whether a share is a loss share is made after taking into account the effects of all applicable rules of law (even if the adjustments required by such provisions are not deemed effective until after the transfer, such as certain adjustments required under sections 108 and 1017 and Treas. Reg. § 1.1502-28).[87]

The ULR has three key components that apply sequentially:

- *"Basis Redetermination Rule" (Treas. Reg. § 1.1502-36(b))* – requires the transferee of a loss share to reallocate, but not reduce, its aggregate bases in its shares of the subsidiary in certain limited instances;[88]

- *"Basis Reduction Rule" (Treas. Reg. § 1.1502-36(c))* – requires that the transferee reduce its basis in the loss share by the lesser of (i) the share's "net positive adjustment" and (ii) the share's "disconformity amount";[89] and

- *"Attribute Reduction Rule" (Treas. Reg. § 1.1502-36(d))* – requires that upon the transfer of a loss share, certain of the subsidiary's tax attributes (and in certain cases any lower tier subsidiary's tax attributes) are reduced by the lesser of the "net stock loss" and the "aggregate inside loss."[90]

Under the Basis Redetermination Rule, all members' basis in their shares of subsidiary stock generally are "redetermined" by reallocating investment adjustments among the various classes or blocks of such subsidiary's stock (e.g., potentially allocating investment adjustments from common stock to preferred stock). This Basis Redetermination Rule does not, however, change

[84] *See* Treas. Reg. § 1.1502-36(a)(2).

[85] *See* Treas. Reg. §§ 1.1502-36(a)(3)(i) and 1.1502-36(f)(7).

[86] *See* Treas. Reg. § 1.1502-36(f)(10).

[87] Treas. Reg. § 1.1502-36(a)(3)(i).

[88] *See* Treas. Reg. § 1.1502-36(b).

[89] *See* Treas. Reg. § 1.1502-36(c).

[90] *See* Treas. Reg. § 1.1502-36(d). A comprehensive discussion of the ULR is beyond the scope of this report. *See* New York State Bar Association, Tax Section, No. 1138, Report on Proposed Consolidated Return Stock Loss Regulations (Dec. 19, 2007), reprinted at 2007 TNT 245-23 (the "2007 Report").

the member's aggregate basis in its shares of subsidiary stock. The Basis Redetermination Rule generally does not apply if (i) there is no disparity in the member's basis in its shares of the subsidiary's common stock and no member owns a share of subsidiary preferred stock with respect to which there is unrecognized gain or loss or (ii) all of the shares of the subsidiary's stock become worthless under section 165 or are transferred in one fully taxable transaction to one or more non-members.[91] In such case, the group may elect to apply the Basis Redetermination Rule, and in certain circumstances it will be advantageous to do so.[92]

The Basis Reduction Rule is applied if, after applying the Basis Redetermination Rule, the transferred share is still a loss share. The purpose of the Basis Reduction Rule is to "eliminate stock loss that is presumed noneconomic."[93] If the Basis Reduction Rule applies, a member's basis in the loss share is reduced, but not below its value, by the lesser of the share's net positive adjustment (the "NPA") or the loss share's disconformity amount (the "Disconformity Amount").[94]

The NPA is the greater of zero and the sum of all investment adjustments reflected in the basis of the share but excluding distributions.[95] The Disconformity Amount is the excess of the member's basis in the loss share over the share's allocable portion of S's "net inside attribute amount."[96] The "net inside attribute amount" is the sum of S's money, basis in assets other than money, NOL and capital loss carryovers, and deferred deductions, reduced by S's liabilities.[97] The determination of S's net inside attribute amount is made as of the transfer of S's stock, taking into consideration all rules of law.[98]

The Basis Reduction Rule may significantly reduce the amount of allowable worthless stock deduction by requiring a reduction in stock basis immediately before the determination of the amount of such loss. For example, some or all of the positive basis in worthless shares may be attributable to built-in gain effectively reflected twice in the basis of worthless shares, once through purchase price on acquisition of the subsidiary's stock, and once through noneconomic basis adjustments when such built-in gain is recognized through disposition or consumption. The Basis Reduction Rule is intended to "weed out" the noneconomic basis adjustments.

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[91] *See* Treas. Reg. § 1.1502-36(b)(1)(ii).

[92] Electively applying the Basis Redetermination Rule would be advantageous if the parent corporation otherwise would recognize a capital loss with respect to the subsidiary's preferred stock and ordinary income on recapture of an ELA with respect to the subsidiary's common stock pursuant to Treas. Reg. § 1.1502-19(b)(4)(i).

[93] *See* Preamble to Prop. Treas. Reg. § 1.1502-36, para. F.3, REG-157711-02, 72 FR 2964 (Jan. 23, 2007).

[94] Treas. Reg. § 1.1502-36(c)(2).

[95] Treas. Reg. § 1.1502-36(c)(3).

[96] Treas. Reg. § 1.1502-36(c)(4).

[97] Treas. Reg. § 1.1502-36(c)(5). "Deferred deductions" generally are deductions and losses that would be taken into account as of the transfer absent the application of a deferral provision, such as section 267(f) or 469 or Treas. Reg. § 1.1502-13. Treas. Reg. § 1.1502-36(f)(2). A "liability" for this purpose generally means a liability that has been incurred within the meaning of section 461(h). Treas. Reg. § 1.1502-36(f)(5).

[98] Treas. Reg. § 1.1502-36(c)(5).

As noted in our 2007 Report, the Basis Reduction Rule may interact with Treas. Reg. § 1.1502-13(g) to artificially reduce allowable loss by giving rise to positive adjustments that distort NPA and result in the effective disallowance of economic loss. The 2007 Report provided the following example:

> *Example.* M acquires the stock of S for $100, financing the acquisition with third party indebtedness. S has a single asset, A1, with a basis of $0 and a value of $100. M desires to "push down" a portion of the acquisition debt for state tax purposes and accomplishes this objective by causing S to declare and pay a dividend in the form of a $60 intercompany note. M's basis in the S stock is reduced to $40 under Treas. Reg. § 1.1502-32(b). The value of A1 declines to zero and S is dissolved. Under Treas. Reg. § 1.1502-13(g)(3), S recognizes $60 of cancellation of indebtedness ("COD") income and M's basis in the S stock is restored to $100. This COD income offsets M's $60 bad debt deduction. Since M has an economic loss of $100, M should be entitled to a loss of $100 on the S stock. However, M's NPA is $60 and its Disconformity Amount is $100. Accordingly, M's basis in the S stock is reduced to $40 and M recognizes only a $40 stock loss upon S's dissolution.

Accordingly, we proposed that regulations exclude items related to intercompany debt from the NPA determination. To date, no such rule has been adopted and thus the potential still exists for COD income attributable to intercompany debt to create NPA resulting in a basis reduction under the Basis Reduction Rule, effectively denying the group a tax loss for loss of its economic investment effectively reflected in intercompany debt.

4. Collateral Impacts: Attribute Reduction

Because an upstream or sideways restructuring triggering a worthless stock deduction for an insolvent subsidiary constitutes a transfer of a loss share for purposes of the ULR, such a restructuring potentially brings into play the Attribute Reduction Rule. A reduction in attributes may be required under the general rules applicable to all transfers of loss shares and under a special rule for a worthless stock deduction.

Under the general Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d)(2), if a transferred share remains a loss share after the application of the Basis Redetermination Rule and the Basis Reduction Rule, stock basis is not reduced, but the subsidiary's attributes are reduced by the subsidiary's "attribute reduction amount." The attribute reduction amount is the lesser of "net stock loss" and the subsidiary's "aggregate inside loss."[99] The subsidiary's "net stock loss" is the excess, if any, of the members' aggregate bases in transferred subsidiary shares over the aggregate value of those shares.[100] The subsidiary's "aggregate inside loss" is the excess, if any, of the subsidiary's "net inside attribute amount" (generally as defined above with respect to the basis reduction rule) over the value of all outstanding shares of the subsidiary's stock.[101]

[99] Treas. Reg. § 1.1502-36(d)(2), -36(d)(3)(i).

[100] Treas. Reg. § 1.1502-36(d)(3)(ii).

[101] Treas. Reg. § 1.1502-36(d)(3)(iii).

Duplicated loss for purposes of the Attribute Reduction Rule is determined by reference to the subsidiary's entire inside loss (not just the transferred loss share's allocable portion thereof).

The subsidiary's attribute reduction amount is applied to reduce (in order) its capital loss carryovers (oldest to newest); NOL carryovers (oldest to newest); deferred deductions (proportionately); and basis in assets (excluding cash and cash equivalents).[102] The reduction is applied proportionately to the attributes within any category described above. If the attribute reduction amount exceeds the attributes described above, the excess amount is eliminated without further effect unless the subsidiary has contingent liabilities (in which case such excess is applied to reduce deductions as such liabilities are taken into account). Any remaining attribute reduction amount has no further effect.

Accordingly, the general Attribute Reduction Rule will apply to P's taking a worthless stock deduction for S (i) in absence of an upstream or sideways restructuring, or (ii) as a result of such a restructuring, whether treated as fully taxable or as a tax-free reorganization (e.g., in an upstream "A" Reorganization in a *Spaulding Bakeries* situation). The effect of the application of the general Attribute Reduction Rule is to eliminate loss duplication.

Treas. Reg. § 1.1502-36(d)(7) provides a supplemental Attribute Reduction Rule applicable in two circumstances: if (i) P transfers a loss share of S solely by reason of worthlessness of the share (and the provisions of -80(c) are satisfied), P recognizes a net deduction or loss on the share, and S is a member of the group on the day following the last day of the group's taxable year during which the share becomes worthless under section 165 (taking into account the provisions of -80(c)), or (ii) P recognizes a net deduction or loss on the share in a transaction in which the subsidiary ceases to be a member and does not become a nonmember within the meaning of Treas. Reg. § 1.1502-19(c)(2) (i.e., the subsidiary does not have a separate return year).[103] The first scenario generally applies where S remains in existence as a continuing member of the group, although it meets the standards of Treas. Reg. § 1.1502-19(c)(1)(iii) for worthlessness. The second scenario involves the cessation of S's existence in a taxable transaction, which may either be a dissolution following a taxable sale of its assets to a third party, or a taxable upstream or sideways restructuring. In these scenarios, S's capital losses, NOLs, and deferred deductions remaining after the application of the general Attribute Reduction Rule, whether separate return or consolidated attributes, are eliminated. The supplemental Attribute Reduction Rule is inapplicable to an upstream or sideways restructuring constituting a tax-free reorganization because S has a successor that is a continuing member (*i.e.*, S is not treated as ceasing to be a member).[104]

The theory underlying the supplemental Attribute Reduction Rule appears to be rooted in a single entity analysis through the coordination of stock worthlessness with the elimination of inside attributes. The general Attribute Reduction Rule effectively addresses loss duplication concerns. In concept, the supplemental Attribute Reduction Rule requires an elimination of

[102] Treas. Reg. § 1.1502-36(d)(4).

[103] Treas. Reg. § 1.1502-36(d)(7)(i).

[104] Treas. Reg. § 1.1502-36(e)(1).

remaining attributes where stock worthlessness is claimed because it effectively views the subsidiary as if it ceased to exist (or has been disposed of) applying single entity principles.

D. Summary of Current Law

The rules applicable to upstream and sideways reorganizations remain a complex mixture of separate company and single entity principles and continue to be plagued by significant gaps and uncertainties. Within the separate company world, some matters have been clarified since we last addressed the subject (e.g., through the issuance of Rev. Rul. 2003-125). But other uncertainties remain (e.g., the potential application of Rev. Rul. 74-515) and some new uncertainties have been created (e.g., through the adoption of the nominal share concept under Treas. Reg. § 1.368-2(l)).

In addition, the interactions of the consolidated return regulations with these separate company principles are pervasive and have become even more so since the 2003 Report. Consolidated return rules now broadly impact timing, character, allowable amount, and collateral consequences of a worthless stock deduction. These rules sometimes reflect single entity principles (e.g., the aggregation of stock ownership under Treas. Reg. § 1.1502-34 and the "look through" approach with respect to the gross receipts test of section 165(g)(3)(B)), but on the whole seek to accommodate the consolidated return rules to a separate company framework for stock worthlessness.

The two frameworks considered in the remainder of this report attempt to apply a stronger form of single entity analysis in the context of insolvent subsidiaries. In so doing, we recognize that neither framework will eliminate the complexity associated with interacting consolidated return principles with separate company rules for worthless stock deductions. However adoption of these paradigms should relieve, especially as a practical matter, some of the pressure that now exists under current law where worthlessness is triggered by virtue of an upstream or sideways restructuring.

IV. Paradigm Two: The 2003 Report

As described above, the Tax Section submitted the 2003 Report to Treasury and the Service on October 29, 2003. The 2003 Report discussed then applicable law and its application in determining the U.S. federal income tax treatment of certain non-bankruptcy transactions involving insolvent consolidated subsidiaries and non-consolidated corporate subsidiaries.[105]

The 2003 Report responded to practical and technical uncertainties existing under the then-existing rules, as well as the fact that substantially different results were driven off of factors that did not seem to reflect meaningful economic differences in the context of a consolidated group. As one example, the separate company subchapter C rules governing upstream and sideways

[105] These are corporations whose parent corporation owns stock meeting the requirements of section 1504(a)(2). The report focused on corporate subsidiaries meeting this stock ownership test because the stock ownership of most subsidiaries satisfies this requirement and this percentage of stock ownership is required for a tax-free liquidation under section 332.

reorganizations described above produce substantially different results depending on how a subsidiary is capitalized. The decision to capitalize a subsidiary with intercompany debt, intercompany preferred stock, or intercompany common stock often does not have significance vis-à-vis the outside world and is driven by other factors, such as the group's accounting system. Notwithstanding this fact, the form of capitalization of a subsidiary is a crucial determinant of whether an upstream or sideways reorganization is taxable or tax-free.

The 2003 Report noted that other uncertainties create additional impediments to business-oriented restructurings and create opportunities to accelerate stock losses without disposing of a troubled business. Such uncertainties include the difficulty of valuing with precision a subsidiary's assets without the presence of a third party transaction. In addition, considerable uncertainty existed in 2003 (and still exists today) as to the characterization of instruments as debt, preferred stock, or common stock for US federal income tax purposes.

The 2003 Report therefore recognized that a strict application of existing law limited the ability of taxpayers to engage in business motivated tax-free restructurings of insolvent corporations and provided opportunities to accelerate (and, based on then-applicable rules, potentially duplicate) stock losses. The purpose of the recommendations made in the 2003 Report was to provide clarity, facilitate business motivated restructurings, limit opportunities to duplicate or accelerate losses, and promote consistency.

For the reasons described herein, the Tax Section continues to believe that the recommendations made in the 2003 Report are appropriate. We believe the recommendations made in the 2003 Report present a unified approach to the treatment of stock of insolvent members of consolidated groups, generally eliminating the worthless stock deduction where the group retains the business of the insolvent member. In addition, we believe that on balance, the guidance issued since the 2003 Report is not incompatible with those recommendations, as discussed below. We therefore suggest that Treasury and the Service consider these proposals anew. While we will not recite the entire 2003 Report in this report, we believe that a brief discussion of the issues addressed and conclusions reached in the 2003 Report with respect to upstream and sideways restructurings would be helpful.[106]

A. 2003 Report Recommendations Concerning Upstream and Sideways Restructuring Transactions

With respect to upstream restructurings, the 2003 Report recommended maintaining current law to prohibit treating an upstream restructuring of an insolvent corporation within a consolidated group as a liquidation under section 332, because in such a transaction there is no distribution to the insolvent subsidiary corporation's shareholder with respect to the subsidiary's common stock. Instead, in an effort to produce more effective reform for upstream restructuring transactions, the 2003 Report turned its focus to the reorganization provisions, which require a real and substantial business purpose, as well as continuity of business enterprise.[107]

[106] Because this report is limited to treatment in consolidation, we will not describe the recommendations set forth in the 2003 Report with respect to upstream and sideways restructurings involving non-consolidated corporations.

[107] For this purpose, it would seem appropriate that the continuity of business enterprise requirement be treated as satisfied if the subsidiary's business continues to be conducted anywhere in the consolidated group following the

The 2003 Report suggested that the Service and Treasury issue regulations under the consolidated return rules and section 368 that would allow an upstream restructuring of an insolvent company to qualify as a reorganization if the statutory and regulatory requirements otherwise applicable to reorganizations were satisfied. To test whether a transaction involving an insolvent subsidiary could otherwise qualify for tax-free reorganization treatment, the 2003 Report suggested first creating and respecting certain deemed transactions that would make the subsidiary solvent prior the transaction.

The 2003 Report posits three scenarios: (i) the subsidiary is insolvent because of intercompany debt owed to the parent, (ii) the subsidiary is insolvent because of debt owed to third parties, and (iii) the subsidiary is solvent but has assets with a value that is less than the liquidation preference on its outstanding preferred stock. Where a subsidiary is insolvent because of intercompany debt owed to the parent corporation, the 2003 Report suggests a deemed contribution of that debt to the subsidiary in a transaction viewed as separate from the upstream restructuring for purposes of testing whether the upstream restructuring qualifies as a tax-free reorganization.[108] If the subsidiary is solvent after the deemed contribution of debt held by the parent, the parent corporation would be considered to receive subsidiary assets in exchange for its subsidiary stock and the transaction would qualify for tax-free reorganization treatment if the remaining section 368 requirements are satisfied. Where the subsidiary is insolvent because of debt owing to an unrelated third party, the deemed transaction would be an assumption by the parent of the subsidiary's debt to the third party immediately before the reorganization. The assumption would be deemed to occur in a separate capital contribution.[109] Finally, a deemed recapitalization would be constructed where the parent owns preferred stock of the subsidiary and the subsidiary's assets are worth less than the liquidation preference on the preferred stock. Specifically, the preferred stock would be treated as recapitalized into common stock in a transaction qualifying under section 368(a)(1)(E), and the upstream reorganization would occur in a separate transaction. The 2003 Report noted that if, following the deemed transactions, the other requirements for treatment as a tax-free reorganization are met, the parent would recognize no gain or loss pursuant to section 354 nor would it trigger any ELA in the stock of the subsidiary. The subsidiary would recognize no gain or loss pursuant to section 361(a) and (c) and the consolidated group would not be entitled to any worthless stock deduction under section 165(g). Also, the parent corporation would succeed to the subsidiary's tax attributes under section 381. If, however, the other requirements for treatment as a tax-free reorganization were

upstream or sideways restructuring (i.e., without the limitations of the qualified group rules of Treas. Reg. § 1.368-1(d)). While this point was not addressed in the 2003 Report, adoption of this approach to continuity of business enterprise would be consistent conceptually with the single entity thrust of the 2003 Report's recommendations and would prevent groups from using the qualified group rules to circumvent the intent of the recommendations.

[108] The deemed contribution would be separate only for purposes of applying section 368 and related provisions to the upstream restructuring. Accordingly, the deemed contribution would not be considered to make the subsidiary solvent for purposes of applying section 332. For potential consequences under Treas. Reg. § 1.1502-13(g), see *infra*.

[109] The 2003 Report suggests providing that the change in obligor under this scenario would not result in a significant modification of the third-party debt, assuming the rules of Treas. Reg. § 1.1001-3(e)(4)(i)(B) would be satisfied if the assumption were deemed to occur in the reorganization itself. For potential consequences under Treas. Reg. § 1.1502-13(g), see *infra*.

not met because, for example, the value of the assets of the subsidiary had also declined to zero such that there was effectively no business to continue,[110] the worthless stock deduction would be immediately available.

Similar to upstream restructurings, the 2003 Report recommended that certain sideways restructurings of insolvent subsidiary members should generally qualify as tax-free reorganizations.[111] The 2003 Report applies the deemed mechanics for sideways restructurings to the same three scenarios described above for upstream restructurings: (i) the subsidiary is insolvent because of debt owed to the parent, (ii) the subsidiary is insolvent because of debt owed to third parties, and (iii) the subsidiary is solvent but has assets with a value that is less than the liquidation preference on its outstanding preferred stock. Similar to the recommendations for the upstream restructurings, where the subsidiary is insolvent because of intercompany debt owed to the parent corporation, the 2003 Report suggests a deemed contribution of that debt by the parent to the subsidiary in a transaction viewed as separate from the sideways restructuring for purposes of testing whether the sideways restructuring qualifies as a tax-free reorganization.[112] The parties would then be deemed to proceed with the reorganization, with the parent exchanging the acquiring subsidiary stock for target subsidiary stock, with sections 354, 361 and 1032 applying to prevent gain or loss. The 2003 Report also suggests that where the acquiring subsidiary actually assumes debt deemed contributed to capital by the parent prior to the reorganization, the acquiring subsidiary would be deemed, in a separate transaction occurring immediately after the reorganization, to redeem an equivalent amount of its stock deemed issued in the reorganization.[113] Where the subsidiary is insolvent because of debt owing to an unrelated third party, the deemed transaction would be a series of assumptions of the subsidiary's debt to the third party, first by the parent corporation, and then by the acquiring subsidiary. The assumptions would be deemed to occur in separate capital contributions and distributions.[114] Finally, similar to the upstream restructuring, a deemed recapitalization would be constructed where the subsidiary's assets are worth less than the liquidation preference on its outstanding preferred stock. Specifically, the preferred stock would be treated as recapitalized

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[110] A mere decline in the value of the subsidiary's assets (with some value remaining) may not destroy continuity of business enterprise.

[111] Note that although the COI and section 354 problems with a sideways merger of an insolvent subsidiary are generally remedied by the deemed transactions described above, the 2003 Report recommended that the Service and Treasury continue to require that the business purpose and continuity of business requirements of Treas. Reg. § 1.368-1(b) and (d) are also satisfied. The 2003 Report also suggested that it would be appropriate to implement rules recapturing certain U.S. federal income tax benefits (e.g., prior worthlessness deductions for intercompany stock or debt) attributable to prior treatment of intercompany investments as debt.

[112] Again, the deemed contribution would be separate only for purposes of applying section 368 and related provisions to the upstream restructuring. For potential consequences under Treas. Reg. § 1.1502-13(g), see *infra*.

[113] The 2003 Report states that generally such redemption would be viewed as dividend-equivalent, and that any resulting income under section 301 would be excluded under Treas. Reg. § 1.1502-13(f)(1), noting that such treatment is consistent with the treatment of boot in intercompany reorganizations under Treas. Reg. § 1.1502-13(f)(3).

[114] The 2003 Report suggests providing that the change in obligor under this scenario would not result in a significant modification of the third-party debt, assuming the rules of Treas. Reg. § 1.1001-3(e)(4)(i)(B) would be satisfied if the assumption were deemed to occur in the reorganization itself. For potential consequences under Treas. Reg. § 1.1502-13(g), see *infra*.

into common stock in a transaction qualifying under section 368(a)(1)(E), and the sideways reorganization would occur in a separate transaction.

To summarize, the 2003 Report generally recommends that the Service and the Treasury adopt regulations to expand opportunities for consolidated groups to reorganize insolvent subsidiaries and to limit opportunities for groups to accelerate worthless stock deductions inappropriately. At the time of the 2003 Report, we suggested that the recommended result may be best accomplished through the application of the tax-free reorganization provisions of section 368, rather than through the tax-free liquidation provisions of section 332. Additionally, we suggested that the Service and the Treasury consider whether the results could be achieved through the adoption of regulations to address restructurings and to provide a mechanism to satisfy continuity of interest and section 354 exchange principles. The regulations should be limited to the promotion of reorganizations that are undertaken for business reasons, and to the continuance of the subsidiary's business. As such, the business purpose and continuity of business enterprise requirements should remain in place.

B. Developments Following the 2003 Report

We continue to believe that the recommendations made in the 2003 Report are appropriate. Regulations promulgated to address the recommendations made in the 2003 Report would expand access to the tax attributes of insolvent subsidiaries, yet also reduce opportunities for duplication and acceleration of losses to the extent not already addressed by current law. Since we submitted the 2003 Report, there have been various developments in the law that potentially impact the legal analysis in such report. On balance, these developments are not incompatible with the recommendations we made in the 2003 Report. Following is a brief discussion of the most significant developments and their impact on the recommendations made in the 2003 Report.

1. Continuity of Interest for Insolvent Companies

The 2003 Report suggested revisions to the continuity of interest regulations that, consistent with the Court's holding in *Helvering v. Alabama Asphaltic Limestone Co.*,[115] would reflect the reality that the creditors are the owners of a proprietary interest in an insolvent corporation. On December 11, 2008, the Service and Treasury issued final continuity of interest regulations under section 368 dealing with this issue.[116] The regulations generally provide that stock received by creditors of an insolvent company, whether or not the insolvent company is in bankruptcy, may count toward satisfying the continuity of interest test. Specifically, the regulations generally treat the most senior class of creditors receiving equity in the acquirer and all classes of creditors that are pari passu or junior to such senior class of creditors, as the owners of a proprietary interest in the insolvent target corporation. However, the claims of the most senior class of creditors receiving equity are only treated as representing a proprietary interest in the insolvent

[115] 315 U.S. 179 (1942).

[116] T.D. 9434 (Dec. 12, 2008). On January 20, 2006, the Tax Section issued Report No. 1102, Report on Proposed Regulations Regarding Organizations, Reorganization and Liquidations Involving Insolvent Corporations, with respect to these regulations, as well as other issues, including the PNV Regulations.

target corporation to the extent of the portion of the value of such claims relating to the acquirer stock received.[117] The preamble to the final regulations provides that "[t]he expansion of the application of the "G" reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress' intent to facilitate the rehabilitation of troubled corporations." Consistent with our recommendations in the 2003 Report, these regulations generally support allowing the reorganization of an insolvent company to qualify as a tax-free reorganization and specifically address one of the suggestions made in the 2003 Report to facilitate reorganization treatment.

2. Treas. Reg. § 1.1502-80(c)

On March 18, 2004, the Service and the Treasury issued temporary regulations under Treas. Reg. § 1.1502-80T(c), broadening the triggers for claiming a worthless stock deduction with respect to the stock of a consolidated subsidiary.[118] Prior to the issuance of Treas. Reg. § 1.1502-80T(c), a parent corporation could not claim a worthless stock deduction with respect to a subsidiary until the stock was worthless under Treas. Reg. § 1.1502-19(c)(1)(iii).[119] The temporary regulations added an additional provision ending deferral of the worthlessness deduction if the subsidiary ceased to be a member of the group for any reason. This addition once again moved the regulatory regime applicable to worthless stock deductions for consolidated subsidiaries in a single entity direction (i.e., ending deferral when single entity treatment is no longer possible because the subsidiary leaves the group). Because the loss disallowance rule became inapplicable following the *Rite Aid* decision,[120] practitioners had argued that the -80(c) rules were no longer necessary and should be eliminated in their entirety. The Service disagreed, noting that the loss disallowance rule was not the principal purpose for the -80(c) regulation. Specifically, the preamble to the 2007 -80(c) regulation, which adopted the 2004 temporary regulation as a final regulation, provided that the principal purpose for the -80(c) rule is "to promote single entity treatment" within a consolidated group. Consistent with the recommendations in the 2003 Report, single entity treatment within a consolidated group supports allowing a reorganization within a consolidated group for valid business reasons, even if one or more of the companies involved in the reorganization is insolvent, without allowing the reorganization to trigger a worthless stock deduction with respect to subsidiary stock.

3. Treas. Reg. § 1.1502-13(g)

Effective December 24, 2008, the Service issued final regulations that revised the intercompany obligation rules of Treas. Reg. § 1.1502-13(g).[121] Treas. Reg. § 1.1502-13(g) applies to three types of transactions: inbound (becoming an intercompany obligation), outbound (where the

[117] The regulations provide a formula for determining the amount of the most senior claims that represent a proprietary interest in the target corporation where there are different classes of senior claims that receive different packages of consideration.

[118] 69 Fed. Reg. 12799 (March 18, 2004).

[119] As noted above, these temporary regulations were finalized in 2007.

[120] 255 F.3d 1357 (Fed. Cir. 2001).

[121] T.D. 9442 (Dec. 29, 2008).

obligation ceases to be intercompany), and intragroup. For all three types of transactions, the current regulations (and the regulations outstanding at the time of the 2003 Report) generally provide that, under certain circumstances, an obligation may treated as satisfied, and, if the obligation remains outstanding, reissued as a new obligation (the deemed satisfaction-reissuance model). The deemed satisfaction-reissuance model preserves the location of a creditor and debtor member's items from an intercompany obligation, matches the timing of the items, and ensures that the future items of original issue discount or premium between the creditor and debtor will similarly correspond in amount and timing.

The 2008 final regulations adopted, with modifications, the proposed regulations published in the Federal Register on September 28, 2007 (the "2007 proposed regulations").[122] The 2007 proposed regulations simplified the mechanics of the deemed satisfaction-reissuance model by separating deemed and actual transactions, but limited the application of the model by creating a number of exceptions to the trigger.[123] As described above, one such exception is for transactions resulting in the extinguishment of intercompany debt in certain circumstances, and the inclusion of the exception more clearly facilitates a contribution of debt to capital qualifying under section 108(e)(6).

In the 2003 Report, we noted that the deemed transactions may invoke the application of Treas. Reg. § 1.1502-13(g). For example, where the subsidiary in an upstream or a sideways restructuring is indebted to the parent corporation and the 2003 Report recommends that the debt be deemed to be contributed to the capital of the subsidiary before the restructuring, the 2003 Report notes that Treas. Reg. § 1.1502-13(g) may apply to the deemed contribution of the debt. Under the extinguishment exception, section 108(e)(6) should apply to the deemed contribution, thereby simplifying the application of the approach (and in certain circumstances avoiding the potential for the deemed transaction to later create unwarranted results under ULR, as described above). Accordingly, intervening changes to Treas. Reg. § 1.1502-13(g) appear to be compatible with the approach advanced in the 2003 Report.

4. Treas. Reg. § 1.1502-35 and the ULR

The final regulations under Treas. Reg. § 1.1502-35, which are very similar to Treas. Reg. § 1.1502-35T,[124] were designed to prevent a group from recognizing more than one tax benefit

[122] REG-107592-00, 72 FR 55139 (Sept. 28, 2007).

[123] Generally under the new model, the following sequence of events occur immediately before, and independently of, the actual transaction: (1) the debtor satisfies the obligation for a cash amount equal to the obligation's fair market value; and (2) the debtor immediately reissues the obligation to the original creditor for that same cash amount. Thus, the parties engaged in the actual transaction but with the new obligation.

[124] T.D. 9254 (Mar. 14, 2006). In the interim between the issuance of the 2003 Report and the finalization of Treas. Reg. § 1.1502-35, the Treasury modified Treas. Reg. § 1.1502-35T(f) to allow an insolvent subsidiary to retain a portion of its CNOL following the period in which a worthless stock deduction was taken with respect to the subsidiary's stock, unless immediately following the taxable year in which the worthless stock deduction is claimed, the subsidiary is a member of a group that includes any corporation (other than a lower-tier subsidiary of the member the stock of which was treated as worthless) that, during that taxable year, was a member of the group that includes the corporation that claimed the worthless stock deduction. *See* T.D. 9118 (Mar. 18, 2004).

with respect to one economic loss.[125] In the 2003 Report, we noted that our proposals addressed loss duplication with respect to reorganizations of insolvent consolidated subsidiaries differently than Treas. Reg. § 1.1502-35T. Specifically, whereas our proposal for upstream restructurings eliminated outside stock basis and preserved inside attributes, the temporary regulation provided that the parent would recognize its "outside loss" (i.e., the worthless stock deduction) in an upstream restructuring of an insolvent subsidiary, but eliminated the unused "inside loss" (inside tax attributes of the subsidiary). Our proposal would have deferred loss recognition and changed the measure of any future loss.

Generally, the final regulations under Treas. Reg. § 1.1502-35 contemplate that a corporation could recognize a worthless stock deduction on the stock of an insolvent subsidiary notwithstanding that the subsidiary's business or assets remains in the group, although the insolvent subsidiary's tax attributes would be eliminated if the subsidiary's business or assets remained in the group. The preamble to Treas. Reg. § 1.1502-35 provides that those regulations were generally intended as a stop-gap until the Treasury and the Service developed more comprehensive rules.[126]

Subsequent to the issuance of Treas. Reg. § 1.1502-35, the Treasury and the Service proposed and finalized the ULR,[127] which now generally governs loss duplication in a consolidated group, with Treas. Reg. § 1.1502-35 now only applicable to covered transactions that are not governed by the ULR.[128] As described above, the ULR allows a parent corporation to recognize a worthless stock deduction with respect to the stock of an insolvent consolidated subsidiary. Similar to the treatment described above with respect to Treas. Reg. § 1.1502-35T, the recommendations in the 2003 Report for upstream restructurings would not result in the application of the ULR because our proposal eliminates outside stock basis without recognition of a worthless stock loss in the case of an upstream restructuring qualifying as a tax-free reorganization. With respect to sideways restructurings qualifying as a tax-free reorganization under the 2003 Report, the ULR would not apply at the time of the restructuring (that is, because S would not cease to be a member (taking into account the acquiring member as a successor to S, and because P would not recognize its loss with respect to S's stock, which loss would be preserved in the stock of the acquiring member). However, the ULR should be applied to the stock of the acquiring corporation to the extent the rules are otherwise applicable based on a subsequent transaction (e.g., a transfer of a loss share, deconsolidation of the acquiring corporation, etc.).

Accordingly, while ULR in its current form generally contemplates a separate company determination of the application of sections 332 and 368 to upstream and sideways restructurings, its mechanics are not necessarily incompatible with the approach proposed in the 2003 Report.

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[125] *See* Treas. Reg. § 1.1502-35(a)(1).

[126] *See* T.D. 9254 (Mar. 14, 2006).

[127] T.D. 9424 (Sept. 17, 2008).

[128] *See* Treas. Reg. § 1.1502-35(a)(2)(iii) (Treas. Reg. §1.1502-35 applies only "[i]f the disposition is of a share of subsidiary stock, it is not a transfer to which § 1.1502-36 applies").

5. PNV Regulations

A summary of the PNV Regulations is provided above. The separate company approach taken by the government in the PNV Regulations is inconsistent with the recommendations of the 2003 Report. Generally, as described above, the PNV Regulations deny tax-free treatment where the Code requires an exchange and the target corporation and/or the acquiring corporation do not have assets the value of which exceeds its liabilities. By deeming the obligations to be assumed or contributed to capital to render the subsidiary target solvent before the restructuring, the model recommended in the 2003 Report would create a means to satisfy the Code's requirement for an exchange in those circumstances.

In issuing the PNV Regulations, the government commented that it considered whether special rules are appropriate in consolidation:

> The IRS and the Treasury Department considered several other approaches to unify and rationalize the nonrecognition rules of subchapter C as they applied to transactions involving insolvent corporations. The IRS and the Treasury Department considered whether there should be special rules for potential nonrecognition transactions between members of a consolidated group. Such rules might disregard the various exchange requirements in the statute because of the single entity principles generally applicable to corporations joining in the filing of a consolidated return. This approach was rejected because there is no consolidated return policy that compels a different set of rules for potential nonrecognition transactions between members of a consolidated group…

We believe that the government should reconsider this tentative judgment. We agree that the single entity principles underlying consolidation do not "compel" a different judgment. But we do believe that these principles, together with the complexity of, and uncertainties involved in, accommodating consolidated return rules to the separate entity rules in the PNV Regulations (which have become apparent since the PNV Regulations were proposed), argue persuasively for a different judgment. We thus continue to believe the approach proposed in the 2003 Report is an appropriate model in the context of a consolidated return, where the business of the subsidiary has not left the group. We note that the PNV Regulations were proposed in 2005 and have not been finalized, and recommend that, in considering whether and in what form to finalize the PNV Regulations, the Service and the Treasury consider the approach taken by the 2003 Report in the context of consolidated groups.

C. Summary of the 2003 Report

To summarize, the 2003 Report generally recommends that the Service and the Treasury adopt regulations to expand opportunities for corporate groups to reorganize insolvent subsidiaries. The recommendations in the 2003 Report represent a unified approach to the treatment of an insolvent member of a consolidated group. On balance, the developments since the 2003 Report are not incompatible with our recommendations. Therefore, we continue to believe that the recommendations made in the 2003 Report are appropriate and should be considered.

V. Paradigm Three: The Suspended Loss Approach

As discussed above, current law and the PNV Regulations generally take a separate-entity approach to the relationship between a parent and its insolvent subsidiary by allowing parent to take a worthless stock deduction under section 165(g) at the time the subsidiary engages in an upstream or sideways transfer of assets,[129] even though on a consolidated basis the underlying business and assets of the subsidiary remain within the group. Alternatively, the 2003 Report takes a single entity approach by deeming the assets to be transferred within the group in an upstream or sideways tax-free transaction, preserving the subsidiary's NOLs and the underlying basis in its assets, while denying parent a worthless stock deduction under section 165(g). Here, we discuss an alternative, a hybrid approach that defers the worthless stock deduction that would otherwise result under current law until a later appropriate triggering event.

As discussed below, absent pursuing the single entity approach in the 2003 Report, we would recommend that the worthless stock deduction realized upon an upstream or sideways restructuring in which the business of the subsidiary is continued (at least in the initial transaction) generally be deferred until the time that the parent leaves the group – regardless of whether the restructuring constitutes a taxable liquidation or a tax-free reorganization of the subsidiary.[130] We suggest for consideration the inclusion of an election by which the common parent of the group can "push down," to the assets of the subsidiary that remain within the consolidated group immediately after the restructuring, the portion of the stock basis that does not represent a duplicated loss. Such election would only be permitted if the worthless stock deduction would otherwise qualify for ordinary loss treatment under section 165(g)(3) and, in cases where an election to reduce the potential for loss duplication under Treas. Reg. § 1.1502-36(d)(6) is available (by reducing stock basis and preserving inside attributes), only if that election is made.

A. Constructing a Worthless Stock Deduction Deferral Regime

1. Deferral of the Worthless Stock Deduction Under Current Regulations

As discussed above, -80(c) currently provides for the deferral of a worthless stock deduction with respect to a consolidated subsidiary until such time as the subsidiary either leaves the consolidated group or certain limited events as set forth in Treas. Reg. § 1.1502-19(c)(iii) occur. Moreover, Example (iii) of Treas. Reg. § 1.1502-36(d)(7)(iii) assumes that such a worthless stock deduction continues to be deferred where the subsidiary engages in a tax-free reorganization with another member of the group, such that there exists a successor member of the group (although the existing regulatory authority for such treatment is uncertain).

2. Other Suspended Loss Regimes

[129] Barring deferral under -80(c), as discussed herein.

[130] An ancillary issue raised by the suspension would be the treatment of the suspended loss for COD attribute reduction purposes. In this regard, to avoid distortion of the ordering rules, we believe that the suspended loss would be appropriately treated as net operating loss or capital loss, as applicable, rather than as basis in property (*cf.* Treas. Reg. § 1.108-3).

Suspending a loss until a later triggering event has occurred is a feature of a number of other provisions in the Code and Treasury Regulations. These provisions include, among others, those relating to section 197 intangible asset dispositions, dividend-equivalent redemptions, intercompany transactions described in Treas. Reg. § 1.1502-13, stock dispositions by a member of a consolidated group, and loss transactions between related parties. The manner and purposes of these suspension provisions are briefly described below.

In the context of the disposition (or worthlessness) of a section 197 intangible, a special rule provides that no loss will be recognized where a taxpayer disposes of a section 197 intangible that was acquired in a transaction (or a series of transactions) in which other section 197 intangibles were acquired ("simultaneously acquired intangibles"), and those simultaneously acquired intangibles have been retained.[131] Although the loss is said to be "disallowed," it is effectively deferred because the bases in the remaining simultaneously acquired intangibles are increased by the amount of the disallowed loss.[132] The loss (or reduction of gain) will be "triggered" when the last of such simultaneously acquired intangibles, having now attracted all of the basis associated with the previously disposed of section 197 intangibles, is itself disposed of (or becomes worthless). This rule may reflect concern about the difficulty of correctly allocating value among several simultaneously acquired section 197 intangible assets and resolves the uncertainty by treating those simultaneously acquired intangibles as a single section 197 intangible asset.[133] Similarly, the termination or worthlessness of only a portion of a separately acquired section 197 intangible does not result in a loss for tax purposes.[134]

Corporations that are members of a controlled group of corporations as defined in section 41(f)(5) are considered to be a single taxpayer for purposes of determining whether a taxpayer that has disposed of a section 197 intangible retains other simultaneously acquired intangibles.[135] Therefore, a corporation will not be able to recognize a loss on the disposal of all of its section 197 intangibles if other corporations within its controlled group retain simultaneously acquired intangibles. In such a case, the basis shifting rule discussed above does not apply. Instead, the loss is suspended and allowed ratably, as a deduction under section 197, over the remainder of the period over which the disposed asset would have been amortized. However, the entire suspended loss may be taken on the first date on which all of the other simultaneously acquired intangibles that were retained by the other corporations have been disposed of.[136] This rule appears to reflect concern about the propriety of shifting basis from one taxpayer to another and resolves the concern in favor of creating a true "suspended loss."

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[131] Section 197(f)(1)(A)(i); Treas. Reg. § 1.197-2(g)(1)(i)(A).

[132] *See* section 197(f)(1)(A)(ii).

[133] *See* Report No. 818, New York State Bar Association Section on Taxation, Report on Issues To Be Addressed in Regulations under Section 197 (Jan. 13, 1995), reprinted at 95 TNT 12-20 (arguing that the acquisitions of goodwill in the course of a large pharmaceutical corporation's purchase of several small biotechnology businesses should not be considered section 197 intangibles acquired in the same or related transactions because if "each of the sellers is different and unrelated, no part of the purchase price of one acquisition can be shifted to the other acquisitions….").

[134] Treas. Reg. § 1.197-2(g)(1)(ii).

[135] Section 197(f)(1)(C); Treas. Reg. § 1.197-2(g)(iv).

[136] Treas. Reg. § 1.197-2(g)(1)(iv)(B).

A similar tension between basis shifting and pure loss suspension plays out in the current and proposed regulations governing dividend equivalent redemptions under section 302(d). A dividend equivalent redemption may occur in the context of a taxpayer's disposal of an entire class of stock if, for instance, the taxpayer owns both common shares and non-voting preferred shares, or the taxpayer is deemed to own other shares of the company through attribution. Under the current regulations, unrecovered basis in the redeemed shares is permitted to shift to other shares in certain circumstances, including to those shares held by the taxpayer's spouse (or potentially other related parties) if all of the taxpayer's shares are redeemed.[137] However, the Treasury has expressed concern that such stock basis shifting can lead to inappropriate results.[138]

Under proposed regulations, the basis shifting rule would be eliminated where all shares of a given class held by a shareholder are redeemed, in favor of preserving the tax consequences of the unrecovered basis to the redeemed shareholder by treating the unrecovered basis as a suspended loss.[139] Recognition of the suspended loss would be triggered on the earlier of (x) "[t]he first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2), or (3), if the facts and circumstances that exist at the end of such day had existed immediately after the redemption" and (y) "[t]he first date on which all classes of stock of the redeeming corporation become worthless within the meaning of section 165(g)."[140] If the redeemed shareholder is a corporation, the loss is also triggered (i) when the corporation has disposed of all of its assets in a fully taxable transaction and the corporation has ceased to exist for tax purposes, (ii) when a foreign corporation transfers its assets to a domestic corporation in a tax-free liquidation or reorganization and (iii) when a foreign corporation that is not a controlled foreign corporation transfers its assets to a controlled foreign corporation in a tax-free liquidation or reorganization.[141]

Loss suspension is an integral part of the consolidated return regulations, and in certain limited circumstances basis shifting is required under such regulations. Consistent with the single entity view of the consolidated group, the regulations implement a deferral system "to prevent intercompany transactions from affecting the timing of consolidated taxable income."[142] Under the "matching rule" of Treas. Reg. § 1.1502-13(c), loss (and gain) realized upon the sale of an asset between two members of a consolidated group is deferred until the asset is later sold outside of the consolidated group or to the extent matching in the asset (or a successor asset) is no longer possible. Under the "acceleration rule" of Treas. Reg. § 1.1502-13(d), loss (and gain) deferred under the matching rule will be taken into account when either of the parties taking part in the intercompany sale becomes a nonmember. These rules were adopted "to fix more accurately the location, character and source of … gain or loss on transactions between

[137] Treas. Reg. § 1.302-2(c).

[138] Preamble to Proposed Amendments of Regulations (REG-143686-07) (Jan. 21, 2009).

[139] Prop. Treas. Reg. § 1.302-5(a)(3).

[140] Prop. Treas. Reg. § 1.302-5(b)(4)(i).

[141] Prop. Treas. Reg. § 1.302-5(b)(4)(ii).

[142] T.D. 8478, 1993-1 C.B. 189 (Mar. 11, 1993).

members" than had been achieved by the previous rules, which had relied on a carryover basis and gain elimination regime.[143]

Building off of the principles of Treas. Reg. § 1.1502-13, section 267 provides another regime for suspending losses incurred in transactions between related taxpayers. The general rule provided in section 267(a) flatly disallows deductions in respect of losses generated by transactions between related persons.[144] But if the loss is generated in a transaction between corporations belonging to the same "controlled group," the loss is allowed, but deferred until such time that it would be taken into account under modified consolidated return principles.[145] One intercompany transaction that is excepted from both loss denial under section 267(a) and loss deferral under section 267(f) is the complete liquidation of a subsidiary into its parent.[146] Section 267 therefore does not impede loss recognition under section 331 or section 336. It has been suggested that this exception recognizes that a liquidation represents a permanent change rather than a mere reshuffling of property among continuing taxpayers.[147]

The consolidated return regulations have implemented a couple of different loss deferral regimes in the context of preventing (i) multiple deductions from being taken with respect to a single economic loss ("loss duplication") as well as (ii) the recognition of noneconomic loss. We will first examine Treas. Reg. § 1.1502-35, which applies to stock transfers to which the ULR does not apply and is specifically concerned with preventing duplicated loss.[148]

Under Treas. Reg. § 1.1502-35, stock basis is redetermined for all group members holding shares in a subsidiary if any member transfers "loss" stock of a subsidiary. Separate rules apply depending on whether the transfer deconsolidates the subsidiary. If the subsidiary remains a member of the group, all members' bases in the subsidiary stock are "blended" and then allocated first to preferred shares (up to their value) and then to common shares (proportionately based on value) immediately before the transfer.[149] If the subsidiary is deconsolidated as a result of the transfer, the amount of basis reallocated is limited to the smaller of the members' aggregate loss in the subsidiary stock and the amount of negative items that have reduced group members' bases in "gain" shares of the subsidiary stock. Similar to the rule above, this limited basis reallocation first reduces or eliminates loss on preferred shares and then (to the extent possible) equalizes all members' bases in common shares.[150] If the basis redetermination does

[143] T.D. 8295, 1990-1 C.B. 165 (Mar. 14, 1990).

[144] Section 267(a)(1). The sentence immediately following the statement of the general rule makes clear that the rule does not apply to losses incurred by the distributing corporation (or the distributee) where there is a complete liquidation.

[145] *See* section 267(f).

[146] Section 267(a)(1).

[147] Bittker and Lokken, Federal Income Taxation of Income, Estates and Gifts ¶ 78.1.2 (Warren, Gorham & Lamont, 2003, with supplement).

[148] Preamble to Proposed Amendments of Regulations, 72 F.R. 2964, 2978 (Jan. 23, 2007) ("The sole purpose of §1.1502-35 … is to address the duplication of loss.").

[149] Treas. Reg. § 1.1502-35(b)(1).

[150] Treas. Reg. § 1.1502-35(b)(2).

not eliminate loss on a transfer of stock of a subsidiary that remains consolidated and that loss is potentially subject to duplication, the stock loss will be suspended until such time as it can be determined whether or not such duplication will actually occur.[151]

The basis shifting required under Treas. Reg. § 1.1502-35 as the first line of defense to prevent recognition of a duplicated loss stands in stark contrast to the concerns evident in the section 197 and section 302 contexts discussed above. However, the Service and Treasury were sensitive to the possibility that taxpayers could seek to affirmatively use the basis shifting rules of these regulations in an attempt to defer or eliminate gain.[152] Therefore, the regulations include a "principle-based" anti-abuse rule that prevents the basis shifting and loss suspension rules from applying where "a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock" by invoking Treas. Reg. § 1.1502-35(b)(1) or (2) where the stock loss or duplicated loss giving rise to the applicability of either such paragraph "is not significant."[153]

A few years after promulgating Treas. Reg. § 1.1502-35 to tackle the problem of loss duplication, the Treasury reconsidered its approach and decided to effectively remove such regulations and replace it with "a more easily administered and more comprehensive approach to addressing loss duplication among members of a consolidated group."[154] This approach, which is set forth in the ULR and is also intended to address the problem of noneconomic loss as described above, generally applies to stock transfers occurring on or after September 17, 2008. Under the ULR, upon the transfer of shares of loss stock of a subsidiary, positive and negative adjustments (exclusive of distributions) are reallocated among the members' bases in subsidiary stock to first eliminate any loss on preferred shares and then minimize any basis disparity on all shares.[155] This rule differs from Treas. Reg. § 1.1502-35 in two significant ways that mitigate the effects of basis shifting in the current regime. First, there is no full basis blending (i.e., only basis attributable to investment adjustments is shifted).[156] Second, members' bases in shares not transferred are not reduced. Accordingly, the anti-abuse rule of the ULR does not have a specific provision targeted toward abuse of the basis shifting provisions similar to Treas. Reg. § 1.1502-35.[157]

B. General Approach

[151] Treas. Reg. § 1.1502-35(c)(1).

[152] Preamble to Treas. Reg. § 1.1502-35T, T.D. 9048, 2003-1 C.B. 644 (Mar. 14, 2003) ("The IRS and Treasury Department do not intend that the basis redetermination rule be applied to defer or eliminate gain" in cases where "there is no significant duplication of loss" and "steps were structured with a view to avoiding the recognition of gain on a disposition of stock.").

[153] Treas. Reg. § 1.1502-35(g)(4).

[154] Preamble to Proposed Amendments of Regulations, 72 F.R. 2964, 2976 (Jan. 23, 2007).

[155] Treas. Reg. § 1.1502-36(b)(2); Preamble to Proposed Amendments of Regulations, 72 F.R. 2964, 2978.

[156] Preamble to Proposed Amendments of Regulations, 72 F.R. 2964, 2977 ("A full basis blending rule is…a significant departure from the rules generally applicable under the Code.").

[157] Treas. Reg. § 1.1502-36(g).

1. Continuity of Business

As discussed earlier, under current law, a worthless stock deduction generally can be (and should be able to be) claimed when an insolvent subsidiary engages in a taxable upstream or sideways restructuring. In our 2003 Report, we proposed, and here continue to recommend, that upstream and sideways restructuring of an insolvent subsidiary be treated in a manner that effectively eliminates or defers (through carryover stock basis) any stock loss if the conditions for a tax-free reorganization can be satisfied (after, in effect, deeming the subsidiary to be solvent). Absent the ability to satisfy the continuity of business enterprise requirement for a tax-free reorganization, we believe that any worthless stock deduction should properly be allowable without further deferral.

The classic hallmark of a tax-free reorganization, and a basic distinguishing factor from a liquidation, is the continuation of the historic business of the target corporation. As such, we would limit the application of the proposed Suspended Loss Approach to an upstream or sideways restructuring that satisfies the continuity of business enterprise requirement, regardless of whether such restructuring satisfies the other requirements for tax-free reorganization treatment. For this purpose, the determination of whether the business has been continued would be determined by treating the post reorganization consolidated group as a single corporation. Accordingly, the worthless stock deduction incurred by the parent of an insolvent subsidiary that converts to a limited liability company and continues its business would be suspended, as further discussed below. In contrast, had the subsidiary previously sold its business (or if the subsidiary shortly thereafter sells its historic assets and its historic business is not continued by the group), the worthless stock deduction would be allowed currently.

2. Deferred Loss Triggered No Later Than Last Moment Consolidated Group Can Take Loss Into Account

In several of the regimes described above, suspended losses are triggered at the time that a member leaves a consolidated/controlled group, where such exit marks the last opportunity for the loss to be taken into account in the calculation of the group's income. As discussed above, the Service effectively views -80(c) as deferring the worthless stock deduction in the context of an intercompany reorganization of an insolvent subsidiary until the subsidiary leaves the consolidated group or otherwise satisfies the conditions of -80(c), which incorporates the conditions of Treas. Reg. § 1.1502-19(c)(1)(iii) (defining "worthlessness").[158] Similarly, under the section 267(f) and Treas. Reg. § 1.1502-13 regimes, a deferred loss must be taken into account at the time that the transferor and the transferee cannot be treated like two divisions of a single corporation.[159] These rules indicate, and we believe appropriately, that if a worthless stock deduction (whether resulting from a taxable liquidation or a tax-free reorganization of the insolvent subsidiary) is suspended, it should be triggered no later than immediately before the parent leaves the consolidated group.

[158] *See* Treas. Reg. § 1.1502-80(c)(ii).

[159] *See* Treas. Reg. § 1.267(f)-1(a)(2); Treas. Reg. § 1.1502-13(c)(2), (d).

If a consolidated group ceases to exist, deferred intercompany transactions (including suspended losses) under Treas. Reg. § 1.1502-13 and ELAs under Treas. Reg. § 1.1502-19 generally will be triggered and recognized on the group's final tax return as the corporations that made up the group become nonmembers.[160] However, if a consolidated group ceases to exist only because the common parent's assets were acquired in a tax-free asset reorganization, because the common parent's stock was acquired, or because the rules under Treas. Reg. § 1.1502-75(d)(2) or (d)(3) are applied, any deferred intercompany transactions and ELAs are not triggered because the old group as an entirety (as a single entity) has been acquired and continues to be consolidated.[161] These same principles should apply to parent's deferred worthless stock deduction.

In some of the loss deferral regimes described in the prior section, the suspended loss is triggered when an uncertainty as to the amount of the loss is resolved. This principle for triggering deferred losses is not applicable for a regime that defers a worthless stock deduction in the consolidated return context. Once the subsidiary's stock has been eliminated through an upstream or sideways restructuring, there is no uncertainty as to the amount of the worthless stock deduction.

C. Potential Additional Triggering Mechanisms

Having concluded that a worthless stock deduction for an insolvent subsidiary that engages in an upstream or sideways restructuring should be triggered no later than when parent leaves the consolidated group (except when the entire group is acquired), the question becomes whether there are earlier events that should trigger the deferred loss.

As we have seen, the basic operation of -80(c) allows the worthless stock deduction to be taken when an insolvent subsidiary disposes of all of its assets within the meaning of Treas. Reg. § 1.1502-19(c)(iii). As such, we considered whether the disposal by the consolidated group of all (or substantially all) of the subsidiary's historic assets should serve as a trigger of the deferred worthless stock deduction. The rule of -80(c) is meant to "promote single entity treatment by enabling the group to continue treating its investment in subsidiary stock as an investment in the subsidiary's assets."[162] In accordance with this principle, a loss with respect to a subsidiary's stock should not be deferred past the point when there is no longer an investment in the subsidiary's assets.

A trigger based on the disposition of a subsidiary's assets could be formulated in a variety of ways, each of which presents potential complexities. For instance, the deferred worthless stock deduction could be triggered when "all" of the assets formerly owned by the subsidiary at the time the worthless stock deduction was realized (other than cash and equivalent items) are no longer owned by any member of the group or have become worthless. Such a trigger may be viewed as most consistent with -80(c), requiring the group as a whole to dispose of the subsidiary's entire set of assets before taking a worthlessness deduction. But this rule seems too

[160] *See* Treas. Reg. § 1.1502-13(d)(3), Ex. 1(f); Treas. Reg. § 1.1502-19(c)(2).

[161] Treas. Reg. §§ 1.1502-13(j)(5) and 1.1502-19(c)(3).

[162] Preamble to Proposed Rules, 72 F.R. 2964, 2986.

strict, in part because the retention of a small amount of the subsidiary's assets by the group, which may be difficult to identify once the assets and business of the subsidiary have become mixed with the assets and business of another group member, should not prevent the triggering of the loss. Alternatively, this problem could be solved by triggering the deferred worthless stock deduction when "substantially all" of the assets owned by the subsidiary at the time the loss was realized (other than cash and equivalent items) are no longer owned by any member of the group or have become worthless. But the problem then becomes defining "substantially all." Also, tracking a subsidiary's assets following an upstream or sideways restructuring, to determine whether the "all" or "substantially all" test has been met, would be administratively burdensome (both for the taxpayer and the Service).

Another possible approach – one that hews closely to the justification for the triggering event – is to trigger the deferred worthless stock deduction when the consolidated group no longer carries on the insolvent subsidiary's historic business. For example, the approach might import standards from other regimes in making this determination. The standards under the continuity of business enterprise rules for section 368 could be utilized as one example; deferral would cease when the group ceased to conduct activities constituting the continuation of the historic business, determined as if the upstream or sideways restructuring qualified as a tax-free reorganization (whether or not it so qualified), and determined based on the actual conduct of the acquiring member (rather than the plans of the parties at the time of the transaction).[163] As another example, section 355's "expansion" doctrine could be employed to distinguish new business lines from activities that are merely part of the same business.[164]

The principal difficulty with this approach is that it requires a tracing analysis to determine if and when the group has discontinued the subsidiary's historic business, potentially for a long period of time. Such tracing may prove administratively difficult to apply in certain circumstances.

At least in certain cases, the administrative burden to track the assets or identify the termination of the historic business likely will not justify utilizing the above approaches. However, it is still possible to effectively link the recognition of the worthless stock deduction to the disposition of the insolvent subsidiary's historic assets. As discussed below, the common parent of the group generally could "push down" the portion of the stock basis of the subsidiary that does not represent a duplicated loss to the assets of the subsidiary that remain within the consolidated group immediately after the restructuring. This elective approach would work in tandem with the ULR and would only be allowed in cases where the worthless stock deduction would otherwise be ordinary pursuant to section 165(g)(3), to prevent capital loss from being transformed into ordinary loss. We refer to this as the "basis augmentation" rule.

D. Interplay of Suspended Loss Approach with the Attribute Reduction Rule

[163] *See* Treas. Reg. § 1.368-1(d). *See also* section 382(c), which reduces the section 382 limitation applicable after an ownership change where the loss corporation (or its successor) ceases to conduct its historic business within two years after the ownership change; Rev. Proc. 2008-52, § 5.04(c), 2008-2 C.B. 587, which requires an acceleration of section 481 adjustments when the taxpayer ceases to conduct the business giving rise to the adjustment.

[164] *See* Treas. Reg. § 1.355-3(b)(3)(ii).

Under current law, the general Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d)(2) applies with respect to a worthless stock deduction when the deduction becomes allowable under -80(c). The imposition of an additional Suspended Loss Approach presents the question of whether the application of the Attribute Reduction Rule at the time of the continued suspension is appropriate or, instead, whether such rule should be applied at the time of the actual allowance of the worthless stock deduction. Significantly, if the Attribute Reduction Rule applies at the time of the continued suspension, the common parent would continue to have the ability to the extent of any duplicated loss to elect under Treas. Reg. § 1.1502-36(d)(6) to preserve inside attributes in lieu of the suspended worthless stock deduction. Alternatively, if the Attribute Reduction Rule is not applied until the worthless stock deduction is ultimately allowed, some type of continuing adjustments to the worthless stock deduction for the continued use of inside "duplicated" attributes seemingly would be necessary to prevent the allowance of double deductions. In our view, the latter alternative introduces unnecessary complexity given the election accorded the common parent under current law, and one that would effectively revert to the essentially discarded approach of Treas. Reg. § 1.1502-35.[165] We therefore would recommend that the general Attribute Reduction Rule be applied at the same time that the Suspended Loss Approach becomes operative with respect to a worthless stock deduction.

We observe that, under the recommended approach, section 382(g)(4)(D) – which imposes a section 382 ownership change on certain controlled loss corporations for which a worthless stock deduction is claimed – would not be implicated, both as a technical matter (because the shares that are the subject of the worthless stock deduction have been cancelled and thus are not owned by parent at the end of the taxable year) and as a policy matter (as any duplicated loss will have been eliminated).[166].

From a somewhat more technical perspective, two conforming or complimentary changes to the supplemental Attribute Reduction Rule in Treas. Reg. § 1.1502-36(d)(7) would be required and/or recommended to implement the Suspended Loss Approach as described. First, Treas. Reg. § 1.1502-36(d)(7)(i) properly provides that an insolvent subsidiary's capital loss and NOL carryforwards and any deferred deductions (including its share of consolidated items) are eliminated when the subsidiary engages in a taxable upstream or sideways restructuring in which a worthless stock deduction is recognized. Additionally, in a taxable restructuring, the transferee takes the assets of the subsidiary with a basis equal to fair market value. Accordingly, in a taxable restructuring, no portion of the worthless stock deduction duplicates the subsidiary's continuing attributes. If the Suspended Loss Approach is implemented, Treas. Reg. § 1.1502-36(d)(7)(i) would have to be amended to apply where a worthless stock deduction would be recognized *but for* such suspension. Second, Example (iii) of Treas. Reg. § 1.1502-36(d)(7)(iii) should be changed such that the Suspended Loss Approach is the operative mechanism for the continued suspension of the worthless stock deduction in the case of an upstream or sideways tax-free reorganization, and not -80(c).[167]

[165] See Treas. Reg. § 1.1502-35(b)(4).

[166] Section 382(g)(4)(D) was intended to avoid the double deduction result achieved by the shareholder in *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977). H.R. Conf. Rep. No. 100-495, at 971 (1987).

[167] Conceptually, the operation of Treas. Reg. § 1.1502-36(d)(7) could be deferred until the time that the suspended worthless stock loss is triggered, as described above. But the complexities associated with this approach might not justify deferring the application of Treas. Reg. § 1.1502-36(d)(7).

E. Basis Augmentation Rule and Examples

The basis augmentation rule would be applied in a similar manner whether or not the upstream or sideways restructuring is a taxable or a tax-free transaction.

Initially, as under current law, the ULR, and in particular Treas. Reg. §§ 1.1502-36(c) and 1.1502-36(d), would be applied.[168] Thus, the worthless stock deduction at issue would only relate to true economic losses and, under Treas. Reg. § 1.1502-36(d)(6), the common parent of the group could elect to forgo the worthless stock deduction to the extent necessary to preserve the subsidiary's "duplicated" inside loss (defined in Treas. Reg. § 1.1502-36(d) as the "aggregate inside loss"). The basis augmentation rule would complement the common parent's reduction election under Treas. Reg. § 1.1502-36(d)(6). The basis augmentation rule would electively allow the consolidated group the benefit of the non-duplicated portion of the worthless stock deduction through an increase in the basis of the subsidiary's assets – in the case of a tax-free upstream or sideways restructuring, for the portion of the stock basis for which a Treas. Reg. § 1.1502-36(d)(6) reduction election is not available (but only if the Treas. Reg. § 1.1502-36(d)(6) reduction election is applied in respect of any duplicated loss to preserve inside attributes), and in the case of a taxable restructuring, for the full stock basis.[169] No election to augment the basis of the subsidiary's assets would be permitted unless the worthless stock deduction otherwise qualified for ordinary loss treatment under section 165(g)(3).

In a taxable restructuring, the basis in the subsidiary's assets would be increased in proportion to their relative fair market value. In a tax-free restructuring, the basis in the subsidiary's assets would be increased in a manner that first increases the tax basis of any gain assets (in relative proportion to the gain in such assets), to the extent of such gain, and then among the assets in a manner that causes the ratio of the basis to the value of each asset to be the same.[170]

We would propose that the basis augmentation rule be elective, although the principles supporting the rule could justify it being mandatory. Our primary concern is that mandatory application of the rule could be administratively costly and burdensome both for the taxpayer and the Service where, for example, the stock basis of the subsidiary is not readily determinable or complex valuations would be required. Even though an elective approach allows the taxpayer to choose the alternative that best suits it, both approaches entail a deferral of the worthless stock deduction in furtherance of single entity principles.

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[168] *See* Treas. Reg. § 1.1502-36(a)(3) ("[Treas. Reg. § 1.1502-36] applies when [Parent] transfers a share of [Subsidiary] stock and…the share is a loss share."); Treas. Reg. § 1.1502-36(f)(10)(i)(A) (For purposes of Treas. Reg. § 1.1502-36, Parent transfers a share of Subsidiary stock on "[t]he date that [Parent] ceases to own the share as a result of a transaction in which, but for the application of [Treas. Reg. § 1.1502-36] (and notwithstanding the deferral of any amount recognized on the transfer, other than by reason of § 1.1502-13, [Parent] would recognize income, gain, loss or deduction with respect to the share.").

[169] Some have likened the conversion of the outside stock loss into inside asset basis to the ordinary loss treatment accorded a worthless stock deduction under section 165(g)(3). Section 165(g)(3) operates to provide a parent corporation an ordinary loss in circumstances where, had it conducted the operations of the subsidiary directly, it would have been entitled to the ordinary loss from the subsidiary's operations. *See, e.g.,* B. Bittker and L. Lokken, "Federal Taxation of Income, Estates and Gifts," ¶ 48.2.2 (3rd Ed., 2000).

[170] *Cf.* Treas. Reg. § 1.1502-35(b)(2).

We recognize that the push down of the stock basis may raise concerns as to the shifting of the location of the loss within the consolidated group where there is multiple member ownership of the worthless subsidiary such that a worthless stock loss is located in one chain and the subsidiary's assets going forward are located wholly or substantially in another chain (e.g., where a corporation in one chain owns the subsidiary's worthless common stock and a corporation in another chain owns the subsidiary's preferred stock).[171] If this is a concern, there is a continuum of potential methods to address the "location" issue, ranging from limiting the basis augmentation rule to situations where the assets remain wholly or substantially in the same chain, to allocating the worthless stock loss among the subsidiary's assets (rather than increasing the basis in such assets) and treating the parent's recognition of such loss in the same manner as a deferred intercompany loss under Treas. Reg. § 1.1502-13. We would be willing to work with the Service to implement any such approach.

The following examples illustrate the application of the basis augmentation rule. For purposes of these examples, continuity of business enterprise is assumed to be satisfied.

Example 1: Taxable Liquidation

Parent purchases all of the stock and outstanding debt of Subsidiary at the end of Year 1 for $400 and $400, respectively. At the time of the purchase, Subsidiary has $300 in cash and a single asset with a basis of $100 and a fair market value of $500. In Year 2, Subsidiary incurs losses of $300 and the value of its sole asset drops to $100. At the end of Year 2, Subsidiary adopts a plan of liquidation and distributes its sole asset to Parent.

Because Subsidiary's liabilities exceed the fair market value of its assets, the liquidation is a taxable transaction. Subsidiary will incur COD income of $300 upon the extinguishment of the $400 debt owing to the Parent for $100 in asset value, and (because the tax basis of the asset equals its fair market value) no net gain or loss upon the transfer of its asset.[172] Because the net investment adjustments to Parent's stock in Subsidiary total zero and Subsidiary has no duplicated loss, the ULR has no impact.

Applying the Suspended Loss Approach, and absent application of the basis augmentation rule, the Parent would take a fair market value basis ($100) in the asset received from Subsidiary and its $400 worthless stock deduction would be suspended until Parent leaves the consolidated group or an earlier triggering event (if any) occurs.

Applying the basis augmentation rule (if elected), Parent would increase the basis in the asset by the amount of the worthless stock deduction to $500.

[171] Independent of any policy concern regarding "location" of basis push downs, there would be resulting investment adjustments due to the shifting of tax basis between the two chains. *See* Treas. Reg. § 1.1502-32(b)(3)(ii)(B), (b)(3)(iii)(B).
[172] Treas. Reg. § 1.1502-13(g)(4)(i)(C) operates to turn off the insolvency exception to COD income, and Treas. Reg. § 1.1502-13(g)(3)(i)(B)(5) operates to turn off the deemed satisfaction and reissuance of the intercompany liabilities.

The result described above would be the same if, rather than liquidating, Subsidiary had merged into Parent. If Subsidiary merged into a sister corporation, that sister corporation would increase the basis in the asset by the amount of the worthless stock deduction if the basis augmentation rule were elected.

Example 2: Taxable Liquidation with Attribute Reduction Rule

Parent capitalized Subsidiary at the end of Year 1 with intercompany debt and $100 of common stock. In Year 2, Subsidiary incurred operating losses of $200. At the end of Year 2, when Subsidiary has intercompany debt of $400 owing to Parent and is therefore insolvent, Subsidiary adopts a plan of liquidation and distributes all of its assets to Parent. At the time of the liquidation, Subsidiary has three assets: Asset A with a basis of $50 and a fair market value of $80; Asset B with a basis of $100 and a fair market value of $120; and Asset C with a basis of $150 and a fair market value of $100.

Because Subsidiary's liabilities exceed the fair market value of its assets, the liquidation is a taxable transaction. Subsidiary will incur COD income of $100 upon the extinguishment of the $400 debt owing to the Parent for $300 in asset value, which would be offset by its current year loss, resulting in a net operating loss for the year of $100, and (because the aggregate tax basis of its assets equals the aggregate fair market value of its assets) no net gain or loss upon the transfer of its assets.[173] This example assumes that the $100 NOL is not absorbed elsewhere in the group (and thus does not result in any net adjustment to Parent's stock basis in the Subsidiary's common stock). Under Treas. Reg. § 1.1502-36(d), the Subsidiary's NOL would be eliminated by reason of a combination of the general Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d)(2) for duplicated loss and the supplemental Attribute Reduction Rule in Treas. Reg. § 1.1502-36(d)(7).[174]

Applying the Suspended Loss Approach, and absent application of the basis augmentation rule, the Parent would take a fair market value basis in the assets received from Subsidiary (presumably only receiving credit for any excess liabilities when paid) and its $100 worthless stock deduction would be suspended until Parent leaves the consolidated group or an earlier triggering event (if any) occurs.[175]

Applying the basis augmentation rule (if elected), Parent would increase the basis in each of the assets in proportion to their relative fair market value, or their basis, after the transaction. Therefore, at the end of the day, Parent would increase the basis in Asset A by $26.66 [$100 x $80/($80+$120+$100)] to $106.66, increase the basis in Asset B by

[173] Treas. Reg. § 1.1502-13(g)(4)(i)(C) operates to turn off the insolvency exception to COD income, and Treas. Reg. § 1.1502-13(g)(3)(i)(B)(5) operates to turn off the deemed satisfaction and reissuance of the intercompany liabilities.

[174] *See* Treas. Reg. § 1.1502-36(d)(7)(ii)(B) (A transfer is subject to additional attribute reduction if "[Parent] recognizes a … loss on the stock of [Subsidiary] in a transaction in which [Subsidiary] ceases to be a member and does not become a nonmember within the meaning of 1.1502-19(c)(2)."). As discussed at Section V, D, this would require an amendment to Treas. Reg. § 1.1502-36(d)(7) in the event that the Suspended Loss Approach is adopted.

[175] If Parent is also the common parent of the consolidated group, this could result in an indefinite deferral of the worthless stock deduction until Parent is itself liquidated.

$40 [$100 x $120/($80+$120+$100)] to $160, and increase the basis in Asset C by $33.33 [$100 x $100/($80+$120+$100)] to $133.33.

Example 3: Tax-Free Restructuring

Parent owns all of the common and preferred stock of Subsidiary. At the end of Year 1, Parent has a tax basis of $100 in the common stock and $400 in the preferred stock (assume no investment adjustments to date), and Subsidiary has no NOL or capital loss carryforwards. In Year 2, Subsidiary incurs an NOL of $200. At the end of Year 2, when Subsidiary's assets are worth only $300, Subsidiary adopts a plan of liquidation and distributes all of its assets to Parent, in partial satisfaction of the liquidation preference of the preferred stock. At the time of the liquidation, Subsidiary has three assets: Asset A with a basis of $50 and a fair market value of $80; Asset B with a basis of $100 and a fair market value of $120; and Asset C with a basis of $150 and a fair market value of $100.

a. Aggregate Inside Loss Equals Worthless Stock Basis: Because the liquidation qualifies as a tax-free reorganization under section 368(a), Subsidiary recognizes no gain or loss on the distribution. This example assumes that Subsidiary's $200 NOL is not absorbed elsewhere in the group (and thus does not result in any net adjustment to Parent's stock basis in the Subsidiary's common stock).

Under Treas. Reg. § 1.1502-36, Parent's common stock (but not its preferred stock) is considered transferred,[176] and thus implicates the provisions of Treas. Reg. § 1.1502-36. The stock basis redetermination and reduction rules of Treas. Reg. § 1.1502-36(b) and (c) do not apply because no investment adjustments have been made to Parent's basis in Subsidiary stock.[177] Absent an election under Treas. Reg. § 1.1502-36(d)(6), Subsidiary's attributes are reduced by the amount of Subsidiary's "attribute reduction amount," which is equal to the lesser of the "net stock loss" and Subsidiary's "aggregate inside loss." Parent's "net stock loss" is $100 (*i.e.*, $100 basis in common stock less the $0 value of the common stock). Subsidiary's "aggregate inside loss" is $200 (*i.e.*, $500, which is the sum of its inside attributes – its $300 asset basis plus its $200 NOL – over $300, the value of its outstanding shares). Accordingly, unless a Treas. Reg. § 1.1502-36(d)(6) election is made, Subsidiary's $200 NOL to which Parent succeeds is reduced to $100.[178]

[176] *See* Treas. Reg. § 1.1502-36(f)(10)(i)(A) (For purposes of Treas. Reg. § 1.1502-36, Parent transfers a share of Subsidiary stock on "[t]he date that [Parent] ceases to own the share as a result of a transaction in which, but for the application of [Treas. Reg. § 1.1502-36] (and notwithstanding the deferral of any amount recognized on the transfer, other than by reason of § 1.1502-13), [Parent] would recognize income, gain, loss or deduction with respect to the share."); Treas. Reg. § 1.1502-36(f)(10)(ii)(A) ("[Parent] does not transfer a share of [Subsidiary] stock if [Parent] ceases to own the share as a result of a transaction to which section 381(a) applies and in which … a member acquires assets from [Subsidiary] provided that … [Parent] recognizes no income, gain, loss or deduction with respect to the share.").

[177] Treas. Reg. §§ 1.1502-36(b)(1)(i), (c)(2).

[178] Because the Parent will succeed to Subsidiary's attributes to the extent remaining after the application of Treas. Reg. § 1.1502-36 as a result of the tax-free reorganization, it is important to determine whether the supplemental Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d)(7) applies. As discussed in Section III, C, 1 above and

Absent application of the basis augmentation rule, Parent will carry over Subsidiary's tax basis in its assets.

To apply the basis augmentation rule, the common parent must first elect under Treas. Reg. § 1.1502-36(d)(6) to reduce Parent's stock basis in the worthless stock by the full $100 duplicated loss. As a result, Parent's stock basis is reduced to zero and the Subsidiary's full NOL of $200 (to which the Parent succeeds) is preserved. There being no stock basis remaining, there is nothing left upon which the basis augmentation rule may apply.

b. <u>Worthless Stock Basis Exceeds Aggregate Inside Loss</u>: Same facts as above, except in Year 2 Subsidiary only incurs a $60 NOL.

Under Treas. Reg. § 1.1502-36, Parent's common stock (but not its preferred stock) is considered transferred, and thus implicates the provisions of Treas. Reg. § 1.1502-36. The stock basis redetermination and reduction rules of Treas. Reg. § 1.1502-36(b) and (c) do not apply because no investment adjustments have been made to Parent's basis in Subsidiary stock. Absent an election under Treas. Reg. § 1.1502-36(d)(6), Subsidiary's attributes are reduced by the amount of Subsidiary's "attribute reduction amount," which is equal to the lesser of the "net stock loss" and Subsidiary's "aggregate inside loss." Parent's "net stock loss" is $100 (*i.e.*, $100 basis in common stock less the $0 value of the common stock). Subsidiary's "aggregate inside loss" is $60 (*i.e.*, $360, which is the sum of its inside attributes – its $300 asset basis plus its $60 NOL – over $300, the value of its outstanding shares). Accordingly, unless a Treas. Reg. § 1.1502-36(d)(6) election is made, Subsidiary's $60 NOL is reduced to zero.

Absent application of the basis augmentation rule, Parent will carry over Subsidiary's tax basis in its assets.

To apply the basis augmentation rule, the common parent must first elect under Treas. Reg. § 1.1502-36(d)(6) to reduce Parent's stock basis in the worthless stock by the full $60 duplicated loss. As a result, Parent's stock basis is reduced to $40 and the Subsidiary's NOL of $60 (to which the Parent succeeds) is preserved. The common parent can now elect to apply the basis augmentation rule to the remaining $40 of common stock basis. Applying the basis augmentation rule, the stock basis in Subsidiary's gain assets (Asset A and Asset B) would be increased in proportion to relative gain until there is no gain remaining. In the aggregate, there is $50 gain inherent in Assets A and B, 60% [$30/($20+$30)] allocable to Asset A and 40% [$20/($20+$30)] allocable to Asset B. As there is only $40 of stock basis to "push down," the full amount is allocated between Asset A and Asset B in that ratio.

illustrated by Example (iii) of Treas. Reg. § 1.1502-36(d)(7)(iii), the supplemental Attribute Reduction Rule will not apply to an upstream or sideways restructuring that constitutes a tax-free reorganization.

If rather than being $40, the remaining stock basis had been $110, the first $50 would be allocated so as to eliminate the gain inherent in Assets A and B, in a 3:2 proportion. The next $60 would initially be allocated to Assets A and B in proportion to their relative fair market value in an attempt to equalize the basis to value ratio among Assets A, B and C. Therefore, the $60 would be allocated 40% [$80/($80+$120)] to Asset A (rather than Asset B) and 60% [$120/($80+$120)] to Asset B.

Alternatively, if the remaining stock basis had been $220, the first $50 would be allocated so as to eliminate the gain inherent in Assets A and B, in a 3:2 proportion. The next $170 would initially be allocated to Assets A and B in proportion to their relative fair market value to the extent necessary to equalize the basis to value ratio among Assets A, B and C (all of Subsidiary's assets). Therefore, $100 would be allocated 40% [$80/($80+$120)] to Asset A (rather than Asset B) and 60% [$120/($80+$120)] to Asset B, bringing their total tax basis to $120 and $180, respectively. At this point, the basis to value ratio of all three assets is 3:2. The final $70 would be allocated among all three assets in proportion to their relative fair market values.

E. Summary of the Suspended Loss Approach

The Suspended Loss Approach is a more narrowly-tailored alternative to the broader single entity approach suggested in the 2003 Report. Under the Suspended Loss Approach, a parent's worthless stock deduction is suspended until the parent leaves the consolidated group where the historic business of the subsidiary is initially retained by the group following the subsidiary's elimination in an upstream or sideways restructuring. The approach works in conjunction with the ULR and does not require significant modifications of those rules. Complementing the ULR, this approach could provide the taxpayer with the opportunity to "push down" to the assets of the subsidiary that remain within the consolidated group immediately after the restructuring the portion of the stock basis that does not represent a duplicated loss (the basis augmentation rule).

VI. Conclusion

As described above, the interactions between the consolidated return regulations and the Code-based rules for determining the timing and availability of worthless stock deductions for failed subsidiaries continue to proliferate. As in 2003, we believe that the net effect of these interactions impedes business-motivated restructurings and provides unwarranted opportunities for acceleration of losses. We believe it is appropriate to adopt a more comprehensive consolidated return regime for accounting for a failed subsidiary which focuses on whether the subsidiary's business is continued within the group, and which facilitates business-motivated restructurings by eliminating artificial tax impediments, or at least precludes inappropriate loss acceleration.