Report 1302

**New York State Bar Association**

**Tax Section**

# Report on Proposed Anti-Loss Importation Regulations

# Under Sections 362(e)(1) and 334(b)(1)(B)

**March 14, 2014**

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**Sections 362(e)(1) and 334(b)(1)(B)**

This Report[1] provides comments on certain issues raised by the recently proposed anti-loss importation regulations that were issued under Sections 362(e)(1) and 334(b)(1)(B).

## I. Introduction and Background

Sections 362(e)(1) and 334(b)(1)(B) were introduced by the American Jobs Creation Act of 2004,[2] enacted on October 22, 2004, and were intended to limit the "importation" of tax losses. On September 9, 2013, the Treasury and the IRS issued proposed regulations (the "Proposed Regulations")[3] under sections 362(e)(1) and 334(b)(1)(B).

As discussed in our prior report with respect to these provisions and section 362(e)(2),[4] the perceived abuse of loss importation can be illustrated by the following

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1 The principal drafter of this Report was Vadim Mahmoudov. Substantial contributions were made by Andrew M. Herman and Adam Namm. Helpful comments were received from Kimberly Blanchard, Larry Garrett, Karen Gilbreath Sowell, Stephen Land, Matthew Lay, Michael Schler, David H. Schnabel, David R. Sicular, Ansgar Simon, Eric Sloan, Eric Solomon and Gordon Warnke. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

2 P.L. 108-357 (2004). Unless otherwise indicated, all references in this Report to "section" and "sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" (or "Prop. Reg. §") are to regulations (or proposed regulations) issued thereunder ("Regulations"). References to the "Service" and the "IRS" are to the Internal Revenue Service, and references to the "Treasury" are to the United States Department of the Treasury.

3 78 Fed. Reg. 54971 (Sep. 9, 2013) (the "Preamble"). *See* Prop. Reg. §§ 1.334-1, 1.362-3. The Treasury recently issued final Regulations under a related provision, section 362(e)(2). *See* Treas. Reg. § 1.362-4.

4 *Report on the Importation and Duplication of Tax Losses*, N.Y. ST. B.A. TAX SECTION, Jan. 6, 2006 (the "Prior Report").

simple fact pattern: a non-U.S. person or U.S. tax-exempt entity holds "built-in loss" property, i.e., property the tax basis of which exceeds its the fair market value ("FMV"). If the holder of the property is not subject to U.S. federal income tax with respect to such property, any gain or loss recognized by that person or entity on the disposition of such property effectively would be irrelevant for U.S. federal income tax purposes. However, if instead of disposing of the property, the holder transfers the built-in loss property to a U.S. corporation in a transferred basis transaction (either a corporate reorganization, a section 351 exchange or a section 332 liquidation) it makes the built-in loss available to offset the taxable income of the U.S. corporate transferee (i.e., the loss is "imported" into the U.S. tax system). Congress considered these types of loss importation transactions abusive on the grounds that it is inappropriate to allow a U.S. federal income tax deduction for an economic loss that arose outside of the U.S. tax system.[5] Accordingly, sections 362(e)(1) and 334(b)(1)(B) generally require the corporate transferee of built-in loss property in this scenario to take a FMV tax basis in all transferred property,[6] and thereby eliminate the built-in loss.

The bulk of the Proposed Regulations is dedicated to describing exactly which transfers, or which portions of transfers, are treated as importing built-in loss into the U.S. tax system. The basic test prescribed by section 362(e)(1)(B) is an evaluation of the tax consequences of a hypothetical sale of the transferred property by the transferor immediately before the transaction, and of a hypothetical sale of the transferred property by the transferee immediately after the transaction. If gain or loss from the transferor's hypothetical sale would not be subject to U.S. tax in the hands of the transferor (such transferor, a "Non-US Taxpayer"), while gain or loss from the transferee's hypothetical sale would be subject to U.S. tax, then the transferred property is subject to the anti-loss importation rules and basis adjustments may apply to it (such property, "Importation Property").[7] The basis adjustment rules apply if the transferee's basis in all Importation Property received from all transferors[8] in the transaction exceeds the aggregate FMV of all such property (such transaction, a "Loss Importation Transaction").[9]

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5 *See* S. REP. NO. 108-357 (Oct. 22, 2004).

6 Therefore, the basis in certain assets may be stepped-*up* to FMV. This regime is different from the anti-loss duplication rules under section 362(e)(2), which apply only to *reduce* basis in property to the extent necessary to eliminate the *aggregate* built-in loss in the hands of the transferee after the transfer.

7 Prop. Reg. § 1.362-3(c)(2).

8 This is different from the anti-loss duplication rules under section 362(e)(2), which apply separately to each transferor.

9 Prop. Reg. § 1.362-3(c)(3).

The Proposed Regulations provide operating rules for determining whether gain or loss recognized in the hypothetical sale is treated as subject to tax.[10] They also provide a special test (the "Look-Through Rule") for transferors that are flow-through entities such as partnerships, S corporations and grantor trusts. Pursuant to the Look-Through Rule, the tax status of the partners or beneficial owners of the flow-through entity as either (i) Non-US Taxpayers or (ii) persons who would be subject to U.S. tax on gain or loss with respect to the disposition of the transferred property ("US Taxpayers") must be determined, and the transferred property is tentatively divided into separate portions in proportion to the amount of gain or loss recognized from the hypothetical sale of such property that would be allocated to each beneficial owner of the flow-through entity.[11] The portions of the property that are deemed to be transferred by Non-US Taxpayers are then treated as Importation Property.

The Proposed Regulations generally exempt certain entities, such as RICs, REITs, cooperatives, and non-grantor trusts, from the Look-Through Rule.[12] Accordingly, these entities are tested for US Taxpayer status at the entity level, without examining the tax status of their beneficial owners. However, under an anti-avoidance rule, transfers by such entities may nevertheless be examined under the Look-Through Rule if such an entity transfers property that was transferred to or acquired by it as part of a plan by any person to avoid the application of the anti-loss importation rules.[13] The Preamble requested comments with respect to this approach.

## II. Summary of Recommendations

We commend the Treasury and the Service for proposing a comprehensive, thoughtful and well-drafted set of Proposed Regulations. For the most part, the recommendations in our Prior Report are reflected in the Proposed Regulations. Accordingly our comments are limited in scope. This Report makes the following recommendations:

1. We urge the Treasury and the Service to consider whether applying the Look-Through Rule is necessary with respect to widely held or publicly traded partnerships, in particular where the partnership holds a small percentage (e.g., less than 5%) of stock of the transferee immediately after the transaction or where stock of the transferee represents a modest portion of the partnership's assets.

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[10] Prop. Reg. § 1.362-3(d).

[11] Prop. Reg. § 1.362-3(e).

[12] Prop. Reg. § 1.362-3(d)(4).

[13] *Id*.

2. To the extent the Look-Through Rule applies, widely held or publicly traded partnerships should be permitted to use simplifying methodologies to identify their partners and their tax status, e.g. statistical sampling/reasonable assumptions.

3. The allocation of gain or loss from the transferor's hypothetical sale under the Look-Through Rule should be done on a closing-of-the-books basis immediately prior to the transfer.

4. Debt-financed property transferred by a transferor that is a tax-exempt entity under section 501(a) (a "Tax-Exempt") should be tentatively divided (similar to property transferred by a partnership) such that the transferor is notionally split into two transferors—a US Taxpayer and a Non-US Taxpayer—based on the portions of gain or loss from the property that would (and would not) be subject to US tax if the property were sold by the Tax-Exempt immediately prior to the transfer.

5. In the case of a liquidation or an inter-group inbound asset reorganization that gives rise to an "all E&P" inclusion under section 367(b) and a net asset basis step-down under section 334(b)(1)(B) or 362(e)(1), the Treasury and the Service should consider promulgating Regulations under section 367(b) reducing the basis step-down, so as to allow the transferee corporation to preserve an amount of built-in loss equal to the "all E&P" inclusion that is triggered by the transaction.

6. The anti-avoidance rules with respect to RICs, REITs and similar entities should be strengthened by specifying certain presumptions or factors that would trigger the application of the Look-Through Rule to such transferors, including (i) whether the entity is closely held and (ii) whether the transferred property was acquired by the transferor in a carryover basis transaction and had a short holding period in the hands of the transferor (e.g., less than 2 years). In the case of a non-grantor trust, if the Look-Through Rule applies, all foreign beneficiaries or beneficiaries whose tax status is unknown should be presumed to be Non-US Taxpayers.

7. In the case of a transferor that is a foreign non-grantor trust, but whose beneficiaries include US Taxpayers, the transferee corporation should be permitted to apply the Look-Through Rule and demonstrate that gain or loss on the disposition of the transferred property would have been subject to Federal income tax in the hands of certain beneficiaries.

8. In the case of a partnership transferor, if the transfer gives rise to both an adjustment of asset basis under section 362(e)(1) with respect to Non-US Taxpayer partners and a reduction of transferee's stock basis pursuant to a section 362(e)(2)(C) election, we recommend further guidance under Subchapter K confirming (i) the allocation of the section 705(a)(2)(B) expenditure associated with the section 362(e)(2)(C) election to the US Taxpayer partners and (ii) the allocation of the

partnership's remaining built-in loss with respect to the transferee's stock to the Non-US Taxpayer partners.

9. We recommend further guidance clarifying how section 743(b) adjustments are allocated among partnership assets under section 755 when the Importation Property subject to basis adjustment is a partnership interest. Regulations under section 755 should specify that the general "two-way" adjustment regime of Treas. Reg. section 1.755-1(b)(1)(i), as opposed to the "one-way" regime for substituted basis transactions, applies in the case of the transfer of such partnership interests.

10. We recommend additional guidance for transfers of all interests in a partnership to a single transferee, which result in a termination of the partnership. We believe that for purposes of section 362(e)(1), the transaction should be treated symmetrically in accordance with its form, such that the potential Importation Property analyzed under section 362(e)(1) would be the partnership interests, not the assets of the partnership.

11. We recommend further consideration be given to the timing of the determination of whether a section 332 liquidation spanning multiple taxable years is a Loss Importation Transaction—specifically, whether such determination should be made at the time of the adoption of the plan of liquidation or the time of the first distribution pursuant to such plan, as opposed to the time of the final liquidating distribution. Although we are not recommending a change to the Proposed Regulations, we note that deferring this determination until the end of the liquidation could produce surprising results for both the taxpayers and the Service and believe this issue deserves further study.

12. We recommend a number of other clarifications and technical corrections, and highlight certain additional areas that require further study.

## III. The Look-Through Rule Should be Modified to Address Significant Compliance Challenges, Particularly in the Case of Widely Held Partnership Transferors

The Look-Through Rule would require a transferee corporation receiving property from a transferor that is a partnership to determine (i) the identity and tax characteristics of the partners in that partnership and (ii) the allocation of gain or loss on a hypothetical sale of the transferred property among these partners. While the hypothetical sale is deemed to occur "immediately before" the property transfer,[14] the Proposed Regulations prescribe that the hypothetical partnership allocation be done "taking into account the net gain or loss actually recognized by the entity *in that tax*

[14] Prop. Reg. § 1.362-3(c)(2).

*year*."[15] In practice, these requirements would present a significant challenge for large partnerships and their corporate transferees.

First, it may be difficult for a transferee corporation (or a transferor partnership) to obtain a snapshot of the transferor's population of partners immediately before the transfer. In some cases, legitimate concerns about confidentiality, investor relations, or other issues (each unrelated to tax) may cause the transferor partnership to refuse to provide information about the tax status of its partner population, particularly where the underlying transaction is not economically significant to the transferor partnership. In some cases, the transferor partnership may not even have access to the required information, such as where the partners of the partnership include other partnerships or where there are frequent changes in the partners of the partnership.[16] As a result, compliance in some cases simply may not be possible. It would be helpful for guidance to address what transferees should do if they cannot obtain the requisite information about some or all of the (direct or indirect) partners of the transferor partnership. If the Treasury and the Service believe that every partner of the transferor partnership should be presumed to be a Non-US Taxpayer unless contrary information (in some form) can be provided, this presumption should be made explicit in the final Regulations.

Second, even if the partnership is willing to supply the information, it may be burdensome for a widely-held partnership to compile a snapshot of its partners (including partners of upper-tier partnerships) and their tax characteristics as of a particular date. This is especially true if its population of partners is constantly changing, e.g. if the partnership is publicly traded. While partnerships that are subject to U.S. tax reporting or withholding requirements are generally required to keep track of partner-level ownership information, many of these rules do not require inquiry beyond the first-tier partners.[17] We note that the Service apparently took into account the difficulty of gathering upper-tier ownership information in deciding to generally exempt RICs, REITs and cooperatives from the Look-Through Rule.[18] The same practical concerns arise in the

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[15] Prop. Reg. § 1.362-3(e)(1) (emphasis added).

[16] Similar issues can arise in the case of corporations seeking to conduct upper-tier ownership analysis for purposes of sections 355 and 382.

[17] Although a partnership must know the identity of its partners to issue Schedule K-1s or withhold U.S. tax, it does not necessarily know the beneficial owners of its flow-through partners or the extent to which its partners are subject to US tax. For example, if a first-tier partner of a transferor partnership is itself a domestic partnership (or a foreign partnership that has entered into a withholding foreign partnership agreement with the Service), then the transferor partnership generally does not need to inquire about the partners of the first-tier partner in order to satisfy its reporting or withholding obligations.

[18] *See* Preamble, at § 1(a)(ii). ("[A]pplying a look-through rule in all such cases would present a significant administrative burden."). *See also* Amy S. Elliott, *IRS Official Defends*

case of widely held partnerships or publicly traded partnerships. In fact, they may be magnified in the case of a partnership with complex allocations, as discussed further below.

Finally, it is not intuitively clear to us that publicly traded or widely held partnerships are more likely to engage in abusive loss importation transactions than RICs, REITs and cooperatives. As a result, we urge the Treasury and the Service to consider whether the application of the Look-Through Rule is necessary in all cases, in particular where the partnership holds a small percentage (e.g., less than 5%) of stock of the transferee immediately after the transaction or where stock of the transferee represents a modest portion of the partnership's assets.

We note, moreover, that the requirement to take into account taxable income for the entire year, including items recognized following the transfer, adds another layer of complexity and uncertainty to the hypothetical allocation analysis. Many partnerships have complex allocation and distribution "waterfalls" that may alter allocation percentages among partners during the year—e.g., it is typical for the general partner in a private equity fund to only be entitled to receive its 20% carried interest allocation after the limited partners have recouped their capital contributions plus a preferred return. It is possible that a snapshot hypothetical allocation done immediately prior to the transfer is reversed later in the year due to subsequent gains or losses, some of which may be allocable to new partners admitted after the transfer.

It is not clear why an "entire year" test is necessary. A snapshot that assumes a closing of the partnership's books on the transfer date may be a more accurate measure of which partners were entitled to the gain or loss from the transferred property at that time, without hindsight that incorporates subsequent events. (Also, while the "entire year" test may capture the fact that a tentative allocation done in the middle of the year may later become "undone" at the end of such year, it is not a complete solution to this issue because it ignores unrealized gains or losses that may "undo" the economics of a particular year's allocations in a subsequent year.)[19] A closing-of-the-books approach would also provide greater certainty to taxpayers by allowing them to fully evaluate the potential applicability of section 362(e)(1) at the time of the transfer, without worrying that the analysis is subject to change due to post-transfer events.

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*Exemptions in Loss Importation Regs*, TAX NOTES, Sept. 23, 2013, at 1368 (quoting Service official as explaining that it would be "ridiculously difficult if not impossible to be able to really identify the ultimate owners of the gain or loss in a RIC or REIT, because you can have so many tiered entities and the entity is not necessarily going to know what's going on upstairs").

19 We refer the Treasury and the Service to our discussion of shifting allocation issues in our Prior Report at 31 (*see* n.36 and surrounding text).

As a practical matter, a transferee corporation that requests a hypothetical allocation from its transferor partnerships may be able to obtain only a closing-of-the-books snapshot as of the transfer date (when it may have the most leverage to demand compliance from its transferors), and may not be able to get subsequent updates from the transferors. This may be particularly true in the case of a transferor that ceases being the corporation's shareholder later during the year of the transfer.

Accordingly, to the extent the Treasury and the Service decide to retain the Look-Through Rule for partnerships, we recommend the following simplifications to ease compliance in cases involving partnership transferors:

- The hypothetical allocation should be done on a closing-of-the-books basis immediately prior to the transfer.
- The Treasury and the Service should provide relief to widely held partnerships, which may be defined as any partnership that either (i) is publicly traded or (ii) has at least 100 partners.[20]
- One option for such relief would be to permit such partnerships to use historical experience to determine their ratio of US Taxpayers to Non-US Taxpayers. For example, a partnership could use data regarding its historic ownership by Non-US Taxpayers in the prior three years being 7%, 8% and 9% to justify a simplifying assumption that its ownership by Non-US Taxpayers was 8% at the time of the transfer (the average of the preceding three years).
- Another potential simplifying methodology for widely held partnerships would be to permit a statistical sampling of partners (eliminating the need to prepare a complete snapshot of the entire partnership population) to determine what percentage of the partnership population consists of Non-US Taxpayers.[21]

[20] To prevent abuse in the case of a partnership that has a few large partners and many small partners, partnerships could be required to identify the existence of large partners (e.g., any partner that owns a 10% or greater interest in the partnership's capital or profits) and a modified Look-Through Rule could be retained with respect to such large partners, while smaller partners would be ignored and presumed to be US Taxpayers. Alternatively, the presence of a few large owners could simply be considered a negative factor in applying the anti-avoidance rule to a partnership that may otherwise be exempted from the Look-Through Rule. *See* discussion of closely-held entities in Section VI, *infra*.

[21] In a similar context involving the calculation of the acquirer's carryover stock basis in target following a "B" reorganization, the Service has permitted statistical sampling to determine the transferring shareholders' bases in the stock of target prior to the reorganization. *See*

## IV. "All or Nothing" Rule for Transfer of Debt-Financed Property Should Be Revised to Provide for Bifurcated Treatment

As a general matter, a Tax-Exempt transferor is considered a Non-US Taxpayer, and a transfer of built-in loss property by a Tax-Exempt to a corporation subject to tax would typically trigger section 362(e)(1). The Proposed Regulations confirm this result in Example 6, but introduce what we thought was a surprising aspect of the rule in paragraph (iii) of that Example.[22] The fact pattern posits a Tax-Exempt transferring asset A1, which constitutes debt-financed property (as defined in section 514) in the hands of the Tax-Exempt, such that the Tax-Exempt "would be required to include in UBTI *a portion* of the gains or losses from a sale of A1."[23] The Example proceeds to conclude that section 362(e)(1) does not apply *at all* to the transfer of A1 because "gain or loss recognized on the sale would have been taken into account in determining a Federal income tax liability, even though at a lesser rate of inclusion. Therefore, A1 is not importation property."[24]

This "all or nothing" rule is a surprisingly good result for taxpayers. Suppose that the debt-financed portion constituted only a tiny portion of A1's basis and value. In that case, the Tax-Exempt may not be subject to tax on the vast majority of the gain or loss from a disposition of A1. (In addition, the Tax-Exempt may be relieving itself of the inherent UBTI tax liability on the debt-financed portion of A1 by transferring it to the corporation subject to the debt, unless the transfer results in the recognition of gain under section 357(c).[25])

Accordingly, we recommend that debt-financed property transferred by a Tax-Exempt transferor be tentatively divided (similar to property transferred by a partnership) such that the transferor is notionally split into two transferors—a US Taxpayer and a Non-US Taxpayer—based on the portions of gain or loss from the property that would (and would not) be subject to tax under UBTI rules if the property were sold by the Tax-Exempt immediately prior to the transfer. This would be similar to the bifurcation

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Rev. Proc. 2011-35, 2011-25 I.R.B. 890 at § 4. The Service has also permitted statistical sampling in several other areas. *See, e.g.*, Rev. Proc. 2011-42, 2011-37 I.R.B. 318 at § 2 (citing precedents).

[22] *See* Prop. Reg. § 1.362-3(f) Example 6(iii).

[23] *Id*. (emphasis added).

[24] *Id.*

[25] *See* Rev. Rul. 77-71, 1977-1 C.B. 155 (no taxable gain when a Tax-Exempt transfers encumbered property to a wholly-owned subsidiary, unless mortgage exceeds basis and results in the recognition of gain under section 357(c)).

analysis that the Proposed Regulations already employ under the Look-Through Rule when the transferor is a partnership whose partners consist of both US Taxpayers and Non-US Taxpayers.[26] Thus, the portion of the transferred property not subject to section 362(e)(1) would then be subject to adjustment under section 362(e)(2).

Finally, we believe that the treatment of partially taxable Tax-Exempt transferors should be provided for in the text of the final Regulations, rather than merely in an example. We note that a similar issue is raised by private foundations that are subject to a 2% excise tax on capital gains under section 4940.

## V. Impact of Basis Reductions on Earnings and Profits and Section 367(b) Inclusions

The Preamble requested comments on what effect a basis reduction required under section 334(b)(1)(B) or section 362(e)(1) may have on earnings and profits ("E&P") and any inclusion required under Treas. Reg. section 1.367(b)-3. We believe that there are at least two potential scenarios in which the interplay of these provisions could produce unfortunate results for taxpayers.

> **Example 1**. A domestic corporation (USP) owns 100% of a foreign subsidiary (FC) that is a Non-US Taxpayer. FC has a single asset (A1) with a basis of $30 and FMV of $10, which has not been used in a US trade or business within the last ten years.[27] FC also has accumulated E&P of $15, which was not attributable to subpart F income and was not previously included in taxable income by USP. FC liquidates into USP, causing USP to include in its income as a deemed dividend an "all E&P" amount of $15 under Treas. Reg. section 1.367(b)-3(b)(3)(i). Under section 334(b)(1)(B), USP is also required to reduce the basis of A1 by $20 to $10 in order to eliminate the built-in loss of $20 that it would have otherwise inherited in the liquidation.

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26 Prop. Reg. § 1.362-3(d)(2); *See also* § 163(j)(4)(B)(ii); Prop. Reg. § 1.163(j)-4(b), -2(g)(4)(ii) (bifurcating a foreign person into a taxable person and a tax-exempt person if a treaty reduces the Federal statutory 30% withholding rate on interest payable to such person to a percentage greater than zero).

27 We believe the final Regulations should clarify that property which was previously used in a U.S. trade or business within the preceding 10 years (but is no longer so used at the time of the transaction), whose sale by the non-US transferor would be subject to US tax under section 864(c)(7), is not Importation Property. *See generally* § 864(c)(7) (if property is disposed of within 10 years of the date on which such property ceased to be part of a U.S. trade or business, such property will be treated as if it were still part of a U.S. trade or business for purposes of determining whether income or gain from such disposition is subject to U.S. tax).

In this fact pattern, USP would suffer a "double whammy" that may not have occurred if it had caused FC to sell A1 prior to the liquidation. If the sale were to an unrelated person or to a related person governed by section 267(a)(1), FC would have realized a loss of $20 that would have eliminated its E&P, allowing USP to receive FC's assets in liquidation without an income inclusion under section 367(b).[28] (However, a different regime would apply if the sale were to a related party and loss recognition had been deferred under section 267(f)(2) (rather than disallowed), which would generally be the case if FC had sold A1 to USP. In that case, the corresponding E&P reduction would have been deferred as well, until the deferred loss had been taken into account under section 267(f) rules.[29]) In the absence of such a sale, USP will incur both the income inclusion under section 367(b) and the basis reduction under section 334(b)(1)(B). Despite the fact that FC's prior fortunes reversed and its net worth has declined in value, USP ends up with $15 of taxable income and no loss on A1 when the dust settles.

The double whammy strikes us as an inappropriate result that could be fixed in at least two ways (as discussed below). One of the original policies behind requiring the "all E&P" income inclusion under section 367(b) was that, in the absence of such inclusion, USP could enjoy permanent exclusion of FC's accumulated E&P from USP's taxable income while importing into the US tax system a higher basis in assets created by such E&P.[30] This policy is not violated, even with no section 367(b) inclusion or a reduced inclusion, to the extent that section 334(b)(1)(B) and section 362(e)(1) now impose a reduction of such tax basis when the assets are brought onshore.

The Treasury and the Service could limit the basis reduction of A1 to only $5, so as to allow USP to preserve an amount of built-in loss ($15) equal to the "all E&P" inclusion that is triggered by the liquidation (or an inter-group inbound asset reorganization where both the "all E&P" inclusion and the basis reduction affect the same taxpayer or consolidated group, which could raise a similar fact pattern)[31] (the "Haircut

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[28] *See* Treas. Reg. § 1.312-7(b)(1).

[29] *See* Treas. Reg. § 1.267(f)-1(g).

[30] The preamble to the 1991 proposed Regulations under section 367(b) explained the policy behind the "all E&P" inclusion as follows: "A domestic acquirer of the foreign corporation's assets should not succeed to the basis or other tax attributes of the foreign corporation *except to the extent that the United States tax jurisdiction has taken account of the United States person's share of the earnings and profits that gave rise to those tax attributes*." 56 Fed. Reg. 41,993 (Aug. 26, 1991) (emphasis added).

[31] In the case of an acquisitive inbound asset reorganization in which two unrelated taxpayers suffer the "all E&P" inclusion and the basis reduction, we believe the applicability of the Haircut Reduction Approach deserves further study.

Reduction Approach").[32] The Treasury and the Service have wide latitude to adjust income inclusions and basis of assets under section 367(b), discussed below.

Alternatively, the Treasury and the Service could make adjustments to the "all E&P" inclusion (the "E&P Reduction Approach"). The Service has a broad grant of authority under section 367(b) to promulgate Regulations governing:

(A) the circumstances under which –

(i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or

(ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder … at a later date, and

(B) the extent to which *adjustments shall be made to earnings and profits*, basis of stock or securities, and *basis of assets*.[33]

Accordingly, the Service could promulgate Regulations under section 367(b) adopting either the Haircut Reduction Approach or the E&P Reduction Approach. In support of the Haircut Reduction Approach, the "all E&P" inclusion is, in effect, a built-in gain item that should offset the built-in loss. In support of the E&P Reduction Approach, the basis reduction can be viewed as a non-deductible expense that reduces (or would have reduced) E&P,[34] even though the "expense" is technically incurred in the

[32] In a case involving multiple assets, a variety of methodologies could be used to implement the Haircut Reduction Approach—for example, basis of built-in gain assets could still be stepped-up to FMV, while basis of built-in loss assets could be reduced by a lesser amount. The allocation of such haircut reduction among built-in loss assets could be done pro rata based on each asset's share of the overall built-in loss, similar to the approach used for section 362(e)(2) adjustments.

[33] § 367(b)(2) (emphasis added). *See also* § 964(a) (E&P of foreign corporation "shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary").

[34] *See, e.g.*, Treas. Reg. § 1.312-7(b)(1) (a loss that is not allowed as a deduction can nevertheless reduce E&P); Rev. Rul. 71-165, 1971-1 C.B. 111 (non-deductible amortization of bond premium on tax-exempt bonds must be reflected in earnings and profits); Rev. Rul. 77-442, 1977-2 C.B. 264 (contributions to foreign political parties and payments to foreign government officials that are not deductible still reduce the earnings and profits of a controlled foreign corporation).

hands of USP and not FC (the generator of the E&P in question) and occurs after the E&P inclusion.[35]

In effect, the basis reduction under section 334(b)(1)(B) would eliminate a potential loss on sale of A1 or depreciation deductions that FC would have eventually recognized if FC had not liquidated, and an offsetting adjustment to E&P (and thus USP's income inclusion), or turning off the basis reduction, is arguably warranted to preserve symmetry of tax attributes.[36]

We note that the history of section 367(b) Regulations includes at least one instance in which taxpayers were allowed to reduce the amount of their up-front income inclusion and "pay" for it by reducing tax attributes that would have otherwise been imported into the US tax system. Former Prop. Reg. section 1.367(b)-3(b)(2)(iii) permitted US shareholders of a foreign corporation whose assets were acquired in an inbound asset reorganization or liquidation to choose between recognizing gain or including the "all E&P" amount. To the extent the "all E&P" amount exceeded gain, the former proposed Regulations required the foreign acquired corporation to reduce various tax attributes that would have otherwise carried over to the domestic acquiring corporation. This trade-off provision was eliminated when the final Regulations removed taxpayers' ability to elect gain recognition in lieu of including the "all E&P" amount.[37]

We do not recommend the E&P Reduction Approach because it would produce a favorable timing outcome for USP that would not have occurred in the absence of basis reduction: USP's immediate income inclusion under section 367(b) would be reduced, while the price paid by USP would be merely a reduction in built-in loss that USP may have recognized some time in the future through depreciation or asset dispositions. In addition, it could lead to abuse if built-in loss assets (some of which may never be sold or depreciated) are stuffed into a foreign subsidiary,[38] whose liquidation or inbound asset reorganization would have otherwise triggered an "all E&P" inclusion, in order to reduce or completely eliminate the amount of such inclusion. Instead, we recommend that the Treasury and the Service adopt the Haircut Reduction Approach, using the wide latitude granted by section 367(b)(2).

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35 Treas. Reg. section 1.367(b)-2(e)(3)(iii) provides that the "all E&P" amount is included in USP's income before the exchange of stock for assets takes place.

36 *Cf.* § 312(l)(1) (discharge of indebtedness income does not increase E&P to the extent of the amount applied to reduce basis under section 1017).

37 *See* T.D. 8863 (Jan. 24, 2000).

38 Section 362(e)(2) would not prevent such stuffing in the case of section 362(b) transactions such as cross-chain asset reorganizations not described in section 351.

One could make a strong argument that the taxpayer in Example 1 does not deserve any relief at all. While sequencing the sale of A1 to occur before the liquidation may have produced a better tax result for USP, that is not in fact what happened. Moreover, as noted above, USP could not have achieved the better result by causing FC to sell the asset to USP (which is the entity that in fact ends up with the asset). Accordingly, USP arguably should just be stuck with the form and sequence that it chose.[39] While it may be preferable to maintain symmetry between E&P and basis in many cases, there is no absolute requirement in the tax law that these attributes be adjusted in lockstep with each other.[40] Indeed, the section 367(b) Regulations already create disconformity by limiting the amount of E&P (or E&P deficit) that may be imported,[41] even though basis created by such E&P can generally be imported, subject to loss importation rules discussed in this Report.

We believe that, to the extent USP is including an "all E&P" amount in its income, USP should be permitted to import a corresponding amount of built-in loss. The policy underlying section 367(b) is consistent with this result, because the "all E&P" inclusion was intended, in part, as a toll charge for importing basis.[42]

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[39] *See, e.g.*, Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (refusing to reject "the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred"); Founders General Corp v. Hoey, 300 U.S. 268, 275 ("To make the taxability of the transaction depend upon the determination whether there existed an alternate form which the statute did not tax would create burden and uncertainty."); Estate of Durkin v. Comm'r, 99 T.C. 561, 571-77 (1992) (citing precedent that supports the view that the taxpayer is free to choose the form of the transaction, but then is bound by such choice).

[40] *See generally Report on Proposed Regulations § 1.312-11: Allocation of Earnings and Profits in Connection with Asset Reorganizations*, N.Y. ST. B.A. TAX SECTION, Oct. 16, 2012, at 16-20 (discussing parity between E&P and basis). We note that, if the Treasury and the Service are inclined not to adopt any mitigating methodologies for the "double whammy" described above, a separate issue that should be considered is whether, and to what extent, USP's E&P inherited from FC under Treas. Reg. section 1.367(b)-3(f) should nevertheless be reduced after the "all E&P" inclusion and the basis reduction in order to reflect the basis reduction as a non-deductible expense of USP. We do not believe there should be any impact on USP's pre-existing accumulated E&P as a result of the asset basis reduction.

[41] *See* Treas. Reg. § 1.367(b)-3(f).

[42] In addition, one potential impact of denying relief in this case (which may be detrimental to the Service) is that taxpayers would be incentivized to defer liquidations of their foreign subsidiaries until all built-in loss assets can be disposed of (or the losses are otherwise triggered under US tax principles), such that E&P and asset basis step-down would be minimized.

However, we believe that an anti-abuse rule should apply (and the Haircut Reduction Approach should be turned off) if Importation Property with a built-in loss was previously transferred to the foreign transferor in a carryover basis transaction with a principal purpose of avoiding section 334(b)(1)(B) or section 362(e)(1) by taking advantage of the Haircut Reduction Approach.[43]

In addition, we note that the impact of foreign tax credits on the Haircut Reduction Approach may require further adjustments. More specifically, the Treasury and the Service may wish to consider whether the haircut reduction should be simply the amount of USP's "all E&P" inclusion or, instead, a potentially lower amount that reflects any foreign tax credits associated with this income inclusion. For example, if the liquidating foreign subsidiary had earned $100 of gross income and paid $35 of foreign taxes, resulting in a potential "all E&P" inclusion of $65 to its US parent, and also has a net built-in loss of $200, should the haircut reduction be $65 or zero if the US parent is able to claim a foreign tax credit of $35 as a result of the "all E&P" inclusion? (We do not believe that the section 78 gross-up, which triggers an additional deemed dividend of $35 to the US parent, should affect the amount of haircut reduction that is potentially available.)

There may be some policy merits to adjusting the haircut reduction for foreign tax credits if the alternative case (sale of built-in loss assets prior to the liquidation or reorganization) would have resulted in fewer foreign tax credits being imported. On the other hand, had USP conducted the foreign business directly, it would have enjoyed both foreign tax credits and high basis resulting from the foreign E&P. In addition, an adjustment to reflect foreign tax credits would introduce further complexity and may require an analysis of their actual utilization by USP, which may not occur in the same taxable year—or at all, if the foreign tax credits ultimately expire unused. We do not recommend such an adjustment at this time, but believe this issue deserves further study.

> **Example 2**. Same facts as Example 1 above, except FC has zero accumulated E&P. Instead, the $30 of basis in A1 was entirely funded by cash contributed to FC by USP. (Alternatively, the $30 was funded from subpart F income that was earned by FC and has been included in income by USP previously.) Upon FC's liquidation, USP inherits A1 with a stepped-down basis of $10 under section 334(b)(1)(B).

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43 We note that such pre-liquidation "stuffing" would be difficult to achieve in light of section 362(e)(2); presumably, a foreign-to-foreign merger or similar reorganization would be required. In addition, if property was transferred to the liquidating foreign subsidiary as part of a plan to import the loss in an inbound liquidation, the Service could challenge the subsidiary's transitory ownership of such property under general principles of tax law.

Here, USP has in effect funded FC's purchase of A1 with cash that has already been subject to tax in USP's hands. Had USP not formed FC and instead purchased A1 directly, it would not have suffered the basis step-down.

While this result seems unfortunate, we do not believe any remedy (which would seem to require tracing the origins of A1's basis and figuring out how much of it was funded with dollars previously taxed to USP) is appropriate. USP chose to conduct its offshore operations through a foreign subsidiary and would have enjoyed U.S. tax deferral if the business had been profitable. To allow USP to import a loss back into the U.S. would frustrate the very purpose of sections 334(b)(1)(B) and 362(e)(1). In addition, if FC's inside basis equals its outside basis, a well-advised taxpayer could simply avoid a section 332 liquidation in this fact pattern by using some form of a Granite Trust structure to trigger a corresponding loss on its FC stock.[44]

## VI. Treatment of RICs and REITs; Anti-Avoidance Rule

For the reasons stated in our Prior Report, we support the Service's decision not to apply the Look-Through Rule to RICs, REITs and cooperatives ("Semi-Transparent Entities") as a general matter.[45] We also support the decision to provide an anti-avoidance rule that applies the Look-Through Rule to RICs, REITs, and cooperatives in abusive situations. We believe that the anti-avoidance rule can be strengthened by specifying certain presumptions or factors that target Semi-Transparent Entities and transactions most susceptible to abuse.

First, we believe that closely-held entities deserve a higher level of scrutiny. For example, while many REITs are publicly traded, there are others whose economics are concentrated in the hands of few holders and are thus more easily manipulated. Furthermore, the administrability concerns that influenced our recommendation (and the Service's decision)[46] not to apply the Look-Through Rule to Semi-Transparent Entities are less acute if the entity's ownership structure is dominated by very few holders. Accordingly, we believe that if 50% or more of the FMV of equity interests in a Semi-Transparent Entity is owned by five or fewer persons (whether individuals, corporations, partnerships or otherwise), a loss importation transfer undertaken by such an entity should either (i) be subject to a rebuttable presumption of being abusive or (ii) be subject to a multi-factor facts and circumstances test (which, if failed, would trigger the application of the Look-Through Rule) in which the closely-held ownership structure is considered a negative factor. The other factors could include the business purpose for the

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44 *See* Granite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1956).

45 *See* Prior Report, at 35-36.

46 *See* Preamble, *supra* note 18.

transfer and the materiality of the potential reduction in federal income taxes attributable to the loss importation as compared to the overall fair market value of the property transferred.[47]

Furthermore, we believe that a short holding period of built-in loss property in the hands of the Semi-Transparent Entity should be another factor requiring closer scrutiny. For example, it is conceivable that one or more Non-US Taxpayers could transfer a built-in loss asset to a Semi-Transparent Entity in a carryover basis transaction that does not trigger section 362(e) because enough built-in gain assets were also added to the transfer in order to avoid a Loss Importation Transaction or a loss duplication transaction. Thereafter, the Semi-Transparent Entity could contribute solely the built-in loss asset to a subsidiary domestic corporation in a section 351 transaction, while retaining the built-in gain assets. This second transfer avoids section 362(e)(1) because the transferor is not a Non-US Taxpayer, unless the Look-Through Rule were to apply. (Although section 362(e)(2) does apply, the transferor could elect to reduce its stock basis in the subsidiary, thus preserving the built-in loss for the transferee.) Thus, the initial transferors can achieve indirectly what they could not have done directly if they had transferred the built-in loss asset to the subsidiary corporation without using the Semi-Transparent Entity as a conduit.[48]

This scheme would clearly trigger the anti-avoidance rule if the initial transfer was made as part of a plan to avoid the application of section 362(e)(1). In the absence of explicit evidence of such a plan, we believe that a holding period of the Semi-Transparent Entity of less than two years before the second transfer into the corporation should be considered as either a rebuttable presumption of such a plan, or at least a "bad" factor in a facts-and-circumstances test. This would be consistent with other provisions

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47 *Cf.* § 7701(o)(2)(A) (requiring the present value of the reasonably expected pre-tax profit from a transaction to be substantial in relation to the present value of the expected net tax benefits from the transaction in order for the transaction to be treated as having economic substance).

48 *See also* Scott M. Levine and James S. Wang, *Coping with Loss: The Anti-Loss Importation and Duplication Rules*, TAX NOTES, Dec. 16, 2013, at 1196 (hereinafter "Levine & Wang") (describing a similar fact pattern in their Example 9). We note that taxpayers would encounter significant hurdles in engineering such a transaction. For example, they would need to ensure that the initial transfer to the Semi-Transparent Entity is a carryover basis transaction that preserves the built-in loss. This would be difficult in the case of a RIC or a REIT because contributions to such entities typically implicate the "investment company" rules of section 351(e). *See* Treas. Reg. § 1.351-1(c)(1)(ii) (transfer triggers section 351(e) if the diversification requirement is also met).

of the Code and Regulations that presume that two steps are related when they are separated by less than two years.[49]

Similarly, a short holding period of the transferred built-in loss property in the hands of the transferee corporation may suggest a tax avoidance motivation for the transfer or series of transfers. Therefore, we believe that a taxable disposition of such property, which was acquired in a carryover basis transaction, by the transferee corporation within two years of the transfer to the transferee corporation should also be a "bad" factor in a facts and circumstances test.[50]

## VII. Treatment of Non-Grantor Trusts

As discussed above, only grantor trusts are automatically subject to the Look-Through Rule under the Proposed Regulations. Non-grantor trusts ("Opaque Trusts") are only examined under the Look-Through Rule if the anti-avoidance rule applies.[51] Accordingly, unless the anti-avoidance rule applies, a domestic Opaque Trust would generally be treated as a US Taxpayer under the Proposed Regulations. We agree with this general framework, for the same reasons that our Prior Report recommended the same treatment for Semi-Transparent Entities. Opaque Trusts have similar tax characteristics: they are subject to tax on their undistributed income, but are generally able to deduct distributions.[52]

The anti-avoidance rule is limited to domestic entities; thus, a foreign Opaque Trust is treated as a Non-US Taxpayer except to the extent it would be subject to Federal income tax on the gain or loss from the disposition of the transferred property. In the case of a foreign trust whose beneficiaries include US Taxpayers, one can argue that the transferee corporation should be permitted to demonstrate that gain or loss on the disposition of the transferred property would have been subject to Federal income tax in the hands of the beneficiaries, whether or not distributed. In other words, there may be instances where taxpayers may wish to apply analysis similar to the Look-Through Rule

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49 *See, e.g.*, § 355(e)(2)(B); Treas. Reg. § 1.707-3(c)(1) (presuming that a transfer by a partner to a partnership followed by a transfer of money or other consideration to the partner within a two-year period is a sale to the partnership).

50 Testing of this factor presumably would be done in an audit taking place at least two years after the year of the potential Loss Importation Transaction.

51 Prop. Reg. § 1.362-3(d)(4)(i).

52 *See generally* §§ 641, 651, 661.

affirmatively to a foreign entity.[53] We believe that taxpayers should be allowed to do so if proceeds from the property would be required to be distributed to a US Taxpayer.[54]

If the anti-avoidance rule applies to a domestic Opaque Trust, the trust is deemed to distribute the proceeds of the hypothetical sale of the transferred property and, to the fullest extent possible under its organizing instrument, the deemed distribution is treated as made to a Non-US Taxpayer (the "Non-US Presumption").[55] After allocating the deemed distribution to potential distributees, one must determine whether the gain or loss on the disposition of the transferred property would be subject to Federal income tax by reference to the deemed distributee or distributees.[56]

Unlike most typical Semi-Transparent Entities described in Part VI above, Opaque Trusts are usually closely held and are not regulated entities. In addition, their governing documents may allow the trustee wider discretion in making distributions to beneficiaries than is typically permitted with respect to equity holders of other entities.[57] Thus, Opaque Trusts should be subject to closer scrutiny. Accordingly, we recommend that the anti-avoidance rule be strengthened by incorporating the following presumptions and/or factors:

- Any transfer by an Opaque Trust of built-in loss property that has been acquired by such Opaque Trust in a carryover basis transaction and (i) held by the Opaque Trust less than two years prior to the transfer or (ii) was acquired with the plan or intention of subsequently transferring the property to a corporation should automatically trigger the anti-avoidance rule and thus the application of the Look-Through Rule;

- In applying the Look-Through Rule, any foreign person should be presumed to be a Non-US Taxpayer but should be permitted to

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53 Taxpayers may have a sympathetic case for applying a look-through rule because determining the residence of a trust may lead to surprising results. Namely, a trust is classified as a foreign trust if a foreign person has some amount of control over the trust. *See* § 7701(a)(30)(E); Treas. Reg. § 301.7701-7(a)(1).

54 A similar approach could be adopted for foreign partnerships, to the extent the Treasury and the Service are inclined to turn off the Look-Through Rule for any partnerships, as discussed in Part III above.

55 Prop. Reg. § 1.362-3(d)(4)(ii).

56 Prop. Reg. § 1.362-3(d)(4)(ii)(C).

57 *See* Levine & Wang, *supra* note 48, at 1196 (demonstrating a potential abuse of discretionary trust provisions in their Example 8).

demonstrate the extent to which gain or loss from the disposition of the property would be subject to Federal income tax in his or her hands;[58]

- To the extent the tax status of potential distributees is unknown, they should be presumed to be Non-US Taxpayers, consistent with the Non-US Presumption; and

- The Service should have the ability to disregard one or more potential distributees from the deemed distribution analysis if such distributees were included in the trust's organizing document for purposes of benefitting from, or avoiding the application of, section 362(e)(1).

Finally, to the extent the gain or loss from the disposition of the transferred property would not have been included in a domestic trust's "distributable net income" within the meaning of section 643(a) in the taxable year of the transfer, we believe the Look-Through Rule should not apply. In that case, the trust itself would be the relevant taxpayer and should be analyzed as the transferor in determining the potential applicability of section 362(e)(1).

## VIII. Application of Both Section 362(e)(1) and (e)(2)(C) Adjustments to Partnership Transferors

Example 5 of the Proposed Regulations[59] illustrates a situation where a partnership (P) with two equal partners, domestic partner (DP) and foreign partner (FP), transfers loss property with a basis of $100 and a FMV of $70 to a domestic corporation (DC) in a section 351 transaction. The transferred property is tentatively divided into a portion deemed transferred by DP with a basis of $50 and a FMV of $35 and a portion deemed transferred by FP also with a basis of $50 and a FMV of $35. FP's tentatively divided portion is Importation Property, meaning that section 362(e)(1) applies to reduce the basis of such property to FMV (from $50 to $35) in the hands of the transferee DC, while DP's tentatively divided portion is not Importation Property and thus section 362(e)(1) does not apply to such portion. Section 362(e)(2) then applies because the transfer is a section 362(a) transaction, and even after the application of section 362(e)(1), DC's basis in the transferred property would still exceed such property's FMV ($85 basis vs. $70 FMV). In paragraph (ii) of the example, a section 362(e)(2)(C) election is made, allowing DC to retain its basis of $85 in the transferred property (after the application of section 362(e)(1)), but requiring P to reduce its basis in the DC stock received in the exchange from $100 to $85.

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[58] We believe the same presumption should apply across the board for purposes of the Look-Through Rule in the case of transferor entities other than Opaque Trusts, as well.

[59] Prop. Reg. § 1.362-3(f) Example 5.

The example mentions that the adjustment to P's basis in the DC stock pursuant to the section 362(e)(2)(C) election is a section 705(a)(2)(B) nondeductible expenditure and that such expense is allocated to DP, causing DP to reduce its outside basis in P by the amount of such expense.[60] This conclusion is intuitively correct because FP's share of the transferred property was already subject to basis reduction pursuant to section 362(e)(1), and so when section 362(e)(2) applies (with or without an (e)(2)(C) election), it applies effectively to DP's share of the transferred property.[61] Therefore, the deemed expense arising from the (e)(2)(C) election seems to be appropriately allocated to DP.

Two issues arise in connection with this fact pattern. First, it is not entirely clear how the intuitively correct conclusion regarding the allocation of the section 705(a)(2)(B) expenditure is reached mechanically,[62] and it is possible that some taxpayers may attempt to take a contrary position. As discussed below, we recommend further guidance mandating the necessary mechanics, including cross-references between the Regulations under subchapter K and the Proposed Regulations as appropriate.

Second, the Proposed Regulations should address the allocation of P's loss if P were to dispose of the DC shares (or similarly, if DC were to liquidate under section 331). As discussed below, we recommend mandating the application of either reverse section 704(c) principles or section 704(c) principles to ensure that the loss from such a disposition is allocated to FP.

### A. Allocation of Section 705 Expense

The result illustrated by Example 5 of the Proposed Regulations should be mandated by the Regulations under sections 705 and 704. The Regulations under section 705 should specifically provide that basis reduction by a partnership transferor in the stock of the transferee corporation pursuant to a section 362(e)(2)(C) election is a section 705(a)(2)(B) expenditure. Such Regulations should contain a cross-reference to Treas. Reg. section 1.362-4(e)(1).

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60 There is also a cross-reference to Treas. Reg. section 1.362-4(f)(1) (which should be corrected to Treas. Reg. section 1.362-4(e)(1)) in the loss duplication Regulations. *See* Section XI, subsection J, *infra*. Treas. Reg. section 1.362-4(e)(1) simply states the rule that a basis reduction pursuant to an (e)(2)(C) election is a section 705(a)(2)(B) expenditure.

61 However, section 362(e)(2) does not have an analog to the mechanism in section 362(e)(1) for tentatively dividing property. Rather, the analysis is done at the level of each actual transferor, in this case being the partnership P.

62 *See* Letter from Paul Kugler (KPMG LLP) & Deanna Walton Harris (KPMG LLP) to the Treasury and the Service ("Comments on Partnership Provisions in Proposed Regulations under § 362(e)(1)") (Oct. 8, 2013).

Additionally, the Regulations under section 704 should provide that on facts similar to Example 5 of the Proposed Regulations, the section 705(a)(2)(B) expenditure resulting from the (e)(2)(C) election is allocated to the domestic partner DP. As mentioned above, this is intuitively the correct result, but there is no specific mechanic that currently requires this result. We recommend articulating the mechanic by negative reference to section 362(e)(1) adjustments. More specifically, the final Regulations should specify that the section 705(a)(2)(B) expenditure is represented by the remaining built-in loss in property after applying section 362(e)(1) and is allocated as follows:

First, any remaining built-in loss after applying section 362(e)(1) in property that was tentatively divided among the partners and was Importation Property with respect to at least one partner, is allocated solely among each partner with respect to which such property was *not* Importation Property.[63] Second, any built-in loss in property that was not Importation Property with respect to any of the partners is allocated among all of the partners.[64] The Regulations under section 704 can mandate these allocations by providing that any other allocation *per se* does not have substantial economic effect.

> **Example 3**. Assume the same facts as Example 5 of the Proposed Regulations, except that in addition to transferring the loss property (LP) with a basis of $100 and a FMV of $70, P also transfers to DC an asset utilized in P's U.S. trade or business (the "ECI asset") with a basis of $50 and a FMV of $20. Also, assume there is a third equal partner who is foreign (FP2). The ECI asset is not Importation Property with respect to any partner because each of FP, FP2 and DP would be subject to tax on its disposition prior to the transfer. Therefore, DC is not required under section 362(e)(1) to reduce its basis in the ECI asset. Section 362(e)(1) does apply to reduce basis in LP, which is Importation Property with respect to FP and FP2, from $100 to $80 (representing a reduction of $10 for each of FP's and FP2's tentatively divided portion of LP).

After application of section 362(e)(1) but before applying (e)(2), DC has received from P assets with an aggregate basis of $130 ($80 from LP plus $50 from the ECI asset) and a FMV of $90 ($70 from LP plus $20 from the ECI asset) in a section 351 transaction, and thus section 362(e)(2) applies to reduce DC's basis in the transferred assets. But if an (e)(2)(C) election is made, P will instead reduce its basis in its shares of DC received in the section 351 transaction by $40, the aggregate amount of the built-in loss in the transferred assets ($10 from LP and $30 from the ECI asset). This $40 basis

63 The allocations between such partners can follow the partnership agreement, general principles of subchapter K and all other applicable requirements of tax law. The important aspect of the recommended rule is that the expense is only allocated among such partners – generally, US partners (or foreign partners transferring ECI assets).

64 Again, the allocations between such partners can follow general principles.

reduction represents a section 705(a)(2)(B) expenditure of P. It should be allocated as follows:

First, there is $10 remaining built-in loss in property (LP) that was tentatively divided and was Importation Property with respect to at least one partner (FP and FP2). That $10 built-in loss represents a portion of the section 705(a)(2)(B) expenditure and is allocated entirely to partners (DP) with respect to which such property was not Importation Property. Second, there is $30 built-in loss in property (the ECI asset) that was not Importation Property with respect to any partner. That $30 built-in loss represents the remaining portion of the section 705(a)(2)(B) expenditure and is allocated to all of the partners ($10 each). Therefore, the $40 of section 705(a)(2)(B) expenditure is allocated $10 to FP, $10 to FP2 and $20 ($10 from LP and $10 from the ECI asset) to DP.

### B. Disposition by the Transferor Partnership of Stock of the Transferee Corporation Following an (e)(2)(C) Election

While the appropriate allocation of the section 705(a)(2)(B) expenditure as described above *ultimately* results in the proper amount of income and loss being allocated to each partner, it does not necessarily prevent temporary inappropriate allocations that are not reversed until the partnership transferor liquidates. Although the partnership reduces its basis in the transferee corporation stock pursuant to a section 362(e)(2)(C) election, it does not always reduce such basis all the way down to FMV—specifically, if there were section 362(e)(1) adjustments prior to applying (e)(2), the net amount of such (e)(1) adjustments would cause there to be a remaining built-in loss of the same amount in the transferee corporation stock following the (e)(2)(C) election.[65] Guidance should be provided as to how to treat such remaining built-in loss when the partnership disposes of the stock of the transferee corporation.

Reverse section 704(c) principles should be used to appropriately allocate any remaining built-in loss that the transferor partnership has in the transferee corporation stock after a section 362(e)(2)(C) election is made. The US Taxpayer partners that receive an allocation of the section 705(a)(2)(B) expenditure associated with the election as described above (generally, the US taxable partners, foreign partners with respect to ECI assets or tax-exempt partners with respect to UBTI assets) should also reduce their capital accounts (as maintained under the section 704(b) Regulations) accordingly. However, without a special rule, the partners that do not receive an allocation of the section 705(a)(2)(B) expenditure are not required to reduce their capital accounts. We recommend adding a rule that the section 351 transfer be a mandatory revaluation event

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[65] This is because the section 362(e)(1) adjustments reduce the amount of built-in loss subject to section 362(e)(2) which could give rise to and be governed by a section 362(e)(2)(C) election.

for the partnership, where such partners that are not allocated the section 705(a)(2)(B) expenditure (generally, the foreign or tax-exempt partners) are in fact required under section 704(b) to reduce their capital accounts, and such reduction is treated as a reverse section 704(c) built-in loss with respect to such partners. This would ensure that a loss from the disposition by the partnership of stock of the corporate transferee is appropriately allocated to the foreign partners. Such partners would be required to reduce their capital accounts by the amount of the section 362(e)(1) adjustments made with respect to such partners.

On the facts of Example 5 in the Proposed Regulations, section 362(e)(1) applied only to FP's tentatively divided portion of the transferred property, reducing DC's basis in the transferred property from $100 to $85, and therefore the other partner, DP, should be allocated the section 705(a)(2)(B) expenditure of $15 arising from the section 362(e)(2)(C) election reducing P's basis in DC from $100 to $85. DP's capital account would be decreased by the $15 expense. Pursuant to the rule we recommend, FP would also reduce its capital account, by the amount of the section 362(e)(1) adjustments made with respect to FP, which is also $15. This $15 reduction in FP's capital account should give rise to a book/tax disparity, which would be governed by reverse section 704(c) principles. P holds the DC stock with a $15 built-in loss (basis of $85 and a FMV of $70), and so if P disposed of the DC stock at its FMV of $70, the $15 loss would be allocated to FP.

Alternatively, section 704(c) principles could be used by, solely[66] for the purpose of allocating gain or loss on disposition of the transferee corporation stock, deeming FP to contribute the DC stock to the partnership with a built-in loss at the time of such contribution equal to the amount of the section 362(e)(1) adjustments that were made with respect to FP. Thus, FP would be deemed to have contributed the DC stock to FP with a $15 built-in loss, and so a future disposition of the DC stock at $70 would result in a $15 loss allocated to FP under section 704(c).

## IX. Transfers of Partnership Interests

Several unresolved issues arise when the property transferred in a Loss Importation Transaction is a partnership interest. The transfer of a partnership interest may be subject to section 362(e)(1) or (e)(2), or both. First, if the corporate transferee's basis in the partnership interest is adjusted pursuant to section 362(e)(1) (or 362(e)(2)), what corresponding adjustments should be made to the partnership's basis in its assets? This question is not addressed in the Proposed Regulations, other than by a cross-reference to Treas. Reg. section 1.743-1.[67] Second, how does section 362(e)(1) (or

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[66] For example, there would not be a deemed contribution for purposes of sections 704(c)(1)(B), 704(c)(1)(C) or 737.

[67] Prop. Reg. § 1.362-3(c)(4)(ii).

(e)(2)) apply to a transaction in which all interests in a partnership are transferred to a single transferee.

### A. Allocation of Adjustments to Transferee Partner's Share of Inside Basis

When a partnership interest is transferred in a Loss Importation Transaction or a loss duplication transaction, and, pursuant to section 362(e)(1) or 362(e)(2), the basis of the partnership interest in the hands of the transferee corporation is adjusted, it will often be necessary to make adjustments to the partners' share of the partnership's basis in its assets pursuant to section 743(b). Section 743(b) applies to transfers of interests in partnerships with respect to which a section 754 election is in effect or which has a substantial built-in loss immediately after such transfer. Nonrecognition transactions such as reorganizations under section 368, contributions to controlled corporations under section 351 and liquidations under section 332 constitute transfers for this purpose.[68] Therefore, it is necessary to determine the proper application of section 743(b) to transactions in which the transferee's basis in the partnership interest is adjusted pursuant to section 362(e).

The Proposed Regulations cross-reference Treas. Reg. section 1.743-1 regarding the application of section 743(b) adjustments to the partners' share of the partnership's basis in its assets. However, there is no reference to section 362(e) in Treas. Reg. section 1.743-1. We recommend further guidance clarifying how section 743(b) adjustments are allocated among partnership assets under section 755.

Section 755(a)(2) provides broad discretion for the Secretary to promulgate Regulations governing the manner of the section 743(b) adjustments. Section 755(b) draws a distinction between two classes of assets: capital assets (and section 1231 assets), and ordinary assets, providing that adjustments arising from a distribution of, or a transfer of an interest attributable to, each such class of assets of the partnership are generally allocated to the same class of assets of the partnership. After the portion of the basis adjustment allocated to each class has been determined, such portion is further allocated among the assets within the class.[69]

The manner of allocation among the two classes of assets and the manner of the further allocation among the assets of each class depend on the type of transaction in

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[68] *See, e.g.*, Treas. Reg. § 1.755-1(b)(5)(i) (referring to basis adjustments resulting from section 351 transactions and section 721 transactions). *See generally* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* ¶¶ 16.07[1], 24.03[1] (4th ed. 2007 & Supp. 2013-4).

[69] Treas. Reg. § 1.755-1(a)(1).

which the interest was acquired.[70] Under the general rule, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease, even if the aggregate net adjustment is zero.[71] In other words, a "two-way" adjustment is made. On the other hand, in the case of a substituted basis transaction—one in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest or the transferor's basis in other property—a net "one-way" adjustment is made, meaning that either positive basis adjustments are made, or negative basis adjustments are made, but not both.[72]

In applying the allocation rules of section 755 to section 362(e)(1) basis adjustments (or section 334(b)(1)(B) basis adjustments), it is not clear whether the general rule of two-way adjustments should be used, or rather if the substituted basis transaction rule of one-way adjustments should be used. After application of section 362(e)(1) (or section 334(b)(1)(B)) to a Loss Importation Transaction, the transferee's basis in the transferred asset is equal to the asset's FMV and so is not determined in whole or in part by reference to the transferor's basis.

> **Example 4**. Foreign corporation (FC) transfers an interest in partnership (PRS) to domestic corporation (DC) in a section 351 transaction. PRS has no liabilities. FC would not be subject to tax on the disposition of the PRS interest, and DC would be so subject, so the PRS interest is Importation Property. FC's basis in the PRS interest is \$100, and the FMV is \$70. Before application of section 362(e), DC's basis in the PRS interest is \$100 under section 362(a), and the transaction seems in the first instance to be a substituted basis transaction subject to one-way section 743(b) adjustments pursuant to section 755. However, the transaction is a Loss Importation Transaction and section 362(e)(1) applies to reduce DC's basis in the PRS interest from \$100 to its FMV of \$70. After the application of section 362(e)(1), the transaction no longer seems to be a substituted basis transaction, because DC's basis is not determined in whole or part with reference to FC's basis.

Prior to the transaction, PRS is an equal partnership between FC and unrelated person X, and owns two assets, each a capital asset: L, with FC's share of PRS inside

70 Treas. Reg. § 1.755-1(b)(1)(i), (b)(5)(i).

71 Treas. Reg. § 1.755-1(b)(1)(i).

72 Treas. Reg. § 1.755-1(b)(5)(ii). Recently proposed regulations alter the one-way adjustment mechanism. *See* Prop. Reg. § 1.755-1(b)(5); 79 Fed. Reg. 3041 (Jan. 16, 2014). However, this does not change our belief, as discussed below, that two-way adjustments should be made.

basis equal to $80 and FC's share of FMV equal to $40, and G, with FC's share of PRS inside basis equal to $20 and FC's share of FMV equal to $30. If the method of allocation under section 755 is determined before application of section 362(e)(1) and therefore the transaction is deemed to be a substituted basis transaction, then the one-way adjustments are made. PRS would adjust its basis in L, but not in G.[73] Since the aggregate basis reduction under section 743(b) is equal to $30 (the excess of DC's $100 aggregate share of PRS inside basis over DC's $70 basis in the PRS interest[74]), the $30 adjustment would be allocated entirely to L, the only loss asset. PRS would adjust its basis in L (solely with respect to DC and not with respect to any other partner) from $80 to $50. PRS, with respect to DC, would then hold L with a built-in loss of $10 (basis of $50 and a FMV of $40) and G with a built-in gain of $10 (basis of $20 and a FMV of $30).

If instead, the method of allocation under section 755 is determined after application of section 362(e)(1) and the transaction is not deemed to be a substituted basis transaction, then two-way adjustments are made pursuant to the general rule and the $30 aggregate section 743(b) adjustment arising from DC's basis reduction in the PRS interest pursuant to section 362(e)(1) would be allocated to both L and G (even though G is a gain asset).[75] PRS (solely with respect to DC and not with respect to any other partner) would adjust its basis in both L and G, with its basis in L decreasing from $80 to $40 and its basis in G increasing from $20 to $30.

We recommend that the allocation method under section 755 be determined after taking into account section 362(e)(1), meaning that a Loss Importation Transaction is not treated as a substituted basis transaction and therefore is subject to two-way section 743(b) adjustments pursuant to the general rule. Since the transaction results ultimately in a FMV basis, we do not see any reason to take a snapshot of the tax treatment of the transaction at the moment of time before the application of section 362(e)(1). All relevant rules of tax law should be considered in determining whether the transferee's basis is based in whole or in part on the transferor's basis. The one-way method under section 755 is aimed at limiting taxpayers' ability to proactively use section 743(b)

[73] Treas. Reg. § 1.755-1(b)(5)(iii).

[74] The Preamble states that for purposes of determining the *amount* of the section 743(b) adjustment, the section 362(e)(1) reduction to DC's basis in the PRS interest from $100 to $70 must be taken into account, such that "any section 743(b) adjustment to be made as a result of the transaction is made *after* any section 362(e) basis adjustment." (emphasis added.) The actual language of the Proposed Regulations is more terse: "See § 1.743-1 regarding the application of section 743(b) following a section 362(e) basis reduction." Prop. Reg. § 1.362-3(c)(4)(ii).

[75] Treas. Reg. § 1.755-1(b)(3).

adjustments as planning opportunities for shifting basis among assets by simply engaging in a simple section 332 or 351 transaction (or other substituted basis transaction) that is generally otherwise tax-neutral.[76] But Loss Importation Transactions are not otherwise tax-neutral—adjusting basis to FMV as required has real tax consequences, much like an actual sale that produces cost basis under section 1012 and that would clearly be under the two-way adjustments regime.[77] Accordingly, there does not seem to be a strong argument for treating Loss Importation Transactions differently from sales for purposes of section 755.[78]

### B. Transfers of All Interests in a Partnership to a Single Transferee

There is limited guidance describing the tax treatment of transactions in which a single person acquires all of the equity interests in a partnership. In general terms, Revenue Ruling 99-6,[79] in the context of a taxable transaction, provides for asymmetrical tax treatment of the parties: the transferors are taxed according to the form of the transaction, a disposition of partnership interests, whereas the transferee is treated as though the partnership first liquidated and then the transferee acquired the partnership's assets from the transferors. Revenue Ruling 84-111,[80] Situation 3, in the context of a

[76] *See generally* 65 Fed. Reg. 17829 (Apr. 5, 2000) (expressing a concern that partners could use substituted basis transactions "to shift basis from capital gain assets to ordinary income assets, or vice versa"); *see also* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 24.04[1][a][ii] (4th ed. 2007 & Supp. 2013-4) (applying the general two-way adjustments to certain nonrecognition transactions "would lead to all sorts of mischief because taxpayers could take advantage of these rules to shift basis among assets at no tax cost").

[77] One difference between a Loss Importation Transaction and a sale is that the transferor in a sale recognizes gain or loss. However, since the transferor in a Loss Importation Transaction is by definition not taxable on a disposition of the transferred property, this difference does not seem relevant.

[78] A full discussion of the application of section 755 to section 362(e)(2) transactions is beyond the scope of this Report, but analogous reasoning could be applied to conclude that if section 362(e)(2) applies to reduce the basis of the transferee corporation in the partnership interest received in the transfer all the way to FMV, then the transaction is not a substituted basis transaction and two-way adjustments should apply. However, since section 362(e)(2), unlike (e)(1), does not always result in FMV basis, more consideration should be given to situations where basis in a partnership interest is reduced, but not reduced all the way to FMV.

[79] 1991-1 C.B. 432. *See generally Report on Revenue Ruling 99-6*, N.Y. ST. B.A. TAX SECTION, Jun. 13, 2011.

[80] 1984-2 C.B. 88.

nontaxable contribution to capital, does not explicitly provide for asymmetry.[81] It is not clear how to apply these rulings to a Loss Importation Transaction.

The statutory framework and the Proposed Regulations do not square neatly with an asymmetrical approach. For example, the definition of "importation property" is property the disposition of which would not be taxable to the transferor but would be taxable to the transferee.[82] When the transferor is deemed to transfer different property (partnership interests) than the transferee is deemed to receive (partnership assets), this definition appears ill-suited. If an asymmetrical approach is used, the most obvious way to implement the definition is to view the partnership's assets as the potential Importation Property, examine whether the partners would be subject to tax on the gain or loss allocated to them if the partnership had sold the assets immediately prior to the transfer, and then examine whether the transferee corporation would be subject to tax if it sold such assets.[83] But there are other potential ways to handle this—for example, one could make an exception to the general principle that the property transferred by the transferor is the same property as that received by the transferee,[84] and instead examine whether the partners would have been subject to tax on a disposition of the partnership interest and whether the transferee corporation would be subject to tax on a disposition of the assets.

We recommend that for purposes of section 362(e)(1), the transaction should be treated symmetrically in accordance with its form. So, if the partners in fact transfer partnership interests, the potential Importation Property would be the partnership interests, not the partnership's assets, and the appropriate test would be whether the partners would be subject to tax on a sale of the interests, and similarly whether the transferee corporation would be subject to tax on a sale of the interests. Or, if the partnership in fact liquidates and the partners then transfer assets to the corporation, the

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81 The extent to which Revenue Ruling 99-6 and Revenue Ruling 84-111, Situation 3 are consistent or inconsistent is beyond the scope of this Report.

82 § 362(e)(1)(B); Prop. Reg. § 1.362-3(c)(2).

83 A tax-exempt entity in certain situations may incur UBTI and be subject to tax on the hypothetical disposition of the partnership's assets but not on the hypothetical disposition of the partnership interest. Therefore, changing the property tested as potential Importation Property can lead to different hypothetical tax results.

84 The application of Revenue Ruling 99-6 to intercompany transactions governed by Treas. Reg. section 1.1502-13 faces a similar burden of making sense of an asymmetrical approach within a set of rules that is premised on the matching of specific assets transferred from one member to another. *See* PLR 200334037 (Aug. 22, 2003) (intercompany items are with respect to disposition of partnership interest, but corresponding items, and therefore the application of the matching rule, are with respect to the assets of the partnership); PLR 200737006 (Sep. 14, 2007) (same).

assets would be the potential Importation Property. Following the form of the transaction provides clarity to taxpayers as to exactly which calculations must be performed under section 362(e)(1), and also makes the terminology and methodology of the Proposed Regulations more neatly layer onto a fact pattern where all partnership interests are transferred to a single transferee.

## X. Testing Multi-Year Section 332 Liquidations May Create Surprising Results for Both the Taxpayers and the Service

The timing of several determinations required to be made by taxpayers pursuant to the Proposed Regulations has implications on how taxpayers apply the anti-loss importation rules to multi-year section 332 liquidations. Liquidations under section 332 generally may take up to four years to complete. More specifically, the liquidating corporation must, in accordance with a plan of liquidation, transfer all the property to be transferred in the liquidation within three years from the close of the taxable year of the first transfer pursuant to the plan.[85]

Given the possibility of a section 332 liquidation that occurs over multiple taxable years, the Proposed Regulations provide rules for the timing of determinations necessary for the application of section 334(b)(1)(B).[86] Several determinations are made at the time of distribution of each individual asset or immediately thereafter (collectively, "Current Determinations"), but one threshold determination is not made until immediately after the final liquidating distribution (the "Deferred Determination"). As discussed below, Deferred Determinations mean that, over a period of several years, the transferee parent corporation and the Service are subject to uncertainty of tax treatment with respect to the tax years from the year of the initial distribution to the year before the final distribution.

Taxpayers may be able to engage in self-help by fixing the date of liquidation for U.S. federal income tax purposes by causing the liquidating subsidiary to elect flow-through tax treatment, resulting in the subsidiary becoming either a disregarded entity (if the subsidiary is wholly-owned) or a partnership (if the subsidiary has minority owners). However, in some cases such entity classification elections will not be available. For example, the subsidiary may be a *per se* corporation,[87] or may have minority owners which either have consent rights over such elections and refuse to consent or that publicly trade their minority interests, causing the subsidiary to be a corporation for U.S. federal income tax purposes under section 7704 notwithstanding an election to the contrary.

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[85] § 332(b)(3); Treas. Reg. § 1.332-4(a)(1). In cases where no plan of liquidation has been adopted, the transfer of property must take place entirely in one taxable year. § 332(b)(2).

[86] Prop. Reg. § 1.334-1(b)(3)(iii)(B).

[87] Treas. Reg. § 301.7701-2(b)(8).

### A. Current Determinations

The relevant value and basis of each individual asset distributed in a liquidating distribution are determined immediately after the distribution of such asset, and thus are Current Determinations.[88] Value and basis of each individual asset are relevant for determining whether, in the aggregate, the 80% distributee corporation will have a basis in the distributed assets (before application of the anti-loss importation rule of section 334(b)(1)(B)) greater than their value and thus whether the section 332 liquidation is a Loss Importation Transaction.[89] Therefore, the parties should know, at the time of distribution, the contribution of each *individual* distributed asset towards the aggregate calculation of built-in loss or built-in gain (but, as discussed below, the parties will not know that *aggregate* calculation until the final liquidating distribution).[90] Similarly, the determination as to whether an individual asset is Importation Property is made as of the time of the distribution of such asset, and thus is a Current Determination.[91]

> **Example 5**. One of a foreign corporation's (FC) assets is a minority interest in stock of a non-publicly traded domestic corporation (DC). At the beginning of Year 1, it is determined that DC is a United States real property holding corporation (USRPHC) within the meaning of section 897(c)(2). Following Year 1, DC disposes of a portion (but not all) of its real estate assets such that starting in Year 2, DC is no longer a USRPHC, and never regains USRPHC status. At the beginning of Year 4, FC adopts a plan of liquidation under section 332 pursuant to which it will distribute its assets to USP. Pursuant to the plan, FC distributes its DC stock to USP in December of Year 5, but the final liquidating distribution is not made until the end of Year 7.

Due to the fact that an asset's status as Importation Property is a Current Determination, the DC stock is not Importation Property. This is because as of the time DC stock is distributed (as opposed to the time of the final liquidating distribution), FC would have been subject to tax on the hypothetical disposition of DC stock by reason of DC's status as a USRPHC during the five-year period (from January of Year 1 to December of Year 5) ending on the date of such hypothetical disposition.[92] If instead, FC distributed the DC stock during March of Year 7, then DC would not have been a USRPHC during the five-year period (March of Year 2 to March of Year 7) prior to the

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[88] Prop. Reg. § 1.334-1(b)(3)(iii)(B)(1), (2).

[89] Prop. Reg. § 1.362-3(c)(3).

[90] *See generally* Prop. Reg. § 1.334-1(b)(3)(iv).

[91] Prop. Reg. § 1.334-1(b)(3)(iii)(B)(3).

[92] § 897(c)(1)(A)(ii).

distribution.  Therefore, FC would not have been subject to tax on the hypothetical disposition of DC stock at such time, and the DC stock would be Importation Property. Accordingly, if the DC stock were distributed in Year 7, the liquidation could still qualify for section 332, but USP's basis in the DC stock may be subject to reduction pursuant to section 334(b)(1)(B).  On these facts, USP can engage in self-help by causing FC to distribute the DC stock at a time at which FC would still be subject to tax on the disposition of such stock.

### B. Deferred Determination

While the value and basis of each *individual* asset are Current Determinations, the determination of whether a section 332 liquidation is a Loss Importation Transaction is made immediately after the liquidating corporation makes its *final* liquidating distribution, and thus is a Deferred Determination.[93]  In other words, although each individual asset distributed by the liquidating corporation to its parent is tested immediately after it is distributed in order to calculate its contribution towards the aggregate gain importation or loss importation, whether in the *aggregate* the parent's basis in loss Importation Property exceeds the value of such property is determined after the final distribution for purposes of identifying whether the liquidation is a Loss Importation Transaction.

Therefore, a transferee parent corporation in a multi-year liquidation might not know until up to four years after the initial distribution if it will take a transferred basis in the transferred assets pursuant to section 334(b)(1) or a fair market value basis in the assets pursuant to section 334(b)(1)(B).  The inability for the transferee parent corporation to know the basis of its assets with certainty for up to four years creates uncertainty for both the taxpayer and the Service.

These complications are exaggerated by the fact that the statute of limitations may have expired on the taxable year during which the asset was distributed by the time the taxpayer or the Service finally determines whether or not the liquidation is a Loss Importation Transaction.  Therefore, there may be procedural obstacles to retroactively reporting events correctly.  This is particularly true if the parent has, in a closed year, disposed of property it received in the liquidation.  The Service is likely in a worse position with respect to this issue, because the taxpayer is more likely to foresee a change in whether or not the liquidation is a Loss Importation Transaction and take measures to reflect that change in status, e.g. by filing an amended return.

The Treasury and the Service should consider the implications of this uncertainty. One alternative is to determine whether a liquidation is a Loss Importation Transaction by using a Current Determination, namely, by valuing all assets up-front at one time,

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93 Prop. Reg. § 1.334-1(b)(3)(iii)(B)(4).

either at the time of the adoption of the plan of liquidation, or the time of the first distribution pursuant to such plan. However, under an up-front determination system, complex safeguards would need to be put in place to ensure that taxpayers do not game the rules and avoid the purposes of section 334(b)(1)(B). For example, taxpayers could anticipate a change in overall built-in loss due to depreciation deductions, or a change in property's status as Importation Property (as demonstrated by Example 5 above. In addition, a liquidating corporation could sell certain assets (which were taken into account in the up-front determination) instead of distributing them to shareholders.

For these reasons, we do not recommend revising the Deferred Determination regime at this time, but recommend that the Treasury and the Service study this issue further.

## XI. Technical Comments to the Proposed Regulations Under 362(e)(1) and 334(b)(1)(B)

### A. Overlap Between §§ 332 and 336

Prop. Reg. section 1.337-1 states that to the extent section 332 provides nonrecognition for a parent receiving assets from its subsidiary in liquidation, the liquidating subsidiary shall not recognize gain or loss pursuant to section 337, subject only to the FIRPTA rules and rules governing distributions to tax-exempt distributees or foreign corporations.[94] However, there is another instance in which section 332 and section 337 are not coextensive. When the liquidating subsidiary is owned by more than one member of a consolidated group, Treas. Reg. section 1502-34 aggregates such ownership for purposes of section 332 but not for purposes of section 337. Therefore, members of a group owning, in aggregate, 80% or more of the liquidating subsidiary may receive property from the liquidating subsidiary without recognition of gain or loss, pursuant to section 332, whereas section 337 only provides nonrecognition to the liquidating subsidiary on its distribution of assets to its direct 80% distributee.[95] For example, if a subsidiary member is owned equally by two members of a consolidated group and the subsidiary liquidates, the two members do not recognize gain or loss under section 332, but the liquidating subsidiary recognizes all of its gain or loss on the distribution of its assets.[96] Prop. Reg. section 1.337-1(a) should be adjusted to reflect this

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94 *See* §§ 337(b)(2), 367(e)(2), 897(d).

95 *See* § 337(a), (c).

96 Such gain or loss arises from an intercompany transaction under Treas. Reg. section 1.1502-13 and therefore is deferred, with each member succeeding to the liquidated subsidiary's intercompany items attributable to assets distributed to the other member. *See* Treas. Reg. § 1.1502-13(j)(9) Example 7.

potential application of section 336, instead of section 337, in the intercompany transaction context, by limiting its scope to a distribution to the 80% distributee.

### B. Partnership Allocation of Gain or Loss from Hypothetical Sale

In determining whether an asset is Importation Property in the context of a partnership transferor, the Look-Through Rule examines whether the partners would be subject to tax on their allocable share of the partnership's gain or loss from the hypothetical sale of the asset immediately before the transaction.[97] The Look-Through Rule states that the allocations from the hypothetical sale must reflect the manner in which gain or loss on the disposition of the transferred assets would be allocated *under the terms of the partnership agreement*.[98] While the partnership agreement is certainly of great importance in determining how items are allocated, it is not necessarily dispositive. Other rules of tax law must be applied as they would be applied to an actual sale and may alter the results contemplated by the partnership agreement. For example, section 704 (including section 704(c)) and the Regulations thereunder may require an allocation other than the allocation prescribed by the partnership agreement. The partnership anti-abuse rule in Treas. Reg. section 1.701-2 may also apply to reach results different from those contemplated in the partnership agreement. In the case of a partnership between entities under common control, section 482 and the Regulations thereunder may apply to alter the terms set forth in the partnership agreement in order to ensure that the transaction is at arms' length.[99] Therefore, we recommend that Prop. Reg. section 1.362-3(e)(1) be expanded to take into account not only the terms of a partnership agreement, but also all relevant provisions of tax law.

### C. Definition of "Acquiring" as Applied to § 332 Liquidations

The anti-loss importation rules in the context of an inbound section 332 liquidation operate by cross-reference to the anti-loss importation rules governing section 351 transactions and reorganizations.[100] The provisions of Prop. Reg. section 1.362-3 regarding section 362 transactions apply, adjusted as appropriate to conform to section 332 liquidations, including by changing references to "section 362 transaction" to "section 332 liquidation." Specifically incorporated into these Regulations under section 334 are the terms "importation property," "loss importation transaction," and "value."

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[97] Prop. Reg. § 1.362-3(d)(2)(ii).

[98] Prop. Reg. § 1.362-3(e)(1).

[99] *See generally* Treas. Reg. § 1.704-1(b)(1)(iii) (explaining that even if an allocation of loss or expense is respected under section 704(b), it can be reallocated under other sections including section 482).

[100] Prop. Reg. § 1.334-1(b)(3)(iii)(A).

The definitions of the first two terms use the defined term "Acquiring," which is in turn defined in Prop. Reg. section 1.362-3(a) as the corporation that is being prevented from importing a net built-in loss. It is clear from the context that the references in Prop. Reg. section 1.362-3 to "Acquiring" should, in the context of a section 332 liquidation, mean only the 80% distributee. However, the definition of Acquiring does not literally translate to the section 332 context. Therefore, we recommend that the operating rules in Prop. Reg. section 1.334-1(b)(iii)(A) include a statement that references to Acquiring mean only the 80% distributee.

### D. Prop. Reg. section 1.362-3(f) Example 3: Transferor's Basis in Transferee Stock

Prop. Reg. section 1.362-3(f) Example 3(v)(A) concludes that if the transferor FC and the transferee DC do not make a section 362(e)(2)(C) election, then FC's basis in the DC stock received in the section 351 transaction described in the example will be $270. The example does not explain how that number is derived, but presumably the analysis was that $270 was thought to equal FC's aggregate basis in all of the transferred assets immediately prior to the transfer, thereby resulting in FC taking an exchanged basis of $270 under section 358. However, it appears that in determining FC's asset basis immediately prior to the transaction, this example takes into account basis adjustments pursuant to section 362(e)(1). More specifically, the $270 seems to be derived from the sum of FC's inside basis in asset 1 *after* the application of (e)(1) ($150, as increased from the historic basis of $40) and FC's inside basis in asset 2 ($120, which was not adjusted pursuant to section 362(e)(1)). The example goes on to say that if the section 362(e)(2)(C) election is in fact made, FC's basis in the DC stock is reduced from $270 to $180.

This approach is in conflict with the principle that the exchanged basis taken by a transferor pursuant to section 358 is not affected by adjustments to the basis of the transferred assets in the hands of the transferee corporation under section 362(e)(1).[101] We recommend that the example be corrected such that FC's basis in the DC stock received in the section 351 transaction is $160 without a section 362(e)(2)(C) election and $70 if reduced pursuant to such an election. This outcome is somewhat counterintuitive because it results in FC holding DC stock with a substantial built-in gain of $110 if the election is made. This is due to the fact that the section 362(e)(1) adjustment on these facts is positive with respect to the property transferred by FC (another transferor had transferred property with a built-in loss that exceeded the built-in gain in the assets transferred by FC). However, this seems to be the necessary result in this case. We believe it would also be helpful for the Regulations to clarify more broadly, and not merely by example, that a transferor's outside basis in transferee stock is

[101] *See* paragraph (v)(B) in the same example discussing F's basis in the DC stock pursuant to section 358. *See also* Prop. Reg. § 1.362-3(f) Example 1(i)(E).

not adjusted to reflect adjustments to inside basis of the transferred assets that are made under section 362(e)(1).

### E. Second Situation of Prop. Reg. § 1.362-3(f) Example 1: Discussion Should Exclude § 362(e)(2)

In Prop. Reg. section 1.362-3(f) Example 1(ii), the foreign target corporation merges into the domestic acquiring corporation in a Loss Importation Transaction. The example concludes that the analysis and results are the same as set forth in earlier paragraphs, specifically including paragraph (i)(E). Paragraph (i)(E), in part, describes the consequences under section 362(e)(2). Since this transaction is a section 362(b) transaction (a reorganization) and not a section 362(a) transaction (a section 351 transaction), section 362(e)(2) does not apply. Therefore, the end of paragraph (ii) should add a statement clarifying that, notwithstanding the reference to paragraph (i)(E), section 362(e)(2) does not apply.[102]

### F. Description of Transfer in Prop. Reg. section 1.362-3(f) Example 3: Reference Should Be Made to Both Transferors

Prop. Reg. section 1.362-3(f) Example 3 involves two transferors, F and FC. Paragraph (iii) says only that FC's transfer is a section 362 transaction. Since section 362(e)(1) is applied on an aggregate basis with respect to all transferors (in contrast to section 362(e)(2) which is applied transferor by transferor), the example should say that FC's *and F's* transfers constitute a section 362 transaction.

### G. Cross-references to the Definition of Loss Duplication Property

The final Regulations under section 362(e)(2) define "loss duplication property" in Treas. Reg. section 1.362-4(g)(1). However, several references in the Proposed Regulations refer to such definition by citing other provisions. The references in Prop. Reg. sections 1.351-3(a)(3)(ii), -3(b)(3)(ii) and 1.358-6(c)(4) to section 1.362-4(c)(1) and (c)(2) should be corrected accordingly.

### H. References in Prop. Reg. section 1.362-3(d)(4)

The references in Prop. Reg. section 1.362-3(d)(4)(ii) to sections 1.362-3(d)(4)(ii)(A) and 1.362-3(d)(4)(ii)(B) should be to sections 1.362-3(d)(4)(i)(A) and 1.362-3(d)(4)(i)(B), respectively.

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102 *Compare* Prop. Reg. § 1.362-3(f) Example 9(i)(C).

### I. Prop. Reg. section 1.362-3(f) Example 4 Typo

The last sentence of Prop. Reg. section 1.362-3(f) Example 4(v)(C), refers to FC when it should refer to F. FC is also a transferor in the same transaction, but is not relevant for purposes of paragraph (v)(C).

### J. Prop. Reg. section 1.362-3(f) Example 5: Cross-references

In Prop. Reg. section 1.362-3(f) Example5(ii), the reference to section 1.362-4(f)(1) in connection with partnership transferors making section 362(e)(2)(C) elections should instead be to section 1.362-4(e)(1). In Prop. Reg. section 1.362-3(f) Example 5(iv)(A), the reference to section 1.152-1 liabilities should be to section 1.752-1 liabilities.

### K. Additional Potential Topics for Clarification or Study

Our Report is limited to certain selected issues under the Proposed Regulations. We believe that a number of additional issues, not addressed in detail above, deserve clarification in the final Regulations and/or study by the Treasury and the Service. While we are not making any recommendations with respect to these issues at this time, we wish to point them out to the Treasury and the Service.

- In determining a transferor's status as a Non-US Taxpayer, how should potential applicability of tax treaties be analyzed? Should the transferor be presumed to invoke the benefits of the treaty (which are normally elective)? Note that, at the time of the transfer, it may not be known whether the transferor will satisfy the "limitations of benefits" provisions of the applicable treaty for the taxable year of the transfer.[103]

- Does an asset basis adjustment under section 362(e)(1) or section 334(b)(1)(B) restart the holding period of the assets, in light of the requirement of section 1223(2) that the basis in transferee's hands be "the same basis in whole or in part…as it would have in the hands of [the transferor]"?[104]

- Should an asset basis *increase* of a section 197 intangible under section 362(e)(1) or section 334(b)(1)(B) be amortized under the same schedule as the remaining basis, in light of the language of section 197(f)(2)(A) that provides for step-in-the-shoes treatment of transferee "with respect to so

[103] *See* Levine & Wang, *supra* note 48, at 1194-95 for further discussion.

[104] *See Id.*, at 1198 for further discussion.

much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor"?[105]

- How should basis adjustments be computed in the case of a transferor that computes basis in a currency other than the US dollar?

- Clarification that, in the case of a U.S. corporate transferee that is a subsidiary member of a consolidated group, asset basis adjustments under section 334(b)(1)(B) or section 362(e)(1) do not "tier up" as stock basis adjustments in the stock of such member or its upper-tier affiliates under Regulations section 1.1502-32.

- Guidance on the application of section 7701(g) and similar principles to transfers of encumbered assets. More specifically, in cases where the gross value of a transferred asset in a Loss Importation Transaction is less than the liabilities to which such asset is subject (and to which it will remain subject after the transfer), should the FMV of such asset (for purposes of computing the amount of built-in loss that would result in basis adjustments) be deemed to be at least equal to the amount of such liabilities, under section 7701(g) or similar principles?[106] If section 7701(g) principles do not apply, a step-down in the basis of such "under-water" asset to FMV without taking into account the liability would create a built-in gain in the hands of the transferee corporation that would be triggered upon a post-transfer sale of the transferred asset, subject to the same liabilities, or upon its foreclosure (in the case of an asset encumbered by nonrecourse debt) by the creditors.[107]

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105 *See Id*., at 1199 for further discussion.

106 Notably, sections 362(d) and (d)(1) specifically turn off the application of section 7701(g), but section 362(e) does not do so.

107 For a discussion of the potential applicability of section 7701(g) in this situation, *see generally* Jasper L. Cummings, Jr. and Robert P. Hanson, *New Limitations on Corporate Built-in Losses*, TAX NOTES, June 20, 2005, at 1564-65. We note that the Proposed Regulations, as well as the final Regulations under section 362(e)(2), address a similar concern, in the case of a partnership interest whose basis includes a share of partnership liabilities (which could give rise to uneconomic gain upon the reduction of such liabilities or their assumption by a third party, if the corresponding amount of outside basis had been reduced under section 362(e) or section 334(b)(1)(B)), by deeming FMV of a transferred partnership interest to be increased by any "§1.752-1 liabilities" of the partnership allocated to transferee immediately after the transfer. *See* Prop. Reg. § 1.362-3(c)(4)(ii) and Treas. Reg. § 1.362-4(g)(12)(ii). We agree with the approach taken by the Treasury and the Service with respect to such partnership liabilities.