NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED CONSOLIDATED RETURN STOCK LOSS REGULATIONS

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Report No. 1138

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REPORT ON PROPOSED CONSOLIDATED RETURN STOCK LOSS REGULATIONS

On January 23, 2007, the Treasury Department and the Internal Revenue Service (the "Service") published proposed regulations providing rules for the treatment of stock of a consolidated subsidiary disposed of at a loss (the "Proposed Stock Loss Regulations").[1] The Proposed Stock Loss Regulations are principally contained in Prop. Treas. Reg. § 1.1502-36, and additional changes are proposed to Treas. Reg. §§ 1.1502-13, 1.1502-19, 1.1502-32, and 1.1502-35. The Proposed Stock Loss Regulations represent a revised approach by the government that addresses (1) the creation of noneconomic stock loss as a result of certain applications of the consolidated return investment adjustment rules (Treas. Reg. § 1.1502-32) and (2) the potential duplication of loss within a consolidated group and the broader tax system. The government has previously addressed these issues in various forms of guidance,[2] and the New York State Bar Association Tax Section (the "Tax Section") has, on several occasions, provided

[1] Unified Rule for Loss on Subsidiary Stock," Notice of Proposed Rulemaking ("NPRM"), REG-157711-02, 72 Fed. Reg. 2964 (January 23, 2007).

[2] *See* Notice 87-14, 1987-1. C.B. 445; Treas. Reg. § 1.1502-20T, T.D. 8294 (March 14, 1990) (the "1990 Temporary LDR"); Prop. Treas. Reg. 1.1502-20, 55 Fed. Reg. 49075 (November 26, 1990) (the "1990 Proposed LDR"); Treas. Reg. § 1.1502-20, T.D. 8364 (September 19, 1991) (the "1991 Final LDR"); Notice 2002-11, 2002-1 C.B. 526; Treas. Reg. § 1.337(d)-2T , T.D. 8984 (March 12, 2002); Notice 2002-18, 2002-1 C.B. 644; Treas. Reg. § 1.1502-35T, T.D. 9048 (March 14, 2003); Notice 2004-58, 2004-2 C.B. 520; Treas. Reg. 1.337(d)-2, T.D. 9817 (March 3, 2005); Treas. Reg. § 1.1502-35, T.D. 9254 (March 14, 2006).

comments on such guidance.[3] This report sets forth the views of the Tax Section with respect to the approach taken in the Proposed Stock Loss Regulations.[4]

The problems of noneconomic stock loss and loss duplication are complex and defy easy solution. The objective of this report is not to provide a comprehensive technical analysis of these rules, but instead to address the major policy issues raised and suggest improvements where applicable. In so doing, we appreciate the considerable thought and effort that the Treasury Department and the Service have put into these matters over the years and in drafting the Proposed Stock Loss Regulations. We also recognize that the government is operating under certain limitations, most prominently the Federal Circuit's rejection in the *Rite Aid* decision of a prior version of a loss duplication rule.[5] Finally, we understand that the objectives of accuracy and administrability are particularly difficult to balance in this area. Uncertainty and ambiguity about the rules governing treatment of loss on disposition of a consolidated subsidiary have persisted for a long time to the detriment of the government and taxpayers alike. Accordingly, we commend the Treasury Department and the Internal Revenue Service for their devoting considerable resources in an effort to bring this chapter to a reasonable close.

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[3] Report on Built-In Gains and the Investment Adjustment Rules in the Consolidated Return Regulations, Committee on Consolidated Returns, New York State Bar Association, Tax Section (January 17, 1990), *reprinted at* 90 TNT 30-17 (the "1990 Report"); Letter of James M. Peaslee, Chair, New York State Bar Association, Tax Section, to Fred Goldberg, Commissioner of Internal Revenue Service (January 29, 1991), *reprinted at* 91 TNT 37-21 (the "Peaslee Letter"); Report on Temporary Regulation Section 1.337(d)-2T and Proposed Regulation Section 1.1502-35, New York State Bar Association, Tax Section (February 28, 2003), *reprinted at* 2003 TNT 43-35 (the "2003 Report").

[4] The principal author of this report is Lawrence Garrett. Significant drafting assistance was provided by Serge Mezhburd, Darren Mills, Brian Peabody, and David Schnabel. Significant comments were provided by John Broadbent, Patrick Gallagher, Stuart Goldring, Martin Huck, David Miller, Michael Schler, and Gordon Warnke.

[5] *Rite Aid Corp. v. United States*, 255 F.2d 1357 (Fed. Circ. 2001).

I. SUMMARY OF CONCLUSIONS

The Tax Section supports finalizing the Proposed Stock Loss Regulations with certain modifications (described below), principally aimed at making them easier to apply in practice. The principle that should be given the greatest weight in shaping the regulatory response to noneconomic stock loss and loss duplication is the need to reach a systemic balance that is administrable. We believe that the policy judgments underlying the Proposed Stock Loss Regulations are fundamentally sound and thus the overall framework of the regulations is an improvement on current law and makes conceptual sense. However, we have serious concerns about the administrability of certain aspects of the regulations and recommend that significant changes be made in these areas.

A. Underlying Policy Issues

- We support the government's decision to address comprehensively the creation of stock loss through noneconomic stock basis adjustments, but to deal with the reduction of gain resulting from such adjustments only through anti-abuse rules.
- We support the government's decision to abandon tracing methodologies in favor of a presumptive approach, because tracing has proved to be fundamentally unworkable. In so doing, we recognize that any presumptive approach will necessarily advantage some taxpayers and disadvantage others, but support such an approach if it is reasonably balanced.
- We support the government's decision to broaden the rules governing stock loss to address the creation of non-economic stock loss through the recognition of income attributable to the wasting or consumption of built-in gain assets.

- We support the government's decision to address loss duplication on a systemic basis through explicit rules (as opposed to relying only on anti-abuse rules). We believe that the proposed rules properly deal with loss duplication by reducing the attributes that a buyer obtains.

- We believe that the Proposed Stock Loss Regulations, in attempting to reach more precise results, are overly complicated, particularly with respect to the rules relating to the reduction of inside attributes to eliminate loss duplication and to the application of Section 362(e)(2)[6] in the consolidated return context.

B. Specific Recommendations

- We recommend that the government consider permitting taxpayers, as an alternative to applying Prop. Treas. Reg. § 1.1502-36(b) (the "Basis Redetermination Rule") on a non-deconsolidating transfer of some but not all of the shares of a subsidiary, to elect to defer basis recovery in excess of value on transferred loss shares – for example, to the extent that such basis is attributable to the allocation of prior positive investment adjustments to the transferred loss shares, or of prior negative adjustments to non-transferred shares. We generally would oppose broader basis leveling approaches either on a member-by-member basis or a group-wide basis, especially to the extent that such approaches would permit shifting basis attributable to capital investment under Section 358 or Section 1012. See part IV.

- We support the netting of positive and negative basis adjustments across taxable years as provided in the net positive adjustment factor of the Prop. Treas. Reg. §

[6] All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

1.1502-36(c) (the "Basis Reduction Rule") and the rejection of various exceptions to the presumptions used therein that would reintroduce tracing (e.g., an exception for "after-acquired" assets or a sunset on the net positive adjustment factor). We do, however, support an exclusion from the factor of cancellation of debt ("COD") income or bond redemption premium resulting from the satisfaction of intercompany debt in limited circumstances. We also support using the disconformity amount as a cap on basis reduction, and the government's decision to address its under-inclusivity as a loss duplication problem. We recommend that the government permit taxpayers to elect to determine the net inside attribute amount with respect to tiered subsidiary structures solely by reference to inside attributes, treating the subsidiary's subgroup as a single entity and disregarding intercompany debt and equity within the subgroup. See part V.

- Prop. Treas. Reg. § 1.1502-36(d) (the "Attribute Reduction Rule") fails to achieve its goal of eliminating loss duplication in certain cases, is very complex, and likely will be unworkable as a practical matter with respect to complicated corporate structures. We believe that the goal of eliminating loss duplication would be better achieved in a more administrable fashion by focusing on duplication of stock loss in the "inside" attributes of lower-tier subsidiaries (i.e., asset basis, net operating losses, etc.), rather than in determining whether there is greater duplication in the inside attributes of such subsidiaries or in the basis of their stock. Under this approach, the attribute reduction amount would be determined by reference to the net inside attribute amount for the subsidiary's sub-group, determined as described in the immediately preceding bullet, with

conforming adjustments to the stock basis of lower tier subsidiaries. We also recommend considering a simpler methodology for allocating the attribute reduction amount: a reverse Section 1060 methodology. See part VI.

- We suggest that the final regulations permit taxpayers to make protective elections for reducing stock basis in lieu of inside attributes and for reattributing attributes. See part VI.C.
- We would eliminate Prop. Treas. Reg. § 1.1502-13(e)(4), which provides rules governing the application of Section 362(e)(2) in the consolidated return context, because it relies on tracing and creates a new system of tracing mechanics. We would instead either rely on an anti-abuse rule or treat the Section 362 amount as a deferred loss subject to the intercompany transaction regulations. See part VII.
- We recommend deferring application of the Basis Redetermination, Basis Reduction, and Attribute Reduction Rules upon an intercompany transfer of loss stock. See part IX.A.
- The Proposed Stock Loss Regulations can have a significant impact on buyers and sellers of loss stock, but are proposed to become effective immediately upon publication of final regulations in the Federal Register. We recommend that the final regulations contain a grandfather rule so that existing law continues to apply to any transfer of loss stock made pursuant to a contract binding on the date the final regulations are published. See part IX.B.

II. BACKGROUND AND DESCRIPTION OF THE PROPOSED STOCK LOSS REGULATIONS

A. The Purposes of the Proposed Stock Loss Regulations

As described below, the Proposed Stock Loss Regulations are intended to achieve two principal objectives. The first is to prevent the consolidated return provisions from reducing a group's consolidated taxable income ("CTI") through the creation of noneconomic loss on dispositions of subsidiary stock. The second is to prevent members (including *former* members) of the group from collectively obtaining more than one tax benefit from a single economic loss (i.e., loss duplication).

Beginning in 1987, the government has sought to address the creation of noneconomic stock loss through the application of the consolidated return investment adjustment rules.[7] These rules potentially permitted taxpayers to avoid the repeal of the *General Utilities* doctrine by offsetting gain on the disposition of appreciated assets with noneconomic stock loss.[8] As discussed below, the potential for noneconomic stock loss exists because basis adjustments are permitted for "built-in" gain or income that is already reflected in stock basis of a consolidated subsidiary (e.g., because the purchase price for the stock reflects an implied value for the subsidiary's assets in excess of its basis therein). The need for protective rules addressing noneconomic stock loss has been largely undisputed, but substantial controversy has arisen as to the appropriate methodology. Any such rules must balance the desire to achieve precision – disallowing noneconomic loss while allowing true economic loss -- and the necessity of providing

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[7] *See* Notice 87-14.

[8] *See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

rules that can realistically be implemented by taxpayers and audited by the government with a reasonable expenditure of time, effort, and money.

The government's concern about loss duplication in the consolidated return context was manifested somewhat later with the adoption of a stock loss disallowance rule in 1990 and a loss limitation rule in 1991. The need for these rules – not just the methodology for their implementation -- has been considerably more controversial. Indeed, the loss duplication rule in the 1991 Final LDR was invalidated by the Federal Circuit in the *Rite Aid* decision, which caused the government to revoke the 1991 Final LDR in favor of a regime under Treas. Reg. § 1.337(d)-2T that addressed only the noneconomic loss problem. Relatively shortly thereafter, it became apparent that some form of loss duplication rule was necessary, at least to address the recognition by a consolidated group of two tax losses for a single economic loss. However, the propriety of a rule addressing duplication involving the recognition of stock loss by a consolidated group and asset loss by a former member after it has been deconsolidated has been the subject of considerable disagreement.

i. Prevention of Noneconomic Stock Losses

The preamble to the Proposed Stock Loss Regulations (the "Preamble") focuses on the investment adjustment rules of Treas. Reg. § 1.1502-32 and its presumptive approach as creating much of the potential for noneconomic stock loss.9 The problem is rooted in two underlying presumptions. First, the rules effectively presume that all of a subsidiary's items represent economic accruals of gain or loss to the group. Second, all of

[9] NPRM, REG-157711-02 (2007).

these items are treated as accruing equally to all outstanding shares within a class.10 These assumptions, it is noted, do not correspond to the facts of all situations, such as where stock of a subsidiary is purchased for fair market value, no Section 338 election is made, and the subsidiary holds appreciated assets. In such circumstances, items of gain or income attributable to such appreciation do not, when recognized for tax purposes, represent an accrual of economic gain or income because the appreciation was already reflected in the group's investment as measured by its basis in the stock. Nevertheless, because the investment adjustment system relies on presumptive rules, it treats these noneconomic items as economic accruals and includes them in the investment adjustment made to stock basis. The net effect is to inflate stock basis artificially, thereby creating the potential for noneconomic stock loss that, in absence of anti-abuse rules, would permit the group to use the loss to offset the recognized built-in gains. Here, the absence of an economic loss makes a deduction for the stock loss inappropriate.

> *Example – noneconomic stock basis adjustment creates noneconomic stock loss.* P, the common parent of a consolidated group, purchases all 100 outstanding shares of S common stock for $150 cash, taking a basis of $1.50 in each share. At the time, S owns one asset, A1, with a basis of $100 and value of $150. Later, S sells A1 to a nonmember for $150 and recognizes a $50 gain, which the M group takes into account. When S sells A1, the investment adjustment system, erroneously presuming that S's gain represents an economic accrual of income, increases M's basis in its S stock to reflect the $50 taken into account by the group. As a result, M's basis in each of its shares increases to $2, even though the

[10] The government has summarized the underlying rationale of the investment adjustment rules of Treas. Reg. §1.1502-32 as follows: "The investment adjustment rules are designed to prevent income or loss that has been recognized at the subsidiary level from again being recognized as investment gain or loss by the subsidiary's parent upon disposition of the subsidiary's stock. This is generally accomplished by requiring positive or negative adjustments to the basis of the subsidiary stock owned by members of the group to reflect the increase or decrease in value of the subsidiary resulting from income or loss that has been taken into account by the group." *See* T.D. 8294 (1990). As an example, assume corporation M forms corporation S by transferring $100 cash to S in exchange for all of S's stock, and M and S elect to file consolidated returns. S earns $50 during the next 5 years, which is included in the CTI of the M group. Under the investment adjustment rules, M's basis in its S stock is increased by $50. Thus, if M sells S for $150 at the end of Year 5, the M group does not recognize any further gain or loss. *See* T.D. 8294 (1990).

fair market value of each share remains $1.50. If M were then to sell all or some portion of the S stock for its fair market value, M would recognize a $0.50 loss on each share ($50 loss in the aggregate).[11]

Allowing M to deduct this noneconomic loss would provide an offset against S's gain recognized on the disposition of A1, thereby effectively reducing or eliminating the corporate-level tax on the asset gain. By eliminating economic gain from the system with noneconomic loss, the repeal of the General Utilities doctrine by Congress in 1986 essentially is contravened.

Additional illustrations of noneconomic results springing from the mechanics of Treas. Reg. § 1.1502-32 are provided in the Preamble. For instance, when the underlying assumptions of Treas. Reg. § 1.1502-32 do not correspond to the facts of a situation because shares held by members have disparate bases, the general operation of the investment adjustment system can give rise to noneconomic or duplicated loss on individual shares of subsidiary stock.12 Another situation in which the investment adjustment system of Treas. Reg. § 1.1502-32 creates noneconomic losses is where the relationship between a share's basis and its proportionate share of unrecognized appreciation or depreciation in S's assets is altered subsequent to the acquisition of such

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[11] *See* Preamble, Example 2.

[12] Illustrations of this point may be found in the Preamble, Examples 4, 7(b), and 7(c). Example 7(c) illustrates the creation of noneconomic loss. In the example, M forms S by contributing an asset, A1, to S in exchange for all 80 outstanding shares of S stock. The basis of A1 is $40 and its value is $80. P (another member in the group) also contributes $20 cash to S in exchange for 20 shares of S stock. S sells A1 for $80 and recognizes a $40 gain that is taken into account by the group. Accordingly, M's aggregate basis in its shares increases by $32 (80/100 x $40), from $40 to $72, and P's aggregate basis in its shares increases by $8 (20/100 x $40), from $20 to $28. P then sells its shares for $20, their fair market value, and recognizes an $8 noneconomic loss.

Interestingly, in each case where the disproportionate reflection of an item in a particular share causes a noneconomic stock loss, that loss is offset by unrecognized gain in other shares, but that gain can be deferred indefinitely or even eliminated by the group through self-help and so the system is not appropriately balanced in such cases.

The potential for investment adjustments, when coupled with disparate share bases, to cause loss duplication is discussed below in part II.A.ii.

share. This relationship may be altered in so-called "redetermination events," which generally include (i) stock basis reallocations,13 (ii) capital transactions that alter the subsidiary's asset pool,14 and (iii) asset acquisitions where basis reflects unrecognized appreciation.15

ii. Prevention of Loss Duplication

The second purpose underlying the Proposed Stock Loss Regulations, as described in the Preamble, is the prevention of loss duplication. Loss duplication occurs

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[13] The relationship between the basis of a share and the interest represented by the share can be altered whenever stock basis is reallocated among shares, including when it is allocated to shares of stock of other members. For example, assume M forms S by contributing $100 to S in exchange for all the stock of S. S purchases two assets, A1 and A2, for $50 each. Subsequently, A1 appreciates to $75 and A2 depreciates to $25. In a transaction qualifying under Sections 355 and 368(a)(1)(D), S transfers A2 to C in exchange for all of the C stock and S then distributes all the C stock to M. Under Section 358 and Treas. Reg. § 1.358-2, M's basis in the S stock is allocated between the S and C stock in proportion to the value of the stock of S and C. As a result, M's basis in its S stock is $75 (75/100 x $100) and M's basis in its C stock is $25 (25/100 x $100). S sells A1 for $75, recognizing a $25 gain that is taken into account on the M group return. M's basis in its S stock increases by $25, from $75 to $100. M then sells its S stock for $75 and recognizes a $25 loss. After the reallocation of stock basis, M's basis in its S stock reflects the unrecognized appreciation on A1. As a result, M's reallocated S stock basis protects the appreciation on A1 from being recognized as both asset gain and stock gain. *Increasing* M's basis in its S stock to reflect the recognition of S's gain on A1 is not only unnecessary, it inflates stock basis and thereby gives rise to either noneconomic loss or noneconomic reduction of gain when the stock is sold. *See* Preamble, Example 6.

[14] The relationship between the basis of a share and the nature of the interest represented by the share can be altered by capital transactions that have no effect on the basis or value of outstanding shares, but that nevertheless alter the interest represented by those shares. Changes in the extent to which unrecognized amounts are reflected in basis can occur whenever the subsidiary's pool of assets is increased or decreased by a capital transaction. The reason is that the interest represented by each share, and thus the relationship between a share's basis and the interest represented by the share, changes whenever the subsidiary's pool of assets changes. Such transactions include issuances of new shares in a Section 351 transaction, acquisitive reorganizations (if new shares are issued), and redemptions. This effect is demonstrated by Example 7(c) of the Preamble (discussed in footnote 12 above).

[15] The relationship between the basis of a share and the nature of the interest represented by the share can be altered by transactions in which S acquires assets with a basis that reflects unrecognized appreciation, such as stock of a new member. The reason is that, after the lower-tier acquisition, the S shares have an interest in unrecognized appreciation and the investment adjustment system will increase the basis of the S shares when those lower-tier items are recognized. For example, assume M forms S by contributing $100 to S in exchange for all the stock of S. S then purchases all the stock of S1 for $100 when S1 holds one asset, A1, with a basis of $0 and a value of $ 100. S1 sells A1, recognizing a $100 gain that is taken into account on the M group return. As a result, both S's basis in its S1 stock and M's basis in its S stock are increased by $100, from $100 to $200. M then sells its S stock, recognizing a $100 loss. In this situation, a deduction for the stock loss would be inappropriate because neither the group nor its members have suffered any economic loss. If M were allowed to deduct that noneconomic loss, the deduction would offset the gain recognized on S's asset and, effectively, eliminate the corporate-level tax on the gain on S's asset. *See* Preamble, Example 8.

when a single economic loss is reflected in both a member's basis in subsidiary stock and in the subsidiary's assets or operations. In the government's view, this type of duplication has a distortive effect regardless of whether the second, duplicated loss is taken with respect to the stock or with respect to the assets, and regardless of whether the duplicated loss is used by the group itself or by a former member after it is deconsolidated.[16]

> *Example – duplication of loss where stock sold first.* M forms S by contributing \$110 to S in exchange for all 100 outstanding shares of S stock. S uses the cash to purchase an asset, A1. The value of A1 later declines to \$10. If M were then to sell all or some portion of the S stock for its FMV, M would recognize a \$1 loss on each share. In this situation, even though M would have recognized the group's economic loss on its disposition of the S stock, the loss continues to be reflected in S's basis in A1. As a result, that loss would remain available for use by M (if the stock sale did not deconsolidate S) or S (if the stock sale deconsolidates S). Upon the disposition of A1, the group's single economic loss would thus be recognized and taken into account more than once by the group and its members or former members.[17]

Loss duplication, like noneconomic losses, also may arise from the existence of disparate stock bases and the application of the normal investment adjustment rules.

> *Example – duplicated loss on disparate stock bases.* M forms S with \$100 and receives all 50 shares of S common stock. S uses the \$100 to buy A1, which then declines in value to \$50. M contributes another \$50 for a second 50 shares of common stock. S then sells A1 and recognizes a loss of \$50 that is taken into account on the M group return. The absorption of the \$50 loss results in a \$0.50 reduction to the basis of each share (original and newly issued). M then sells all or some portion of the original shares to X for \$1 each (each with a basis of

[16] *See, e.g.*, FSA 200121013 (February 12, 2001) (in discussing the loss duplication factor of former Treas. Reg. § 1.1502-20, the Service stated that "[d]uplicated loss occurs typically, but not exclusively, when a subsidiary has an asset that declines in value, or when a subsidiary pays or accrues an expense, but the loss or expenditure has not reduced the basis of the subsidiary stock, because, e.g., the loss has not been utilized by the group or the deduction was deferred. Duplication can occur whether or not the subsidiary remains a member of the group and whether or not the loss or expense will be deductible by the subsidiary the stock of which is sold."); TAM 200006014 (October 22, 1999) (similar).

[17] *See* Preamble, Example 3, (also noting that, in contrast, if the duplicated loss had first been taken into account with respect to A1, the investment adjustment system would have prevented a duplicative benefit to the group and its members by reducing M's basis in S stock by the amount of the loss; in that case, the group would have enjoyed the tax benefit attributable to the loss, but that benefit would not remain available for another use by the group and its members or former members).

$1.50) and recognizes a $0.50 loss on each share (up to $25 total). Although the $50 asset loss and the $25 stock loss both reflect an economic loss of the group, they are both reflecting the same loss. The group has actually experienced only $50 of economic loss. Therefore, the $0.50 loss recognized on each of the original shares (up to $25 total) is duplicative.[18]

Note that the redetermination events described above are less relevant in the loss duplication context. While it is true that these events can alter the extent to which a share's basis is duplicative of an inside loss, the time for measuring a duplicated loss is when it is either recognized or preserved for later use; thus, a single loss duplication measurement at that time effectively represents a cumulative product of the redetermination events.

B. Summary of Prior Guidance

For ease of reference, the principal forms of guidance issued by the government since 1986 regarding disallowance of noneconomic stock loss and loss duplication in the consolidated return context are summarized below.

- Notice 87-14 -- In an exceedingly brief fashion, the government announced its intention to promulgate regulations that generally would deny basis adjustments attributable to the built-in gain with respect to an asset (i.e., value in excess of basis at the time of the stock acquisition) that is later recognized by a target upon sale or distribution of the asset.
- Treas. Reg. § 1.1502-20T (the 1990 Temporary LDR); Prop. Treas. Reg. § 1.1502-20 (the 1990 Proposed LDR); Treas. Reg. § 1.1502-20 (the 1991 Final LDR) – In March 1990, the government published a temporary regulations generally disallowing loss recognized on disposition of the stock of a consolidated

[18] *See* Preamble, Example 5(a).

subsidiary. The 1990 Temporary LDR was withdrawn in November 1990 and such withdrawal was accompanied by the issuance of new proposed regulations (the 1990 Proposed LDR). The final version of the loss disallowance regulations was published in September 1991 (the 1991 Final LDR).[19] The 1991 Final LDR generally disallowed an amount of loss on disposition of a consolidated subsidiary equal to the sum of three factors: (i) extraordinary gains, (ii) positive investment adjustments, and (iii) duplicated loss. Further, in determining positive investment adjustments, the 1991 Final LDR allowed netting of profits and losses within the same year (other than profits attributable to extraordinary gain dispositions), but not profits and losses arising in different taxable years. As was the case with the 1990 Temporary LDR, the 1991 Final LDR applied in circumstances where the subsidiary was being sold at a loss, but did not apply when such subsidiary was being sold at a gain, even though some of the post-acquisition economic appreciation in the value of the share could be shielded by positive investment adjustments attributable to recognized built-in gains or income.

- Notice 2002-11; Treas. Reg. § 1.337(d)-2T; Notice 2002-18 -- In February 2002, following the Rite Aid decision, the government announced that it would no longer litigate the validity of the loss duplication rule in the 1991 Final LDR. Shortly thereafter, it suspended the application of the 1991 Final LDR in its entirety and issued a temporary regulation (Treas. Reg. § 1.337(d)-2T) providing an interim rule denying stock loss except to the extent the taxpayer could demonstrate that the loss is not attributable to the recognition of gain on the disposition of an asset already reflected in stock basis (i.e., tracing). At the same

[19] The approach in the 1990 Proposed LDR was largely adopted in the 1991 Final LDR.

time, the government announced its intention to promulgate rules preventing a consolidated group from benefiting twice from the same economic loss, once through a stock loss, and once through an asset loss.

- Treas. Reg. § 1.1502-35T -- In March 2003, the government fulfilled its promise in Notice 2002-18 by issuing a temporary regulation addressing loss duplication. The regulation contained a basis redetermination rule generally leveling the basis of a subsidiary's shares in the hands of members upon deconsolidating and non-deconsolidating dispositions of subsidiary stock and suspending stock loss upon non-deconsolidating dispositions to the extent such losses are duplicated in the subsidiary's assets.
- In response the *Rite Aid* decision, the American Jobs Creation Act of 2004 amended Section 1502 to provide that, in carrying out the authority to prescribe consolidated return regulations for affiliated corporations, the government "may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations file separate returns."[20]
- Notice 2004-58 – In August 2004, the government effectively provided a safe harbor method for taxpayers to determine disallowed loss under Treas. Reg. § 1.337(d)-2T. Under the "basis disconformity method," the amount of loss disallowed is the least of three measurements: (i) net positive investment adjustments (disregarding distributions), (ii) aggregate gain on asset dispositions, and (iii) the disconformity amount (i.e., the amount by which basis of the loss

[20] P.L. 108-357, Sec. 844(a).

share exceeded its share of net asset basis). Notice 2004-58 acknowledged that other methods, including tracing, are permissible.

Treas. Reg. §§ 1.337(d)-2 and 1.1502-35T were finalized without substantial change in 2005 and 2006, respectively.

C. Summary of Prior Tax Section Reports

The Tax Section has submitted comments relating to several iterations in the government's position. As described in greater detail below, while the approach taken by the government in the 1990 Temporary LDR differed significantly from the Tax Section's initial recommended solutions to the problem of noneconomic stock loss, the approaches favored by the government and the Tax Section have converged over time to a significant extent. For example, we initially supported addressing through regulations the creation of stock loss and the reduction of stock gain through noneconomic basis adjustments, but have gradually come to support the government's compromise of addressing only stock losses (subject to certain anti-abuse rules). Our position on various forms of tracing analysis also has evolved to a point closer to the government's view that tracing is unadministrable. In addition, we have, over time, recognized the need to address the potential for built-in income items to create noneconomic stock loss. For its part, the government's position has evolved in the area of loss duplication, now proposing a solution in line with the views of the Tax Section in the Peaslee Letter that loss duplication generally should be addressed on the buyer's side. Moreover, the government has now accepted the view, also expressed in the Peaslee Letter and the 2003 Report, that, in designing a presumptive system for identifying noneconomic stock loss, the government should permit income and losses to be netted across years (not just within a single year).

i. Notice 87-14 and the 1990 Report

In February 1990, the Tax Section issued the 1990 Report in response to Notice 87-14. The 1990 Report discussed five possible solutions to the problem of noneconomic stock loss and did not address loss duplication. First, the 1990 Report reviewed a mark-to-market regime, pursuant to which the investment adjustment rules would be modified to provide that, solely for purposes of computing the amount of earnings and profits in connection with investment adjustments, each asset of an acquired corporation would be assigned an earnings and profits basis equal to its fair market value ("Mark-To-Market Approach"). Second, the 1990 Report discussed an approach whereby the investment adjustment rules would be modified to establish a rebuttable presumption (which would have to be rebutted by the taxpayer to take advantage of a positive investment adjustment resulting from any post-acquisition gain) that all gain recognized by an acquired corporation with respect to the sale or exchange of a capital asset constitutes a built-in gain to the extent of unrealized built-in gain ("presumptive limitation on investment adjustments" or "PLIA"). Third, the 1990 Report considered replacing the investment adjustment rules altogether in favor of a rule providing that the outside basis in a subsidiary would be equal to the greater of inside net asset basis or "adjusted cost basis" (purchase price plus actual contributions, less actual distributions) in the stock ("Modified Cost Basis"). Fourth, the 1990 Report analyzed a rule that would disallow losses upon any disposition of stock of a member of an affiliated group ("Loss Disallowance Rule"). Fifth, the 1990 Report discussed a rule that would disallow losses upon disposition of stock of a member of an affiliated group to the extent the gains were taken into account in computing basis adjustments under Treas. Reg. § 1.1502-32 (the "Loss Limitation Rule").

The 1990 Report concluded that, while the Mark-to-Market approach would produce the most accurate results in theory, it would be too administratively burdensome in practice. The Modified Cost Basis approach was rejected as a complete departure from current law that would in any event produce inappropriate results in many circumstances. Similarly, the 1990 Report concluded that the Loss Disallowance rule would be overreaching, as it would deny economic losses unrelated to investment adjustments. The 1990 Report recommended that the government adopt the PLIA rule, but that such rule only apply for a limited number of years following an acquisition of subsidiary stock and that during such period the PLIA rule would be backstopped by the Loss Limitation rule. In effect, as a general rule, the Loss Limitation rule would apply to dispositions of subsidiary stock at a loss and the PLIA rule would apply to dispositions of such stock at a gain.

ii. The 1990 Proposed Regulations and the 1991 Peaslee Letter

The Tax Section submitted its comments on the 1990 Proposed LDR in the Peaslee Letter. The Peaslee Letter asserted that the 1990 Proposed LDR constituted an improvement over the 1990 Temporary LDR, but had certain suggestions for more narrowly tailoring the regulations to apply to noneconomic losses only. First, the Peaslee Letter suggested that loss duplication would be more appropriately addressed on the purchaser side and not the seller side, given the seller may actually have suffered an economic loss that would be disallowed under the duplicated loss factor. Second, the Peaslee Letter recommended that neither the "positive investment adjustment" nor the "gains from extraordinary asset dispositions" factor of the 1990 Proposed LDR apply to the extent a loss is attributable to positive investment adjustments relating to gains from (a) the disposition of assets acquired by purchase from unrelated parties if such purchase

occurred after the subsidiary became a member of the consolidated group or (b) cancellation of indebtedness incurred after the subsidiary became a member of the consolidated group. The Peaslee Letter argued that such gains are inherently not built-in gains, and it would be inappropriate for the loss disallowance rules to apply to losses resulting from positive adjustments relating to such gains. In this respect, the Peaslee Letter also recommended a cap on loss disallowance; the aggregate amounts disallowed pursuant to the "positive investment adjustment" and "gains from extraordinary dispositions" factors should not exceed the original purchase price of the subsidiary's stock plus the amount of the liabilities of the subsidiary at the time of its acquisition – i.e., the maximum potential built-in gain of the subsidiary. Third, the Peaslee Letter proposed that the government should allow positive and negative basis adjustments arising in different taxable years if the underlying operating gains and losses arise from the same trade or business (i.e., netting across years). The Peaslee Letter noted the economic equivalency of same year and different year trade or business profits and losses.

iii. Treas. Reg. §§ 1.337(d)-2T and 1.1502-35T and the 2003 Report

As described below, the 2003 Report supported Treas. Reg. §§ 1.337(d)-2T, but criticized other aspects of that regulation, as well as Prop. Treas. Reg. § 1.1502-35.

First, we supported the decision by the government not to adopt a "full tracing regime" that would fundamentally overhaul the investment adjustment rules by prohibiting recognized built-in gains from generating positive adjustments to subsidiary stock basis. We generally supported the government's continued focus on disallowing noneconomic loss, without addressing the use of noneconomic basis adjustments to reduce stock gain attributable to post-acquisition unrealized appreciation in a subsidiary's

assets. We noted that this decision reflects a compromise, given that the loss disallowance presumptions generally would likely be overbroad when applied to stock sales in loss scenarios.

Second, we criticized Treas. Reg. § 1.337(d)-2T as being too narrow in that it addressed the recognition of built-in gain only to the extent it arises from the disposition of an asset and not to the extent it results from the wasting or consumption of a gain asset (i.e., "built-in income items"). We recommended that any solution to the noneconomic stock loss should address such built-in income items because such items have the same effect on stock basis under the investment adjustment rules as does the recognition of built-in gain on a disposition.

Third, we recognized the need for presumptions because of the difficulty of tracing, but recommended alleviating their impact when the presumptions led to inappropriate results by making them rebuttable in certain instances. Under one recommended approach, regulations would "build-down" from the 1991 Final LDR, by eliminating the loss duplication factor and modifying the "positive investment adjustments" and "extraordinary asset disposition" factors to alleviate overbreadth on the loss side. For example, a taxpayer would be able to avoid loss disallowance to the extent it was able to establish that any gain giving rise to a positive investment adjustment was attributable to assets acquired after the date the subsidiary joined the affiliated group. Moreover, the "positive investment adjustment" factor would be disregarded after the subsidiary stock has been held for a specified period of years (i.e., 5 years) because it is unlikely that the subsidiary affiliated with the acquirer for such a lengthy period was acquired for the purpose of generating noneconomic stock loss. Further, we repeated our

support, first stated in the Peaslee Letter, for netting under the positive investment adjustments factor of profits and losses from the same business incurred in different taxable years.

Fourth, we discussed the appropriate approach to the problem of loss duplication. While recognizing that the government has a legitimate interest in preventing duplication of loss within a single consolidated group, we were concerned that Prop. Treas. Reg. § 1.1502-35 was overly complex and potentially inaccurate. We recommended the publication of interim guidance addressing such loss duplication through an anti-abuse rule focusing on "stuffing transactions" (e.g., the contribution of a built-in loss asset to a corporation in exchange for stock in a carryover basis transaction). Over the longer term, we noted that guidance must be based on an analysis of whether unplanned duplication or even loss acceleration is sufficiently objectionable to merit a regulatory response.

D. Description of the Proposed Stock Loss Regulations

The Proposed Stock Loss Regulations address the problems of noneconomic stock loss and loss duplication in the consolidated return context through an integrated system of stock and asset basis adjustments. Three principal rules are at the heart of this system – the "Basis Redetermination Rule" of Prop. Treas. Reg. § 1.1502-36(b), the Basis Reduction Rule" of Prop. Treas. Reg. § 1.1502-36(c), and the "Attribute Reduction Rule" of Prop. Treas. Reg. § 1.1502-36(d). These rules apply sequentially to wring out of the system stock basis attributable to noneconomic loss and asset basis that duplicates stock loss. A fourth operative rule, found in Prop. Treas. Reg. § 1.1502-13(e)(4), essentially applies a "wait and see" approach to the application of Section 362(e)(2) in the context of an intercompany Section 351 transaction, suspending its application until certain

triggering events occur. The regulations are proposed to be effective for all transfers on or after the date that final regulations are published in the Federal Register.

i. Definitions

The fundamental operation of the Proposed Stock Loss Rules requires an explanation of two key terms: "loss share" and "transfer." The term "loss share" means a share of stock with a basis that exceeds its value.[21] The term "transfer" of S stock generally means the earliest of (i) the date that another member (M) ceases to own the share as a result of a transaction in which, but for the application of the Proposed Stock Loss Regulations, M would recognize gain or loss with respect to the share; (ii) the date that M and S cease to be members of the same group; (iii) the date that a nonmember acquires the share from M; and (iv) the last day of the taxable year during which the share becomes worthless under Section 165(g), taking into account the provisions of Treas. Reg. § 1.1502-80(c) deferring the timing of worthless stock deductions with respect to member stock.[22] Accordingly, S does not transfer its stock of a lower-tier subsidiary "S1") if M transfers the stock of S and S and S1 continue to filed consolidated returns after the transfer.

The regulations provide certain exceptions to the concept of a transfer. For example, no transfer occurs if the share is disposed of in certain tax-free transactions (e.g., intercompany reorganizations in which S's assets are acquired by another member

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[21] *See* Prop. Treas. Reg. § 1.1502-36(f)(7). The term "value" means the amount realized, if any, or otherwise the fair market value. *See* Prop. Treas. Reg. § 1.1502-36(f)(12).

[22] *See* Treas. Prop. Treas. Reg. § 1.1502-36(f)(11)(i). For example, assume M owns all 100 of the outstanding shares of S stock with a basis of $2 per share. S owns land with a basis of $100, has a $120 loss carryover, and has no liabilities. Each share has a value of $1. M sells 30 of the S shares to X for $30. As a result of the sale, M and S cease to be members of the same group. Accordingly, M "transfers" all 100 S shares. *See* Prop. Treas. Reg. § 1.1502-36(d)(7), Example 1(i)(A) (cross-referencing § 1.1502-36(f)(11)(i)(A) and (f)(11)(i)(B) for this conclusion).

and M recognizes no gain or loss with respect to the share, and a tax-free Section 355 distribution of the S share by M to a non-member).[23]

M is considered to transfer a loss share of S even though the share is transferred in an intercompany transaction to another member and the loss is not taken into account currently pursuant to the consolidated return intercompany transaction regulations (Treas. Reg. § 1.1502-13). As described later, the triggering of the operative rules of Prop. Treas. Reg. § 1.1502-36 upon an intercompany stock transfer is likely to lead to considerable complication.

In addition to the two primary terms (loss share and transfer), other definitions play a role in the Proposed Stock Loss Regulations. However, as these other terms are not as pervasive, they will be explained in their respective contexts below.

ii. Certain Operating Rules

Special operating rules apply throughout the Proposed Stock Loss Regulations. Primarily, these rules provide that the Proposed Stock Loss Regulations apply to predecessor or successor persons, groups, and assets to the extent necessary to effectuate their purposes.[24] Furthermore, special rules apply to modify the computations of Prop. Treas. Reg. § 1.1502-36(c) and (d) to adjust for the effects of certain events that alter the relationship between stock basis and inside attributes.[25] These events include the reduction of S's attributes under Section 362(e)(2) (taking into account the provisions of

[23] M does not "transfer" a share of S stock if (i) M ceases to own the share as a result of a Section 381(a) transaction (generally Section 332 liquidations and acquisitive reorganizations described in Section 368(a)) in which any member acquires assets from S or in which S acquires assets from M, provided that, in either case, M recognizes no gain or loss with respect to the share; or (ii) M ceases to own the share as a result of a distribution of the share to a nonmember in a transaction to which Section 355 applies, provided M does not recognize any gain or loss with respect to the share as a result of the distribution of the share. *See* Prop. Treas. § 1.1502-36(f)(11)(ii).

[24] *See* Prop. Treas. Reg. § 1.1502-36(e)(1).

[25] *See* Prop. Treas. Reg. § 1.1502-36(e)(2).

Prop. Treas. Reg. § 1.1502-13(e)(4) (described below))[26] and the reduction to the basis of any share of S stock as the result of an election under Section 362(e)(2)(C) (taking into account the provisions of Prop. Treas. Reg. § 1.1502-13(e)(4)).[27] In addition, adjustments may be made as appropriate if the relationship between a member's basis in a share of S stock and the share's allocable portion of S's attributes has been altered, *other than* by the operation of Prop. Treas. Reg. § 1.1502-32 or Prop. Treas. Reg. § 1.1502-36, provided that such change is not otherwise addressed in Prop. Treas. Reg. § 1.1502-36.[28]

iii. Operative Rules

Prop. Treas. Reg. § 1.1502-36 applies when M transfers a share of S stock and, after giving effect to all applicable rules of law other than Prop. Treas. Reg. § 1.1502-36, the share is a loss share. The Basis Redetermination Rule applies first to require, in certain circumstances, redeterminations of members' bases in shares of S stock. If the transferred share remains a loss share after any basis redetermination, the Basis Reduction Rule may apply to require certain reductions in M's basis in the transferred loss share. If the transferred share is still a loss share after any such basis reduction, the Attribute Reduction Rule may apply to require that S reduce certain of its tax attributes.

a. Basis Redetermination Rule

The Basis Redetermination Rule reduces the extent to which there is disparity in members' bases in shares of S stock, with the intent that the reduction will prevent the operation of the investment adjustment system of Treas. Reg. § 1.1502-32 from creating

[26] *See* Prop. Treas. Reg. § 1.1502-36(e)(2)(i).

[27] *See* Prop. Treas. Reg. § 1.1502-36(e)(2)(ii).

[28] *See* Prop. Treas. Reg. § 1.1502-36(e)(2)(iii).

noneconomic or duplicated loss when members hold S shares with disparate bases.[29] These rules operate by reallocating previously applied investment adjustments, but do not alter the *aggregate* amount of basis in shares of S stock held by members or the *aggregate* amount of investment adjustments applied to shares of S stock.[30]

Specifically, if M transfers a loss share of S stock, all members' bases in all their shares of S stock are subject to redetermination under Prop. Treas. Reg. § 1.1502-36(b). The adjustments are made in accordance with Prop. Treas. Reg. § 1.1502-36(b)(2). First, M's basis in each of its transferred loss shares of S stock is reduced, but not below value, by removing positive investment adjustments ("PIAs") previously applied to the basis of the share.[31] Second, if a transferred share is still a loss share after applying Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(A), M's basis in the share is reduced, but not below value, by reallocating and applying negative investment adjustments ("NIAs") to the transferred loss share from shares held by members that are not transferred loss shares.[32] These reductions are made first to M's bases in transferred loss shares of S preferred stock and then to M's bases in transferred loss shares of S common stock.[33] Third, after the application of Prop. Treas. Reg. § 1.1502-36(b)(2)(i), the PIAs removed from transferred

[29] *See* Prop. Treas. Reg. § 1.1502-36(b)(1)(i).

[30] *Id.*

[31] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(A)). For purposes of Prop. Treas. Reg. § 1.1502-36(b), the term "investment adjustment" means the adjustment for items described in Treas. Reg. § 1.1502-32(b)(2), excluding Reg. §1.1502-32(b)(2)(iv) (distributions). *See* Prop. Treas. Reg. § 1.1502-36(b)(1)(iv). The term includes all such adjustments reflected in the basis of the share, whether originally applied directly by Treas. Reg. §1.1502-32 or otherwise, and therefore includes investment adjustments reallocated *to* the share, and it does not include investment adjustments reallocated *from* the share, whether pursuant to Treas. Reg. §1.1502-36 or any other provision of law. *Id.* It also includes the proportionate amount of investment adjustments reflected in the basis of a share after the basis is apportioned among shares, for example in a transaction qualifying under Section 355. *Id.*

[32] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(B). Note that investment adjustments can only be reallocated to shares that were held by members in the period to which the adjustment is attributable. *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(1).

[33] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(B).

loss shares are reallocated and applied to increase, but not above value, members' bases in gain shares of S preferred stock,[34] and any PIAs removed from transferred loss shares and not applied to S preferred stock are then reallocated and applied to increase members' bases in shares of S common stock.[35]

> *Example – basic operation of Prop. Treas. Reg. § 1.1502-36(b).* For many years, M has owned two assets, Asset 1 and Asset 2. On January 1, year 1, M receives four shares of S common stock (the "Block 1" shares) in exchange for Asset 1, which has a basis and value of $80. The exchange qualifies under Section 351 and, therefore, under Section 358, M's aggregate basis in the Block 1 shares is $80 ($20 per share). On July 1, year 1, M receives another share of S common stock (the "Block 2" share) in exchange for Asset 2, which has a basis of $0 and value of $20. This exchange also qualifies as a Section 351 exchange and, under Section 358, M's basis in the Block 2 share is $0. M's Block 1 and Block 2 shares are the only outstanding shares of S stock. On October 1, year 1, S sells Asset 2 for $20. On December 31, year 1, M sells one of its Block 1 shares for $20. After applying and giving effect to all generally applicable rules of law (other than Prop. Treas. Reg. § 1.1502-36), M's basis in each Block 1 share is $24 (P's original $20 basis increased under Reg. §1.1502-32 by $4 (the share's allocable portion of the $20 gain recognized on the sale of Asset 2)). In addition, M's basis in its Block 2 share is $4 (P's original $0 basis increased under Reg. §1.1502-32 by $4 (the share's allocable portion of the $20 gain recognized on the sale of Asset 2)). M's sale of the Block 1 share is a transfer of a loss share and therefore subject to the provisions of Prop. Treas. Reg. § 1.1502-36.
>
> Under Prop. Treas. Reg. § 1.1502-36(b), M's bases in all its shares of S stock are subject to redetermination. First, Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(A) applies to reduce M's basis in the transferred loss share, but not below value, by removing PIAs applied to the basis of the share. Accordingly, M's basis in the transferred Block 1 share is reduced by $4 (the amount of the PIA applied to the

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[34] A "gain share" is a share of stock with a value that exceeds its basis. *See* Prop. Treas. Reg. § 1.1502-36(f)(7).

[35] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(ii). *See also* Preamble, para. F.2 (stating that "[t]he positive adjustments removed from the transferred loss shares are allocated and applied only after the negative items have been reallocated. The reason is to preserve the most flexibility possible in reallocating positive adjustments, in order to minimize disparity to the greatest extent. Thus, the operation of these rules has the effect of removing basis from transferred loss shares and using it to reduce disparity in members' bases in S shares."). Reallocations are made to shares of common stock without regard to whether a particular share is a loss share or a transferred share, and without regard to the share's value. *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(ii)(B).

In general, an investment adjustment under Treas. Reg. § 1.1502-32 is made with respect to the stock of a member that experiences an adjustment under Prop. Treas. Reg. § 1.1502-36(b) on the stock of another member that it owns. *See, e.g.*, Prop. Treas. Reg. § 1.1502-36(b)(3), Example 3(iv).

share), from $24 to $20. No further reduction to the basis of the share is required under Prop. Treas. Reg. § 1.1502-36(b) because the basis of the share is then equal to value. Under Prop. Treas. Reg. § 1.1502-36(b)(2)(ii)(B), the PIA removed from the transferred loss share is reallocated and applied to increase M's bases in its S shares in a manner that reduces basis disparity to the greatest extent possible. Accordingly, the $4 PIA removed from the Block 1 share is reallocated and applied to the basis of the Block 2 share, increasing it from $4 to $8.[36]

In applying the three-step approach of Prop. Treas. Reg. § 1.1502-36(b), special operating rules apply. For instance, the aforementioned reallocations are made in a manner that reduces basis disparity among shares of preferred stock and among shares of common stock to the greatest extent possible (that is, causes the ratio of the basis to the value of each member's share to be as equal as possible),[37] and, subject to the preceding mandate, generally are made first with respect to the earliest available adjustments.[38] Further, investment adjustments can only be reallocated to shares that were held by members in the period to which the adjustment is attributable, and special rules apply to prevent the reallocation of investment adjustments from either increasing or decreasing members' aggregate bases in subsidiary stock such that no investment adjustment (positive or negative) may be reallocated to the extent that it was (or would have been) used prior to the time that it would otherwise be reallocated under Prop. Treas. Reg. § 1.1502-36(b)(2).[39] Finally, if shares of stock of more than one subsidiary are transferred in a transaction and shares of stock of the lowest-tier transferred subsidiary ("S2") are loss shares, first Prop. Treas. Reg. § 1.1502-36(b) and then Prop. Treas. Reg. § 1.1502-

[36] *See* Prop. Treas. Reg. § 1.1502-36(b)(3), Ex. 1(i)(B).

[37] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(iii)(A).

[38] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(iii)(C).

[39] *See* Prop. Treas. Reg. § 1.1502-36(b)(2)(iii)(B).

36(c) apply with respect to the S2 shares,[40] after which gain or loss is computed on all transferred S2 shares.[41]

Stock basis adjustments reflecting transfers of capital, whether contributions or distributions, are not adjustments attributable to the recognition of appreciation or depreciation and, accordingly, such adjustments do not increase or decrease the extent to which stock basis is noneconomic. For that reason, such amounts are not taken into account under the Basis Redetermination Rule in determining the extent to which subsidiary stock basis is subject to reduction. This limitation on the Basis Redetermination Rule represents an important departure from the broader basis reallocation rule of Treas. Reg. § 1.1502-35(b)(1), which permits reallocation of basis attributable to invested capital.

There are two exceptions to the application of the Basis Redetermination Rule. First, basis redetermination is not required if redetermination would not result in a change to any member's basis in any share of S stock.[42] Second, basis redetermination is not required if, within the group's taxable year in which the transfer occurs, every share of S

[40] *See* Prop. Treas. Reg. § 1.1502-36(a)(3)(ii).

[41] *Id.* Any adjustments under Prop. Treas. Reg. § 1.1502-36(b) and (c), any gain or loss recognized on transferred S2 shares (whether allowed or disallowed), and any other related or resulting adjustments are then applied to adjust members' bases in subsidiary stock under the principles of Treas. Reg. § 1.1502-32. *Id.*

[42] *See* Prop. Treas. Reg. § 1.1502-36(b)(1)(ii)(A). For example, if S has only one class of stock outstanding and there is no disparity in members' bases in S shares, no member's basis would be changed by the application of Prop. Treas. Reg. § 1.1502-36(b) and, accordingly, under Prop. Treas. Reg. § 1.1502-36(b)(1)(ii)(A), no redetermination would be required. Similarly, if S has preferred and common stock outstanding, there is no gain or loss on any member's preferred, and there is no disparity in members' bases in the common stock, no member's basis would be changed by the application of Prop. Treas. Reg. § 1.1502-36(b) and, accordingly, under Prop. Treas. Reg. § 1.1502-36(b)(1)(ii)(A), no redetermination would be required.

stock held by a member is transferred to a nonmember in one or more fully taxable transactions.[43]

b. Basis Reduction Rule

The Basis Reduction Rule is applicable if, after applying the Basis Redetermination Rule, the transferred share is still a loss share. According to the Preamble, the Basis Reduction Rule attempts to "eliminate stock loss that is presumed noneconomic."[44] If the Basis Reduction Rule applies, a member's basis in the loss share is reduced, but not below its value, by the lesser of the share's net positive adjustment (the "NPA") or the loss share's disconformity amount (the "Disconformity Amount").[45]

The NPA is the greater of zero and the sum of all investment adjustments reflected in the basis of the share but excluding distributions.[46] "Investment adjustment" has the same meaning for purposes of the basis reduction rule as it does for the basis redetermination rule.[47] The NPA may include a portion of an investment adjustment reallocated to the share under the Basis Redetermination Rule.

The Disconformity Amount is the excess of the member's basis in the loss share over the share's allocable portion of S's "net inside attribute amount."[48] The "net inside attribute amount" is the sum of S's money, basis in assets other than money, net operating loss and capital loss carryovers, and deferred deductions, reduced by S's

[43] *See* Prop. Treas. Reg. § 1.1502-36(b)(1)(ii)(B). *See also* Preamble, para. F.2 (noting that, in this case, the group recognizes all the gains and losses on the shares and so obtains no benefit from the disparate reflection of gain or loss (i.e., the disparate bases, which results in both noneconomic gain as well as noneconomic loss, wash out when all are sold)).

[44] *See* Preamble, para. F.3.

[45] Prop. Treas. Reg. § 1.1502-36(c)(2).

[46] Prop. Treas. Reg. § 1.1502-36(c)(3).

[47] *Id.*

[48] Prop. Treas. Reg. § 1.1502-36(c)(4).

liabilities.[49] The determination of S's net inside attribute amount is made immediately before the transfer of S's stock, taking into consideration all rules of law except Prop. Treas. Reg. § 1.1502-36.[50] The loss share's "allocable portion" has the same meaning as Treas. Reg. § 1.1502-32(b)(4)(iii)(B).[51] Under Treas. Reg. § 1.1502-32(b)(4)(iii)(B), if there is one class of stock, each share would have the same allocable portion of net asset basis. Where there are multiple classes of stock, adjustments are necessary so that the allocable portion is determined by taking into account the terms of each class and other factors relating to the overall economic arrangement.

Where S owns stock in a lower-tier subsidiary (S1) and S1 shares are not transferred in the same transaction, in determining S's net inside attribute amount a special rule treats S's basis in its S1 share as tentatively reduced.[52] According to the Preamble, this rule only applies in determining S's basis reduction amount with respect to the disconformity computation and has no other effect.[53] The adjustment to S1's stock basis is the lesser of the S1 share's NPA and the S1 share's Disconformity Amount, using the same principles set forth above in determining S's NPA and Disconformity Amount.[54] This tiering rule is applied successively, from the lowest tier to the highest tier underneath S.

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

[50] *Id.*

[51] *Id.*

[52] Prop. Treas. Reg. § 1.1502-36(c)(6).

[53] Preamble, para. F.3.a.

[54] Prop. Treas. Reg. § 1.1502-36(c)(6)(ii).

The policy concern underlying the tiering rule is to prevent S1's recognized gains from giving rise to a noneconomic loss in S's stock.[55] As illustrated by the following example, this tiering rule is necessary to prevent lower tier adjustments from facilitating the recognition of noneconomic stock loss.

> *Example.* M forms S with $500 cash. S buys the stock of S1 for $300. S1's has no tax basis in its assets but a value in those assets of $300. S1 sells its assets for $300, recognizing a $300 gain. The $300 gain tiers-up and increases the basis of stock of both S and S1 by the $300 to $800 and $600, respectively. M then sells the stock of S for $500 with a basis of $800, recognizing a $300 noneconomic loss. However, by application of this special rule, S's basis in S1 is treated as $300 rather than $600 (i.e., S1's NPA is $300 as a result of the $300 gain, and the Disconformity Amount is $300 as well because outside stock basis is $600 and inside asset basis is $300; therefore, S tentatively reduces its basis in the S1 stock by $300 to $300 for purposes of computing the disconformity amount). As a result, M must reduce its basis in the S stock by $300. M's NPA and Disconformity Amount are $300; the Disconformity Amount is the difference between $800 (M's basis in the S stock) and $500 (which is the sum of M's $300 tentatively reduced basis in its S1 stock and its $200 basis in its other assets).

The Proposed Stock Loss Regulations contain a netting rule that is applicable solely for purposes of computing any basis reduction required by the Basis Reduction Rule. If there is a loss share of S's stock that is transferred, it is treated as reduced proportionately, with respect to the loss, by the amount of gain taken into account by other members of the consolidated group as to all of S's gain shares that have been transferred.[56] This rule applies if both the gain and loss shares are transferred in the same transaction and the gain is taken into account in the year of the transaction.[57]

c. Attribute Reduction Rule

The Attribute Reduction Rule addresses loss duplication concerns not addressed by the Basis Redetermination Rule. If a transferred share remains a loss share after the

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[55] Preamble, para. F.3.a.

[56] Prop. Treas. Reg. § 1.1502-36(c)(7).

[57] *Id.*

application of the Basis Redetermination Rule and the Basis Reduction Rule, the loss with respect to the transferred share is allowed, but the subsidiary's attributes are reduced by the subsidiary's "attribute reduction amount", which is the lesser of "net stock loss" and the subsidiary's "aggregate inside loss."[58] The subsidiary's "net stock loss" is the excess, if any, of the members' aggregate bases in transferred subsidiary shares over the aggregate value of those shares.[59] Note that this definition is applied on the basis of net loss, rather than gross stock loss (i.e., gains and losses are offset). The subsidiary's "aggregate inside loss" is the excess, if any, of the subsidiary's "net inside attribute amount" (as defined above with respect to the basis reduction rule, except as described below with respect to basis in lower-tier subsidiaries) over the value of all outstanding shares of the subsidiary's stock.[60] Duplicated loss for purposes of the Attribute Reduction Rule is determined by reference to the entirety of the subsidiary's inside loss (not just the transferred loss share's allocable portion thereof).

The subsidiary's attribute reduction amount is applied to reduce (in order) its net operating loss ("<u>NOL</u>") carryovers (oldest to newest); capital loss carryovers (oldest to newest); deferred deductions (proportionately); basis in publicly traded property (other than stock of a subsidiary), but only to the extent of the excess of such basis over the property's value (i.e., loss inherent in the property); and basis in other assets, excluding cash (and equivalents) and publicly traded property.[61] Note that stock of a subsidiary is subject to the attribute reduction rule. The reduction is applied proportionately to the

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[58] Prop. Treas. Reg. § 1.1502-36(d)(2), -36(d)(3).

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

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

[61] Prop. Treas. Reg. § 1.1502-36(d)(4).

attributes within any category described above. If the attribute reduction amount exceeds the attributes described above, the excess amount is eliminated without further effect unless the subsidiary has contingent liabilities (in which case such excess is applied to reduce deductions as such liabilities are taken into account). Any remaining attribute reduction amount has no further effect.

The regulations provide a special set of rules with respect to lower-tier subsidiary stock.[62] In general, the regulations consider the subsidiary to have a "deemed basis" in the stock of a lower-tier subsidiary (S1). The "deemed basis" is the greater of the subsidiary's actual basis in its S1 shares and the portion of S1's net inside attribute amount allocable to the subsidiary's shares of S1 stock. This rule is necessary because it is unclear whether S1 stock basis or S1's inside attributes represent duplication (or greater duplication). To prevent over-reduction, however, the regulations propose a "conforming limitation" rule and a "stock basis restoration" rule. The "conforming limitation" rule limits the reduction to S1's attributes to the excess of the portion of the S1's net inside attributes allocable to all S1 shares held by members immediately before the transaction over the sum of the value of all S1 shares (if any) transferred by members in the transaction and the sum of all members' bases in any other shares of S1 stock held immediately before the transaction (after any reduction under the stock loss rules). The "stock basis restoration" rule reverses reductions to stock basis under the general rule to conform each member's basis in a share of S1 stock to the share's allocable portion of S1's net inside attribute amount.

[62] *See* Prop. Treas. Reg. § 1.1502-36(d)(5).

Attribute reduction occurs immediately before a stock transfer and has no effect on the basis of stock of upper-tier subsidiaries.[63] A group can avoid attribute reduction by electing to reduce members' bases in the transferred loss shares and/or to reattribute some of the subsidiary's attributes such as its loss carryovers (but only in circumstances when the subsidiary leaves the group), up to the amount of the attributes that would be otherwise reduced.[64]

d. Special Rules

1. Section 362(e)(2)

Section 362(e)(2) addresses loss duplication when loss property is transferred to a corporation in a Section 351 transaction (or as a capital contribution) by limiting the transferee corporation's basis in the transferred assets to such assets' fair market value or, if the taxpayers so elect, limiting the basis of the stock received in the exchange to its fair market value. Such adjustments prevent duplicated loss from arising as a result of a Section 351 transaction itself. However, the effect of Section 362(e)(2) is to create a disparity between outside stock basis and inside asset basis, a result that is generally at odds with the results intended to be achieved by the investment adjustment rules of Treas. Reg. § 1.1502-32.

The Proposed Stock Loss Regulations respond to the potential inconsistency between Section 362(e)(2) and the investment adjustment rules by suspending the application of Section 362(e)(2) until the occurrence of a "Section 362(e)(2) application event."[65] Further, the proposed regulations provide that Section 362(e)(2) applies only to

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[63] Prop. Treas. Reg. § 1.1502-36(d)(4)(ii)(C).

[64] Prop. Treas. Reg. § 1.1502-36(d)(6).

[65] Prop. Treas. Reg. § 1.1502-13(e)(4).

the extent the investment adjustment system does not effectively eliminate remaining duplication. Until the occurrence of a "Section 362(e)(2) application event", the Proposed Stock Loss Regulations require the group to identify and track over time the amount (the "Section 362(e)(2) amount") and location of basis in the transferred assets that would have been reduced had Section 362(e)(2) applied at the time of the Section 351 transaction (or capital contribution). Upon the occurrence of a Section 362(e)(2) application event any such basis that has not previously been eliminated must be reduced.[66] A Section 362(e)(2) application event occurs when all or a portion of the duplicated loss can no longer be effectively eliminated through the investment adjustment rules – i.e., a transfer of the subsidiary stock or an asset transfer in which a third party buyer takes a carryover basis. As noted above, Section 362(e)(2) allows the taxpayer to elect to reduce basis of the stock in the transferee instead of the basis of the transferred assets. The election is also available under the Proposed Stock Loss Regulations, and may be made on either the group return for the year of the original intercompany transaction or the year of the Section 362(e)(2) application event.

2. Anti-Abuse Rules

The Proposed Regulations contain anti-abuse rules to backstop the basic operating rules. The principal anti-abuse rule, Prop. Treas. Reg. § 1.1502-36(g), states: "If a taxpayer acts *with a view* to avoid the purposes of this section or to apply the rules of this section to avoid the purposes of any other rule of law, appropriate adjustments will be made to carry out the purposes of this section or such other rule of law." [Emphasis added.] In order for this anti-abuse rule to be invoked, the taxpayer must act "with a

[66] Attribute reduction resulting from a Section 362(e)(2) application event has no effect on the basis of stock of upper-tier subsidiaries.

view" to avoid the purposes of Prop. Treas. Reg. § 1.1502-36. The use of the phrase "with a view" suggests a broad formulation of the anti-abuse rule. The Preamble indicates that this anti-abuse rule is intended to attack transactions that have not been made in the ordinary course of business.

To illustrate the application of Prop. Treas. Reg. § 1.1502-36(g), the Proposed Stock Loss Regulations contain a number of examples. These examples include "stuffing" a gain asset into the subsidiary; loss trafficking (e.g., acquiring limited losses to reduce the disconformity amount and/or skew attributed reduction); use of a partnership to prevent current attribute reduction; and creation of an intercompany receivable to mitigate attribute reduction. These transactions are abusive if done "with a view" to avoid the purposes of the Proposed Stock Loss Regulations or to use their provisions to avoid any other rule of law.

III. CRITICAL POLICY ISSUES

Before the report provides specific recommendations with respect to the operation of the Proposed Stock Loss Regulations, this section addresses judgments made by the government regarding certain underlying policy issues.

In our view, the principle that should be given the greatest weight in guiding resolution of these issues is the need to reach a systemic balance that is administrable. We recognize that, in achieving that balance, certain presumptive rules must be adopted that will disadvantage some taxpayers and advantage others based on their particular facts.

The government has strong and legitimate interests in preventing stock basis adjustments from distorting CTI through the creation of noneconomic loss. The

difficulty is that it is simply not possible to determine, with precision, to what extent recognized items of income, gain, loss, and deduction are already reflected in stock basis. The government reached this conclusion initially in 1990 with the issuance of the 1990 Temporary LDR. That judgment has been validated by five years of experience since the withdrawal of the 1991 Final LDR in 2002. Accordingly, as the 2003 Report recognized, the adoption of some set of presumptions is essentially unavoidable if the system is to be administrable.

Somewhat less obvious, but important as well, is the government's interest in rectifying systemic imbalance generated when taxpayers duplicate loss through the sale of stock of depreciated enterprises and avoid duplicative gain on the disposition (actual or deemed) of the assets of appreciated enterprises.67 On the other hand, a taxpayer should be entitled to recognize and take into account losses attributable to true economic decline that occurred in its hands. This is true regardless of whether the buyer may be able to duplicate the loss since this fact alone does not change the measurement of the decline in the seller's economic position.

As described below, we believe that, on the whole, the Proposed Stock Loss Regulations provide a conceptual framework that reaches an acceptable systemic balance. In most areas, we agree with the fundamental policy judgments made by the government as reflected in the Proposed Stock Loss Regulations. We do, however, have serious concerns as to the administrability of certain aspects of the Proposed Stock Loss Regulations, particularly the Attribute Reduction Rule in its current form and the rules governing the application of Section 362(e)(2) in the consolidated return context.

[67] If the buyer and seller make a joint election under Section 338(h)(10), the assets of a consolidated subsidiary are deemed to be disposed, even though the form of the transaction is a sale of the subsidiary's stock.

Accordingly, our principal recommendations concern ways in which to make the rules more administrable within the framework provided by the Proposed Stock Loss Regulations. Overall, we believe that the adoption of the Proposed Stock Loss Regulations as final regulations, with the modifications suggested below, would provide an appropriate basis for bringing certainty to a complex area of tax law that has been plagued by uncertainty for over 20 years.

A. Eliminating Non-Economic Stock Loss Versus Reducing Stock Basis Attributable to Non-Economic Gain or Income

Notice 87-14 was the government's initial response to the potential distortion caused by the use of the consolidated investment basis adjustment rules to create noneconomic basis and, as described above, it was aimed at the artificial creation of stock loss and reduction of gain. The Notice stated the government's intention that "a tracing-based regime would be adopted to determine adjustments to members' bases in shares of subsidiary stock."[68] With the issuance of the 1990 Temporary LDR and the 1991 Final LDR, the government rejected tracing, adopting instead a presumptive regime. In addition, the government concluded that it was appropriate to focus on disallowing noneconomic stock loss, effectively permitting basis attributable to the recognition of noneconomic income or gain to offset unrealized post-acquisition appreciation in stock value. However, the ability of taxpayer's to offset noneconomic stock loss against gain from other sources (i.e., gain inherent in other assets) was limited by an "anti-stuffing rule," which generally prohibited contributions of gain assets to the loss subsidiary, or contributions of stock of a loss subsidiary to a gain subsidiary, with a view toward avoiding the purposes of the 1990 Temporary LDR or 1991 Final LDR rules. The

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[68] See Preamble, para. A.2.

government noted that, where noneconomic basis adjustments reduced stock gain attributable to post-acquisition appreciation, taxable gain attributable to such appreciation was not permanently eliminated from the tax system; such gain ultimately would be taken into account upon disposition or wasting of the underlying appreciated assets. The government determined that applying the 1990 Temporary LDR or 1991 Final LDR only to stock losses reached an appropriate balance; given the potential over-inclusiveness created by using irrebuttable presumptions in the loss disallowance mechanics, as compared to a more precise tracing method, the government believed that from a systemic viewpoint over-inclusiveness was tolerable on the loss side but not on the gain side.[69]

Through the various iterations of the rules in this area, the government has consistently applied the framework regarding the treatment of stock gain first applied in the 1990 Temporary LDR: precluding the use of noneconomic basis adjustments to create noneconomic stock loss, while dealing with the gain side only through an anti-abuse rule. The Proposed Stock Loss Regulations maintain this balance. The Basis Redetermination, Basis Reduction, and Attribute Reduction rules apply only with respect to transfers of loss stock. Moreover, the Proposed Stock Loss Regulations contain an anti-abuse rule, in part to prevent stuffing transactions undertaken with a view to avoid the impact of the rules.[70]

Our view of the treatment of gain stock has evolved. As described above, the 1990 Report supported an approach – the PLIA rule – that would have traced built-in gains recognized during a limited period of years to deny resulting basis adjustments

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[69] Preamble to T.D. 8294, 55 Fed. Reg. 9426 (March 9, 1990).

[70] Prop. Treas. Reg. 1.1502-36(g)(2), Ex. 1.

regardless of whether their effect was to create or increase loss or to reduce or eliminate gain. The 2003 Report essentially supported the balance struck by the government, particularly applauding the government's decision not to revise the investment adjustment rules as a generic matter to deny all adjustments attributable to built-in gains. However, the 2003 Report suggested that the government might want to address the gain side through a limited rule denying basis adjustments attributable to built-in gains recognized through dispositions occurring within a limited time period.[71]

We believe that the approach taken by the Proposed Stock Loss Regulations – effectively nullifying noneconomic basis adjustments that create stock loss, but permitting such adjustments to offset post-acquisition appreciation in the subsidiary's assets – strikes an appropriate systemic balance. As described in greater detail below, experience has demonstrated that there is no administrable way to apply a pure tracing regime, particularly if the recognition of built-in income from wasting assets is to be addressed. Even a tracing system limited to asset dispositions is likely to be extremely complicated and lead to uncertainties in practice (e.g., due to the valuation difficulties and the existence of redetermination events). Presumptive regimes inherently create over- and under-inclusiveness. To us, the inaccuracies inherent in such regimes are tolerable in the stock loss context so long as they do not tilt too far in one direction. Thus, a mild bias in applicable presumptions favoring the government seems consistent with other aspects of the regulations that favor taxpayers and with the widely accepted view that provisions allowing deductions and losses should be narrowly construed as a general matter. But such inaccuracies would be intolerable to the extent that they result in

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[71] This rule would be in addition to an anti-stuffing rule.

the overstatement of gain by taxpayers in numerous cases; no general principle of tax law supports such treatment.

B. A Tracing Approach Versus a Presumptive Approach

In designing Prop. Treas. Reg. § 1.1502-36, as indicated in the Preamble, the government considered a variety of ways to foreclose the benefits of non-economic losses that contravene *General Utilities* repeal. The approaches generally fall into two broad categories: *tracing-based* and *presumptive* approaches. Under a *tracing-based approach*, the allowable stock loss is computed by determining the extent to which built-in gain or income of the disposed or deconsolidated member is already reflected in the basis of the stock. This determination, assuming it can be made, would provide the greatest degree of precision in measuring allowable stock loss under that theory. However, this approach would require taxpayers to create and maintain records, on a share-by-share basis, to establish (among other things) (i) the identity of every asset held by the subsidiary (and any lower-tier subsidiaries) on the date the subsidiary joined the group and on every redetermination event (described above), (ii) the appreciation on each asset held by the subsidiary (and any lower-tier subsidiaries) on each such date; and (iii) the extent to which such appreciation is recognized (whether as income or gain) and included in an adjustment to stock basis.[72] A mirror burden -- that of examination and verification -- would fall on the Service. Developing information of this type might be not only

[72] To implement fully a tracing regime, taxpayers also would need to create and maintain similar records for assets with unrecognized depreciation, because the recognition of that depreciation would be allowed to reduce the amount of recognized income or gain treated as tainted. Furthermore, some type of relief would have to be provided to taxpayers for prior periods when the law did not include tracing, and, as a result, taxpayers presumably would not have maintained information reasonably necessary to apply a tracing analysis.

exceedingly expensive and labor-intensive but also perhaps impossible in many contexts, such as in determining the extent of income attributable to wasting assets.

Tracing was required prior to the effective date of the 1991 Final LDR and has been required subsequent to its revocation in 2002, although under Notice 2004-58, taxpayers have had the option since 2004 to elect to use a version of the disconformity amount in lieu of tracing. Given the informational needs for implementation, both taxpayers and the government have encountered substantial difficulty in attempting to implement tracing (e.g., identifying built-in gain assets contained within a vast pool of acquired properties, measuring built-in gains with a reasonable degree of accuracy, tracking asset dispositions to distinguish recognized built-in gains from other gains, accounting for frequent redetermination events requiring new analyses, etc.). In our experience, taxpayer records typically are not sufficiently detailed to apply tracing in anything approaching a precise fashion. As an initial matter, many subsidiaries now being disposed of at a loss were acquired prior to the 2002 revocation of the 1991 Final LDR at a time when taxpayers were not required to keep information necessary to apply tracing. While this problem would diminish over time, it seems that other difficulties would not dissipate. Chief among these problems are valuation difficulties because purchase accounting records for financial reporting purposes in many instances just are not sufficiently refined to permit accurate tracing.

These problems would become infinitely more difficult if tracing were extended beyond asset dispositions to identify built-in income items generated by wasting assets. Any regime that would require the identification and tracking of such items would impose enormous costs on taxpayers and the government. Uncertainties would abound

because of the subjectivity involved in the economic analysis that would be required. As a result of these considerations, the government, in drafting Prop. Treas. Reg. § 1.1502-36, decided (as it did when it drafted the 1990 Temporary LDR) that a tracing approach simply is not viable.

We do not believe that the difficulties involved in tracing would be ameliorated by importing Section 704(c) principles into the endeavor – that is, tracing built-in gain, income, loss, and deductions to the "contributing shareholder" in cases where built-in gain or loss property is transferred to corporation in exchange for stock with a basis determined by reference to the tax basis of such property, as is required in the partnership context under Section 704(c). Such tracing would introduce the same problems generally associated with tracing, such as the need to value the underlying property, the need to separately identify and track built-in items, and possibly the need to account for income (or depreciation) in the case of a wasting or depreciable asset. Any such issues would be compounded if so-called "reverse 704(c) principles" were imported, pursuant to which a subsidiary's built-in gain might be specially allocated to existing shareholders in cases where a new shareholder acquires stock of the subsidiary for cash or other property or an existing shareholder increases it interest. Thus, for example, if S1 merges with S2 (another member of the same consolidated group) in a tax-free reorganization, the built-in gain as of the time of the merger in S1's historic assets might be specially allocated to the former S1 shareholders under 704(c) principles and the built-in gain as of the time of the merger in the historic S2 assets might be specially allocated to the former S2 shareholders under reverse 704(c) like principles. We think that the complexity associated with applying Section 704(c) principles is difficult in the partnership context and would be

equally or more difficult to apply in the context of business enterprises filing consolidated returns.

A *presumptive approach*, on the other hand, generally mitigates the record-keeping, valuation, asset identification, and other substantial administrative burdens associated with tracing by, in effect, formulaically specifying amounts of stock basis as representing noneconomic adjustments. The formula creates an irrebuttable presumption, rather than a rebuttable presumption, so that neither taxpayers nor the government have the option of demonstrating that any adjustment is economic or noneconomic. Such an approach is designed to achieve a result approximating that of tracing without requiring the same degree of intensive factual development. Of course, no set of presumption-based rules can achieve the precision inherent in rules that operate off of highly-developed facts, such as the pure tracing approach described above, assuming that tracing were possible as a practical matter. Thus, any set of presumptive rules will necessarily be both over- and under-inclusive, disallowing economic stock losses in certain instances and allowing noneconomic stock losses in others.

To be sure, some amount of inaccuracy in a tracing analysis ought to be tolerable. Indeed, given the inherent over- and under-inclusiveness of presumptions, it can be argued that limited inaccuracy inherent in a tracing regime would be preferable to the systemic creation of winners and losers in a presumptive regime. However, our sense is that the inaccuracy inherent in tracing is likely to be widespread and substantial. Moreover, taxpayers are better positioned to develop the facts necessary for a tracing analysis (e.g., have better access to relevant records, experts, data, and personnel) and generally have more resources available to do so than the government. On the whole,

one would expect that tracing would, on a system-wide basis, favor taxpayers. In contrast, a presumptive approach serves to level the playing field. Moreover, a presumptive approach may be much more easily administered by both taxpayers and the Service than a tracing approach. We also note that Congress, in the American Jobs Creation Act of 2004, amended Section 1502 to clarify the broad authority of the Secretary to issue consolidated return regulations. The legislative history of that amendment specifically states that the Secretary is authorized to "prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions."[73] Thus, despite the inherent drawbacks of a presumptive regime, we support the government's decision to abandon the tracing regime inherent in Treas. Reg. § 1.337(d)-2 and adopt a presumptive approach, incorporating into Prop. Treas. Reg. § 1.1502-36 a set of mechanical, objective rules that are applied consistently across all taxpayers.

C. Addressing Built-in Income Items (Wasting Assets)

It is now generally recognized that recognition of built-in income items potentially generates stock basis effects similar to those created by the recognition of built-in gain.

> *Example: Creation of Non-Economic Stock Loss Through Wasting Asset Income.* S has one asset with a basis of $0 and a value of $100. M buys all the stock of S for $100 and M and S elect to file consolidated returns. S uses the asset in business operations. The asset earns $20 and declines in value by $20 in each year over a 5-year period. Under the investment adjustment rules, M's basis in the stock of S is increased by the earnings to $200, but the value of S remains $100 and M may recognize a loss of $100 if M sells the S stock (thus offsetting the income produced by the asset).[74]

[73] *See General Explanation of Tax Legislation Enacted in the 108th Congress*, Joint Committee on Taxation at 415 (May 2005) (the "2005 Blue Book").

[74] *See* Example 3, T.D. 8294 (1990). *See also* CO-93-90 (1990) (citing Example 3 in T.D. 8294 as illustrating the wasting asset problem and stating that "[c]onsumption of wasting assets is not outside the

If tainted appreciation is recognized as income earned through the *wasting or consumption* of the appreciation, instead of as gain on the disposition of the asset, tracing is possible only if the tainted appreciation generates an identifiable stream of income. However, this is frequently not the case. For example, intangible assets, like patents or goodwill, are the source of significant tainted appreciation, yet they often do not generate identifiable income streams. Similarly, tainted appreciation may generate income through a lease of the property rather than through its disposition.

Unlike the 1991 Final LDR, which presumed that all positive investment adjustments were attributable to built-in income, current Treas. Reg. § 1.337(d)-2 requires only the consideration of asset dispositions. Thus, built-in amounts reflected in stock basis through income inclusions are not required to be identified or addressed. Accordingly, the resulting noneconomic stock loss is not disallowed.

In the 2003 Report, we recognized that built-in income from the consumption of gain assets has the same potential to cause noneconomic stock loss as built-in gain from asset dispositions and, accordingly, recommended that any loss disallowance approach deny taxpayers the ability to create such loss through the recognition of such income items. At the time, we noted that tracing is not a realistic solution to the wasting asset problem. Indeed, the most problematic aspect of tracing typically has been establishing the connection, or lack thereof, between income items taken into account by the group and particular amounts of tainted appreciation. As a result, we proposed using certain

scope of *General Utilities* repeal because dispositions and consumption may produce identical investment adjustment. Failing to take wasting assets into account would treat taxpayers in similar circumstances differently.").

conventions in determining income from wasting assets, generally over the tax lives of a subsidiary's assets.[75]

We continue to support rules that address noneconomic stock increases resulting from the recognition of either built-in gain or built-in income; there is no sound rationale for treating built-in gains recognized through asset dispositions differently than built-in income recognized through economic wasting or consumption. We are now convinced, however, that dealing with wasting assets through presumptions estimating the amount of built-in income that they generate over time would be difficult to administer in the context of stock loss regulations, and that the disadvantages of this approach outweigh its advantages. As an initial matter, implementing such a proposal would likely involve valuation uncertainties – that is, extrapolating values of individual assets from the price paid for, or valuations of, subsidiary stock. Moreover, the complexities involved in the context of stock loss rules are compounded by the potential for numerous redetermination events requiring new computations. In our view, these difficulties are more significant here than in other contexts where multiple redetermination dates are less likely (e.g., successive ownership changes in the Section 382 context).

The Proposed Stock Loss Regulations use a broader-based presumption to address income from wasting assets – the NPA. This presumption is at once over- and under-inclusive, essentially assuming that all items of income, gain, deduction, and loss are noneconomic. Over time, one would expect the NPA to favor the government as it reflects more and more post-acquisition items. Nevertheless, we support this approach as

[75] The government has applied similar conventions in other areas of the tax law to which the recognition of built-in income is relevant. *See, e.g.,* Notice 2003-65, 2003-2 C.B. 747 (following an ownership change, generally treating as recognized built-in gain pursuant to Section 382(h)(6) the excess of (1) hypothetical depreciation assuming a Section 338 election had been made over (2) actual depreciation).

a reasonable simplification. We believe that the Proposed Stock Loss Regulations strike a reasonable balance by permitting netting of income and losses not only within a taxable year, as permitted under the 1991 Final LDR, but also across years. Our support for the NPA is consistent with both the Peaslee Letter and the 2003 Report. Moreover, the extent of the over-inclusiveness is balanced by the existence of the Disconformity Amount as a cap on basis reduction. On the whole, we conclude that the NPA strikes a reasonable balance.

D. Addressing Loss Duplication (Internal and External) on a Systemic Basis

Another complex issue raised by the Proposed Stock Loss Regulations is whether the government should attempt to address loss duplication comprehensively or limit its efforts to the promulgation of anti-abuse rules. In the 2003 Report, we supported the objective of limiting the opportunities for members of a consolidated group to take more than one deduction or loss for a single economic loss, but viewed the problem principally as one of abuse, at least in the near term. In particular, our views were influenced by the necessity of issuing interim guidance on an accelerated basis, and we were concerned that a hurried attempt to craft a systemic approach would not properly address a number of issues and factors requiring additional study.

We believe that the government has a legitimate interest in addressing loss duplication on a systemic basis. The need for rules addressing loss duplication is compelling where there is internal loss duplication (i.e., two losses or deductions by the consolidated group for a single economic loss). There can be little justification for allowing this result. While anti-abuse rules may sufficiently address internal duplication in a number of contexts, we support a more comprehensive approach through presumptive rules. The burden imposed by a well-structured presumptive regime is

reasonable given the nature of the potential abuse and the fact that internal duplication arises only where less than all of a subsidiary's stock is disposed of, which is less frequent than a complete termination of the group's interest in a subsidiary.

The need for, or propriety of, systemic consolidated return rules addressing external loss duplication (i.e., the recognition of stock loss by a consolidated group and a corresponding asset loss by another taxpayer including a former member of the group) is less clear. The Code already contains certain limitations on the ability of taxpayers to engage in external loss duplication. For example, in certain circumstances, Section 382 may deter transactions undertake for the purpose of duplicating losses and otherwise limit the benefits of loss duplication, at least on a present value basis. Further, the basis reduction rules of Section 362(e)(2) are an additional deterrent to tax-motivated or duplication-generating transactions. Moreover, the system inherently duplicates gains and losses in stock and assets, and the phenomenon is not limited to consolidated return filers.

Nonetheless, we believe, on balance, that the government has made the more persuasive case for addressing external loss duplication. First, existing protections, such as Section 382 and Section 362(e)(2), may not provide a sufficient limitation on loss duplication. Section 382 applies limits, but does not necessarily disallow, loss duplication because the buyer is permitted to use pre-change losses to the extent of the Section 382 limitation. In certain circumstances, the limitation may be sufficiently large so as not to be a practical impediment to loss duplication. With respect to built-in losses inherent in a subsidiary's assets when it is sold, Section 382 applies for only a limited period of time (i.e., the five-year recognition period under Section 382(h)). Section

362(e)(2) evidences Congressional concern with loss duplication and it does limit stuffing opportunities. But it does not address loss duplication that arises more "organically" (e.g., through depreciation in asset values after assets are contributed to a subsidiary or cash is contributed to fund the acquisition of the assets). Neither of these rules is thus a comprehensive solution to loss duplication.

Second, it seems fair for the government to proceed on the assumption that taxpayers will often employ self-help (i.e., actual or deemed asset sales) to avoid or minimize gain duplication. On the other hand, it can be expected that taxpayers ordinarily will sell stock without a Section 338 election where opportunities exist for loss duplication.

Third, we recognize that addressing loss duplication on a systemic basis is a necessary backstop to the Basis Reduction Rule, as it is constructed in the Proposed Stock Loss Regulations. As described below, the Disconformity Amount is under-inclusive where built-in losses reduce disconformity and recognition of built-in gains is not matched by recognition of built-in losses. The Attribute Reduction Rule, while not a perfect solution, at least requires a reduction in the asset basis received by the buyer in these circumstances (as discussed further below).

Finally, we recognize that Congress in the legislative history to the American Jobs Creation Act of 2004 stated specifically that the legislation would allow the Treasury to adopt the various approaches it had stated it was considering in the loss disallowance context, including the adjustment of inside attributes when a subsidiary leaves a group.[76]

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[76] *See* 2005 Blue Book at 415.

In short, while we have certain suggestions described in more detail below, we generally support the government's attempt to address loss duplication on a systemic basis.

E. Gain Duplication

The Proposed Stock Loss Regulations do not address gain duplication (i.e., the recognition of gain on the disposition of subsidiary stock by a consolidated group that is replicated in unrealized appreciation in the subsidiary's assets). The Preamble suggests that the government has tentatively concluded that "adequate protections, and the incentive to use them, already exist to prevent the duplication of gain. See TD 8294, TD 8364 and TD 8984. For example, see sections 332, 336(e) (which is the subject of another current guidance project), and 338(h)(10)."[77] According to the Preamble, the government is continuing to study the issue of gain duplication.

We think that, as a general matter, the Preamble understates the frequency and extent to which gain duplication occurs in the system and over-estimates the efficacy of the self-help mechanisms available to taxpayers. As an initial matter, no regulations have been promulgated under Section 336(e), and it is not clear whether taxpayers may avail themselves of this provision in the absence of enabling regulations. More important, it is relatively common to have a gain subsidiary with respect to which there is an "outside-inside" basis disparity (outside stock basis in the subsidiary is less than the stock's value, but significantly higher than net inside basis in the subsidiary's assets). This kind of basis disparity often is caused by the fact that the subsidiary was purchased at a premium and continued to appreciate after its acquisition. In such circumstances, self-help

[77] See Preamble, para. D.3.

mechanisms, such as a Section 338(h)(10), may be relatively unattractive; they typically would impose a level of taxation on the seller which is unattractive. Moreover, the consistency rule of Treas. Reg. § 1.338-8 and general step transaction principles may make bifurcated acquisition structures (part assets, part stock) unattractive or unavailing. While these issues may be avoided with sufficient planning and forethought, it happens quite frequently that the situation does not receive attention until it is too late (e.g., self-help would be negated because it would occur within the consistency period under Treas. Reg. § 1.338-8). As a result, gain may be duplicated in the system when the stock of the subsidiary is sold at a gain.

It remains a difficult question whether systemic balance would be better achieved by adding an additional mechanism for taxpayers to avoid or minimize gain duplication. Differing views exist as to whether the addition of such a mechanism would create imbalance or a better balance.

Under one view, the Proposed Stock Loss Regulations are already balanced in that any failure to prevent gain duplication, as well as the disallowance of real economic loss in some situations, is offset by under-inclusivity in the rules in allowing noneconomic stock losses in some situations and allowing noneconomic basis increases to shelter economic gain on stock sales. In particular, under this view, it would be unduly pro-taxpayer for the regulations to continue to allow such sheltering of economic income on the gain side, and at the same time reduce gain duplication. An alternative view posits that the regulation is over-inclusive on the loss side by disallowing too many real economic losses, and the proper way to achieve a "fair and balanced" result in the system is by comprehensively addressing gain duplication. Moreover, under this view, the fact

that the regulation allows the sheltering of some economic post-acquisition gains with noneconomic stock basis does not undercut the argument that the duplication of true economic gain is improper and should be reduced.

This report does not reach a conclusion as to whether gain duplication should be systematically addressed. Instead, it discusses (in part VIII below) a methodology for how such a rule addressing gain duplication might be structured.

F. Complexity/Precision Versus Simplicity/Ease of Administration

A major consideration in developing fair and workable rules governing the elimination of noneconomic stock loss and loss duplication is balancing the desire to achieve accuracy with the imperative of making any rules administrable given the complexity of real world scenarios. We understand and appreciate that this is a difficult balance to strike. Nevertheless, we believe that the balance inherent in the Proposed Stock Loss Regulations could be improved significantly.

As discussed above, the government's rejection of tracing in favor of a presumptive regime seems compelled by administrability concerns. Moreover, on an overall basis, the presumptions chosen by the government seem to us not to tilt too far in one direction.

There are a few areas where we question the results reached under the Proposed Stock Loss Regulations. Our biggest concern with the Proposed Stock Loss Regulations, however, lies not in the belief that they are not sufficiently precise, but rather that in certain contexts they demand a precision through the application of rules that likely will be quite difficult to achieve in practice. For example, the rules governing the application of Section 362(e)(2) seem inconsistent with the general rejection of tracing methodologies and unnecessarily complex. In addition, application of the Basis

Reduction and Attribute Reduction Rules to corporate structures involving tiers of subsidiaries are extremely complex, and result in complexity and precision at the expense of administrability. As an initial matter, these rules are very complicated, and complex legal provisions can themselves lead to misapplication of the rules. Moreover, while it can be argued that these rules require that the taxpayer use data that it is already supposed to have (e.g., stock basis in all of its subsidiaries), in reality few taxpayers are likely to have detailed stock basis calculations (or ready ability to produce the data necessary for accurate calculations) for the many tiers of companies in their corporate groups. We believe that the government needs to understand and appreciate that taxpayers, as a practical matter, are far more likely to maintain complete and reliable records relating to asset basis than to stock basis. Accordingly, as described below, we believe that the government should consider certain simplifying conventions, even at the cost of some greater imprecision.

G. Overall Conclusion

On the whole, the Proposed Stock Loss Regulations achieve a reasonable systemic balance and, with certain modifications described below, represent a significant improvement over current law. In addition, we think that finalizing the regulations without a major change in their conceptual framework makes fundamental sense at this time because it would promote stability and certainty in an area where confusion and instability have been the hallmarks since the late 1980's.

IV. SPECIFIC COMMENTS ON THE BASIS REDETERMINATION RULE – PROP. TREAS. REG. § 1.1502-36(b)

On balance, we support the government's imposition of the Basis Redetermination Rule as a reasonable response to the interaction between disparate stock

bases and the allocation of stock basis adjustments under the presumptive regime of Treas. Reg. § 1.1502-32. After explaining our reasons for our support, we consider certain alternatives or modifications to the rule.

A. Conceptual Underpinnings

On a conceptual level, the Basis Redetermination Rule addresses real problems created by the allocation of basis adjustments under Treas. Reg. § 1.1502-32. In the Preamble, the government makes a persuasive case that the interaction between disparate stock bases and the allocation of stock basis adjustments creates the potential for loss duplication where recognition of the asset loss (i.e., the "inside loss") precedes the recognition of stock loss (i.e., the "outside loss").[78] This form of loss duplication would not be otherwise addressed solely by relying on the Basis Reduction or Attribute Reduction Rules (provided that the asset loss is utilized by the group prior to the recognition of the stock loss).

As the government also demonstrates, the interaction between disparate stock bases and the allocation of stock basis adjustments also can generate loss duplication where the outside loss precedes the inside loss but the subsidiary remains in the group.[79] While it can be argued that this problem could be handled by the Attribute Reduction Rule alone, it seems reasonable for the government to apply stronger medicine. Relying only on the Attribute Reduction Rule would not be an adequate response to this form of duplication in the sense that it may have the effect of reducing the basis of a long-lived asset. In such case, the net effect of such reliance would be to allow a substantial benefit on a present value basis in the form of the current recognition of stock loss at the cost of a

[78] *See* Preamble, Example 5(a).

[79] *See* Preamble, Example 4.

reduction of future asset basis recovery even though the underlying asset has remained in the group.

It is also true, as demonstrated in the Preamble, that the interaction between disparate stock bases and the allocation of stock basis adjustments can result in noneconomic stock loss.[80] This problem potentially could be addressed by the Basis Reduction Rule, but the Basis Redetermination Rule is at worst redundant in these circumstances.

On the whole, we conclude that the Basis Redetermination Rule is appropriately aimed at problems that merit a regulatory response.

B. Mechanics

Turning to the mechanics of the Basis Redetermination Rule, we have two fundamental criticisms. Our first criticism is that the rule is based on an over-inclusive presumption about the origin of the positive and negative basis adjustments that it seeks to shift. In effect, the Basis Redetermination Rule assumes that (i) all prior positive basis adjustments to the transferred loss share are attributable to recognized built-in gain or income already reflected in the transferred share's basis, and (ii) all prior negative basis adjustments to other shares are attributable to recognized built-in losses or deductions already reflected in the transferred share's basis. Obviously, this will not be the case as an economic matter in many cases. It can be argued that, as a result, the Basis Redetermination Rule replaces one set of inaccurate presumptions with another, thereby seriously undercutting the rationale for the rule. If the mechanics of the Basis Redetermination Rule also leads to arbitrary and noneconomic results as a consequence,

[80] *See* Preamble, Example 5(b).

does it make sense to impose a whole new and admittedly complex system of allocating basis adjustments?[81]

Nevertheless, this degree of imprecision is inherent in a presumptive regime, and we are persuaded by the lack of credible alternatives. As discussed above, a tracing regime for determining the origin of prior basis adjustments is fundamentally unadministrable (i.e., distinguishing between basis adjustments that are attributable to built-in items and post-acquisition items). Moreover, we support limiting basis redeterminations to prior basis adjustments, as does the Basis Redetermination Rule. In this sense, the Basis Redetermination Rule represents a significant improvement over Treas. Reg. § 1.1502-35. In contrast to the Basis Redetermination Rule, Treas. Reg. § 1.1502-35 requires (or allows) a broader form of basis shifting – that is, in promoting basis leveling, the regulation requires in certain circumstances shifting basis attributable to actual capital investment taken into account under Section 358 or cost basis applicable under Section 1012. As discussed further below, this broader basis shifting has greater potential in our view for doing damage or facilitating mischief.

A second criticism is that the application of the Basis Redetermination Rule is likely to prove quite complicated in practice. Where applicable, it essentially requires that, upon transfer of a loss share, the group undertake a study to determine the history of positive and negative basis adjustments made with respect to all of the subsidiary's shares, the basis of each block of the subsidiary's stock, and the relationship of value to basis for each such block. Although it is true that group's are supposed to know, or be

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[81] Certain commentators made a similar criticism of the basis shifting rules of Prop. Treas. Reg. § 1.1502-35. *See* Comments on Consolidated Group Basis Redetermination and Loss Suspension (REG-1314478-02), American Bar Association, Tax Section (February 20, 2003), *reprinted at* 2003 TNT 36-61 (the "2003 ABA Report").

able to determine, such information (except for values) from data on the group's tax return, in our experience, group's rarely have, or have ready access to, such information in a format that would make the necessary calculations easy or accurate. For example, determining the tax basis of different blocks of stock may require groups to disentangle extensive webs of intercompany accounts created through internal accounting systems. Stock basis studies often are time-consuming, expensive, and, in certain cases, imprecise (e.g., because of intercompany dealings that may be accounted for inconsistently or may be insufficiently documented). Therefore, it likely will be challenging for many taxpayers to comply fully with the rules of Prop. Treas. Reg. § 1.1502-36(b).

Practical difficulties will be mitigated to a significant extent by virtue of the exemption from the Basis Redetermination Rule for transfers where the group disposes of all of the subsidiary's in one or more fully taxable transfers within the same taxable year. Since most subsidiaries are disposed of in this manner, it is expected that the Basis Redetermination Rule will operate in only a minority of cases.[82] Nevertheless, where applicable, complying with the Basis Redetermination Rule is likely to involve a fair degree of complication, effort, and expense.

C. Possible Election To Defer Excess Basis Recovery

In light of the complexity involved in applying the Basis Redetermination Rule in all of its aspects, we believe that the government should explore the possibility of giving taxpayers a mechanism to defer their recovery of stock basis in excess of value. In effect, taxpayers would be permitted to defer their recovery of excess basis with respect to a transferred loss share until all of the subsidiary's stock is disposed of or the subsidiary is

[82] Consideration could be given to extending this exemption to situations in which all of the subsidiaries shares are disposed of within one year even if this period extends over two taxable years.

deconsolidated. In particular, consideration should be given to allowing taxpayers to elect to reallocate any basis in excess of the value of the loss share(s) transferred to the retained shares on a pro rata basis (as opposed to a methodology that levels basis of non-transferred shares, requiring taxpayers to know the disparity between each share's basis and value). This would permit taxpayers to determine stock basis only with enough precision to identify the transferred shares as loss shares so that, under the election, the taxpayer would regard the shares as having a fair market value basis (i.e., no loss would be recognized on the transfer of the subject stock). Only when the remaining shares are disposed of (or enough shares to deconsolidate the member are transferred, or the taxpayer chooses not to make the election on a subsequent disposition) would the taxpayer be required to undertake a comprehensive stock basis study and potentially apply the Basis Redetermination Rule in its entirety.

The specifics of such an election would require significant analysis to ensure that achieving the goal of simplification does not create imbalance in the basis redetermination system or, indeed, end up creating additional complexities. Among the factors one would have to consider is whether the excess, shifted basis determination is simply quantitative in nature (i.e., a specific amount of basis that shifts without regard to how that basis came about) or also has a qualitative aspect. For instance, under the latter approach, the amount of basis eligible for shifting could be limited to prior positive investment adjustments on the transferred loss share (provided the removal of prior positive adjustments from the transferred loss shares would be sufficient to eliminate loss on the shares). Under a more expansive alternative, negative investment adjustments on non-transferred shares also could be shifted. Under either alternative, a simplifying

assumption would be used to identify which basis adjustments were shifted (e.g., first-in-first-out).

The effects achieved under the election would differ from the results reached under the proposed Basis Redetermination Rule in at least three ways. First, under the election, no loss would be recognized on the transferred loss share even in circumstances in which the basis of such shares would have exceeded its value following the basis leveling required under the proposed Attribute Reduction Rule. Second, the election avoids the need to identify all prior negative and positive adjustments, as well as the basis and value of all non-transferred shares; any basis that is shifted would be allocated to other shares on a pro rata basis. Third, the election avoids the complexity of applying the Basis Reduction and the Attribute Reduction Rules to the transferred loss share. If all of the non-transferred shares were later sold in a single transaction, the Basis Redetermination Rule would not apply at that time, though the Basis Reduction and Attribute Reduction Rules potentially would come into play.

If basis not attributable to the adjustments made under Treas. Reg. § 1.1502-32 (e.g., Section 358 basis resulting from capital contributions, or cost basis under Section 1012) is permitted to be shifted under the election, then to some extent the election clearly would go beyond shifting basis attributable only to noneconomic basis adjustments. In our view, this would open the door to abuse for the same reasons that concern us with respect to the shifting of such basis under current Treas. Reg. § 1.1502-35. Moreover, the shifting of such basis might require more elaborate tracing mechanisms to determine whether certain attributes should attach to the shifted basis. For example, do attributes of the stock in question (such as holding period, Section 382

or SRLY limitations, underlying E&P attributable to the share, etc.) shift to the benefited member, and how is any "special status" of the benefited member taken into account?[83]

Another problem could be the affirmative use of the election to shift noneconomic basis that would otherwise be reduced under the Basis Reduction Rule to a gain share, where the shifted basis could offset post-acquisition appreciation. However, this result seems consistent with the netting of gain and loss shares sanctioned by Prop. Treas. Reg. § 1.1502-36(c)(7).

D. Other Basis Leveling Alternatives

As described above, the Basis Redetermination Rule of Prop. Treas. Reg. § 1.1502-36(b) operates to shift the effects of investment adjustments from some shares to other shares, with a general goal of reducing the disparity in basis that may exist between various shares. It is believed that the government is considering a "basis leveling" rule as an alternative to the Basis Redetermination Rule. While no operational particulars of this approach have been disclosed, there are various possibilities, some of which are considered below.

In its simplest form, the regulations could require that all shares of the same class (or with similar economic entitlements) of a subsidiary's stock held by any group member have the same (or uniform) basis. Another possibility would be to provide that all such shares held by a single member have the same (or uniform basis).[84]

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[83] It is true that these issues exist with respect to shifting prior basis adjustments under the Basis Redetermination Rule; however, given that the assumption underlying this form of basis shifting is that the original allocation of the prior basis adjustments was uneconomic, these issues do not seem as problematic in this context.

[84] A third possibility would be to have the investment adjustment system operate to reduce basis disparity among shares of the same class of member stock. Thus, this proposal could include within the general operating rules of Treas. Reg. § 1.1502-32 a rule similar to that of current Treas. Reg. §§ 1.1502-19(d) and -32(c)(2)(i). Under Treas. Reg. §§1.1502-19(d) and -32(c)(2)(i), if one member owns multiple blocks of

We do not support adopting a broad basis-leveling rule requiring that all members of a consolidated group take a uniform basis in shares of the same class (or with similar economic entitlements) of a subsidiary's stock. First, we note that such a rule is not compelled by single entity principles. Indeed, the Section 1012 and the regulations thereunder contemplate that a single shareholder can have multiple blocks of stock, each with a different basis and holding period, and that such a shareholder may specifically identify which shares are disposed.[85] Second, we think that any regime would likely give rise to considerable complexity in defining the class or classes of stock to which it applied. It would be distortive to apply the rule to classes with materially different economic entitlements (e.g., preferred and common stock), but if minor differences in entitlements voided the application of the basis leveling rule, it could be easily avoided. It can be expected that there would be practical difficulties in determining when the rights of different classes of shares are sufficiently different so as to be outside of the basis leveling rule. Third, any basis shifting mechanism necessarily raises ancillary concerns and complexities (e.g., do attributes of the stock in question, such as holding period, Section 382 or SRLY limitations, underlying E&P attributable to the share, etc., shift to the benefited member, and how is any "special status" of the benefited member taken into account regarding this windfall). Fourth, a broad group-wide basis shifting rule, especially one that permits shifting basis that represents economic investment created or recognized under Section 358 or 1012, creates the potential for abuse. For example, the 2003 ABA Report demonstrated how the basis shifting rules of Prop. Treas. Reg. §

stock of the same class in another member, and one of those blocks has an excess loss account, investment adjustments made with respect to that stock class are not made in the usual way (i.e., equally across all shares within the class) but rather are made in such as way as first to eliminate (or to reduce an increase in) the excess loss account.

[85] *See* Treas. Reg. § 1.1012-1(c).

1.1502-35 could create opportunities to achieve "mirror subsidiary"-like results. In response to these comments, the government was forced to add an anti-abuse rule when it promulgated Treas. Reg. § 1.1502-35T, thereby further complicating the regime.[86]

If the basis leveling rule were implemented only on a member-by-member basis, some of the complexity or abuse potential of the broader group-wide approach discussed above would be ameliorated. However, a considerable degree of complexity would remain. For example, it would still be necessary to define the nature of the classes of S stock that would be subject to basis leveling. Otherwise, basis leveling across classes of stock with different economic characteristics likely would lead to distortions. Moreover, the treatment of attributes (e.g., holding period) associated with shifted basis would still be in play.

Most important, because more than one member of the group may own S shares with disparate bases, a member-by-member basis leveling rule would be easily avoided and the Basis Redetermination Rule would be needed to police disparate bases held by different members.

> *Example – noneconomic loss on member-by-member basis leveling*. M forms S by contributing an asset, A1, to S in exchange for all 80 outstanding shares of S stock. The basis of A1 is $40 and its value is $80. P, another member, contributes a second asset, A2, to S in exchange for 20 shares of S stock. A2 has a basis of $0 and a value of $20. S sells both assets and recognizes a $60 gain that is taken into account by the M group. As a result, M's basis in its shares increases by $48, from $40 to $88, and P's basis in its shares increases by $12, from $0 to $12. M then sells 20 of its S shares for $20, their fair market value, and recognizes a $2 loss. So, simply by having P, rather than M, obtain the second block of S stock, the member-by-member basis leveling rule would be rendered ineffective.

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[86] *See* Treas. Reg. § 1.1502-35(g)(4).

While this end run around a basis leveling regime necessitates more complicated capital structures, there would be a strong incentive for taxpayer to employ such structures to access or create stock. Moreover, as there may be significant periods of time between (and sound business reasons for) investment in a subsidiary by two or more other members, the creation of uneconomic or duplicative stock loss through split ownership and disparate bases may be difficult to address through an anti-abuse rule alone. In practice, therefore, a member-by-member basis leveling rule is likely to entail significant complexity and be subject to abuse unless coupled with the Basis Redetermination Rule.

Accordingly, we do not support adopting a member-by-member basis leveling rule as an alternative to the Basis Redetermination Rule in all but the simplest cases. As a simplification measure, a basis leveling rule could be made available to taxpayers in circumstances where the subsidiary has a single class of stock outstanding and all outstanding shares are held by a single member.

V. SPECIFIC COMMENTS ON THE BASIS REDUCTION RULE – PROP. TREAS. REG. § 1.1502-36(c)

We believe that the Basis Reduction Rule, in the context of an overall regulation that includes the Attribute Reduction Rule, reaches an appropriate, if imperfect, systemic balance and provides much needed clarity in an area plagued by uncertainty for a long time.

In our view, the presumptions used in the Basis Reduction Rule are mildly (though not uniformly) pro-government. In addition, the Basis Reduction Rule is pro-taxpayer in that it only reduces stock losses, thus allowing uneconomic basis increases to reduce taxable gain. We believe that these overall results are acceptable on balance.

More specifically, on the one hand, the Basis Reduction Rule hurts taxpayers by assuming that all net positive investment adjustments are attributable to noneconomic gain or income. Without any time limitation (i.e., sunset) on the NPA, this presumption is likely to favor the government. On the other hand, the investment adjustment formula may help taxpayers by allowing S's post-acquisition recognized built-in income or gain to be sheltered by S's post-acquisition losses or deductions that economically arose after M acquired S. Similarly, the Disconformity Amount may operate to favor taxpayers. As noted in the Preamble, the Disconformity Amount result is under-inclusive to the extent that built-in losses reduce disconformity but are not recognized while built-in gains are recognized. Ultimately, the government determined that such under-inclusivity was tolerable in light of the fact that such situations typically will bring into play the Attribute Reduction Rule. Accordingly, the government concluded that "combining the disconformity cap with a loss duplication rule to address under-inclusivity provides the most appropriate balancing of interests."[87] However, the ability to use noneconomic positive basis adjustments to create noneconomic stock loss at the cost of reduction in the basis of assets may be a trade-off some taxpayers readily may be willing to accept (especially if the reduction occurs with respect to long-lived assets or Section 382-limited losses). Accordingly, we believe that the anti-abuse rule of Prop. Treas. Reg. § 1.1502-36(g) and a supplemental anti-duplication rule that operates in circumstances governed by Section 362(e)(2) are a necessary part of the balance.

Our principal concern with the Basis Reduction Rule is that its application is likely to be very complicated in practice, at least in certain circumstances. In particular,

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[87] Preamble, para. C.4.vi.

as described more fully below, we are concerned about the difficulty of applying the Disconformity Amount in the context of multi-tiered corporate structures.

A. NPA

As an initial matter, we support the elimination of the gross gain factor in Notice 2004-58. This factor is a remnant of the focus of Treas. Reg. § 1.337(d)-2 on asset dispositions. Consistent with our view that regulations should address built-in income items generated by wasting assets, and with the replacement of that regulation by the Proposed Stock Loss Regulations, the gross gain factor would be distortive.

As in the 2003 Report, we continue to support allowing taxpayers to net positive and negative adjustments across all post-acquisition tax years, not just within a single tax year as was permitted under the 1991 Final LDR. On balance, we think that netting across all tax years yields a more balanced result because it is unrealistic to assume that a positive adjustment in one year is attributable solely to recognized built-in gain or income, while a negative adjustment in another year is attributable solely to post-acquisition losses or deductions. Of course, any presumptive factor, including the NPA, is likely to be over- or under-inclusive in any given case, but on the whole we feel that netting across years yields a better measure.

The Preamble indicates that the government considered but rejected certain additional limitations that could have been employed to mitigate over-inclusiveness. A couple of these limitations were supported by the Tax Section in the 2003 Report. In particular, the 2003 Report supported a five-year sunset for the NPA and an exclusion for "after-acquired" assets. We are now convinced that the government has made a persuasive case for the proposition that applying these limitations would be unadministrable (reintroducing tracing) and would tend to create imbalance.

Any sunset would be difficult to administer because of the potential for numerous redetermination events. The sunset would have to be tolled where such events occur (e.g., the subsidiary acquires the stock of a lower tier subsidiary without making an election under Section 338), or there would have to be different sunsets for different income streams. Moreover, the sunset likely would have to be policed by an anti-abuse rule to prevent taxpayers from simply deferring their recognition of built-in gains until after the sunset date.

An exception for "after-acquired" assets also would difficult to administer because of redetermination events. Excluding after acquired assets from the calculation of the NPA would have the effect of adding a "tracing" element to the analysis. To avoid under-inclusiveness, a balanced exception would require that taxpayers exclude from the NPA "after-acquired" gain and loss assets, thereby increasing the scope of items that would have to be traced. For example, depreciation and amortization deductions on such assets, and gain or loss on the sale of such assets, would have to be excluded from the system. In addition, given the frequency with which redetermination events occur, this would be administratively burdensome. Following a redetermination event, an additional determination of what assets are "after-acquired" would have to be made.

At least one stream of income and loss or deductions, in our view, raises particularly difficult questions about whether it should be excluded from the NPA: items associated with intercompany debt, such as interest deductions, interest income, and

income and loss created by operation of the deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3)(ii).[88]

In general, the funding of subsidiary operations through intercompany debt, as opposed to equity, is often driven by considerations other than federal income taxes (e.g., state tax planning). For many groups, the creation of intercompany debt is simply automatic under their internal accounting systems, often memorialized only through book entries, and essentially is just a record of intercompany capital flows and expense allocations. In addition, interest income and expense substitute readily for contributions and distributions and may have little or no significance to third parties.

Though there are exceptions, one would expect that intercompany debt generally will not give rise to items of built-in income or deductions. For example, to the extent that intercompany debt is created as a mechanism to "push down" to a subsidiary the cost of its acquisition, or to fund the subsidiary's post-acquisition operations and capital expenditures, items subsequently generated by the intercompany debt generally would not already be reflected in the cost basis of the subsidiary's shares.[89]

Given the frequent similarity in the corporate finance roles played by intercompany debt and equity, and the observation that intercompany debt generally does

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[88] As currently defined, the NPA appears to include positive and negative adjustments for a subsidiary's share of the group's federal income tax liability, its benefit from the utilization of the tax attributes of another member, and the benefit of the use of its tax attributes by another member. *See* Treas. Reg. § 1.1502-32(b)(3)(iv). As a conceptual matter, it is difficult to assess the propriety of treating federal income taxes as built-in items because it is difficult to determine whether and to what extent buyers and sellers factor into pricing decisions the deferred tax liability or benefit associated with built-in gain or loss assets. On balance, in the context of a broad presumption such as the NPA, taking such tax liabilities and benefits into account seems appropriate.

[89] As one example in which intercompany debt could generate built-in items, S may hold an intercompany receivable that is appreciated relative to its basis at the time that a member (M) makes a capital investment in S in exchange for newly issued shares. The inherent gain in the receivable is built-in gain vis-à-vis the newly issued shares, just as inherent gain in any other asset held by S at the time is built-in gain. To the extent that built-in items subsequently generated by the intercompany debt are misallocated under Treas. Reg. § 1.1502-32, one would expect the Basis Redetermination Rule to address the problem adequately.

not generate built-in items, one is tempted to exclude items generated by intercompany debt in calculating NPA. Indeed, such an exclusion would have the virtue, at least in certain circumstances, of preventing cancellation of debt income created under the deemed satisfaction rule of Treas. Reg. § 1.1502-13(g)(3) from giving rise to a large positive investment adjustment that distorts NPA and results in the effective disallowance of economic loss:

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

While the exclusion of items related to intercompany debt from the NPA determination would reintroduce an element of tracing, it could be argued that such items are segregable and their identification does not involve the practical difficulties of, say, tracking after-acquired assets.

Nevertheless, the exclusion of all items associated with intercompany debt from the NPA would create imbalance since the NPA already includes all post-acquisition items (whether or not built-in). For example, if S's intercompany debt arises from a borrowing of cash, the cash will either directly generate a deduction or else create asset basis that will result in a deduction if the asset is sold or depreciated. In those cases, the resulting deduction will offset S's COD income and prevent the creation (or reduce the

amount) of an NPA. As a result, excluding COD income associated with such debt from the NPA would fail to match associated streams of income and deduction and thus understate the proper measurement of NPA. For example, suppose M acquires S's stock for $40 and S has an asset with a value of $40 and a basis of zero. M then loans S $60 for a note, and S buys a second asset. Both assets than decline in value to zero and are abandoned. S will have $60 of loss on the second asset and $60 of COD income, M will have no NPA, M will have a loss of $60 on the note, and (without any special rule for the COD income) M will have a loss of $100 on its S stock that is allowed because there is no NPA.

Accordingly, we believe that, in lieu of a general exclusion of items from intercompany debt from the NPA, final regulations should include a rule targeted at COD income or bond redemption premium from intercompany debt where debt did not give rise to a deduction or create asset basis. The rule would exclude from the NPA calculation COD income or bond redemption premium from intercompany debt the incurrence of which (i) did not itself create an item of deduction or asset basis taken into account in the determining NPA, and (ii) resulted in a reduction in stock basis.

B. Disconformity Factor

In general, we support the use of the Disconformity Amount essentially as a cap on basis reduction. We recognize that events subsequent to the acquisition of a share can change the relation between outside stock basis and net inside basis (e.g., the tax-free liquidation under Section 332 of an "after-acquired" subsidiary). In addition, we recognize that the existence of assets with both built-in gain and built-in loss can cause this factor to understate the amount of loss that should be disallowed. Nevertheless, the Disconformity Amount is a reasonable objective measure of the maximum amount of

recognized built-in gain or income reflected in stock basis, and, as discussed above, the attribute reduction rule provides a backstop for the government in the case of a subsidiary with built-in gain and loss assets. We believe that achieving greater precision likely would involve the difficulties associated with tracing, and that the Disconformity Factor is the most reasonable cap on basis reduction.

i. Under-Inclusivity

From a conceptual standpoint, the principal concern with the Disconformity Amount is its treatment of built-in loss items. As the Preamble illustrates, the Disconformity Amount potentially is under-inclusive where built-in losses reduce the disconformity amount even though the subsidiary has disproportionately recognized built-in gains as compared to built-in losses (or loss attributes remain unutilized because of limitations such as a Section 382 limitation).[90] In effect, the Proposed Stock Loss Regulations deal with this problem in two ways. In these circumstances, they require a reduction in attributes under the Attribute Reduction Rule as the unrealized built-in losses or unabsorbed losses should create loss duplication.

> *Example.* M acquires the stock of S for $100. S has two assets: A1 with a basis of $0 and a value of $100 and A2 with a basis of $100 and a value of $0. S sells A1 for $100 and recognizes a $100 gain. M's basis in the stock of S is increased to $200. M then sells the stock of S for $100. M's NPA is $100.[91] M's Disconformity Amount is zero because its basis in its S stock and S's net inside attribute amount (the sum of the $100 cash proceeds and the $100 basis in A2) are both $200. Thus, there is no basis reduction under the Basis Reduction Rule. However, S would be required to reduce its basis in A2 to $100 under the Attribute Reduction Rule.[92]

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[90] Preamble, para. C.4.v.

[91] For illustrative purposes, the effect of any basis adjustment under Treas. Reg. § 1.1502-32(b)(3)(iv)(D) in respect of federal income taxes is disregarded in this example.

[92] *See, also,* Prop. Treas. Reg. 1.502-36(c)(8), Example 8.

Thus, the Attribute Reduction Rule is an important backstop to the Disconformity Amount. However as described above, treating the under-inclusivity of the Disconformity Amount as a "problem of loss duplication" may create a trade-off that taxpayers readily will take: immediate allowance of noneconomic stock loss in exchange for reduction of basis or losses that would have generated little or no benefit, or perhaps would have generated a benefit over a relatively long period of time.

> *Example.* Assume the same facts as in the preceding example, except that, instead of owning A2, S has a net operating loss carryover of $100, which carryover is subject to a low Section 382 limitation from a prior ownership change. There is no reduction in stock basis under the Basis Reduction Rule and S is required to reduce its Section 382-limited loss carryover to zero under the Attribute Reduction Rule.

For this reason, we support the adoption of anti-abuse rules designed to limit opportunities for taxpayers to take advantage of the under-inclusivity of the Basis Disconformity Rule. Prop. Treas. Reg. § 1.1502-36(g) is important in this regard, essentially by preventing taxpayers from deliberately acquiring built-in losses or Section 382-limited losses for the purpose of manipulating the Disconformity Amount.[93] Section 362(e)(2), or some variation thereof, also may play a significant role in limiting opportunities for manipulation.[94]

Other, broader measures would appear to be unadministrable or arbitrary. For example, it seems unlikely that taxpayers or the government could determine an appropriate discount to be applied to unrealized built-in losses or unabsorbed recognized losses in calculating the Disconformity Amount. Valuations would be highly subjective and any assumed percentage discount would correspond with reality only by chance. We

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[93] *See, e.g.*, Prop. Treas. Reg. § 1.1502-36(g), Ex. 2.

[94] *See* part VII below for a further discussion of Section 362(e)(2).

believe that ease of administration outweighs precision and potential disagreements between taxpayers and the government, and accordingly that the gross amount of net operating losses and capital loss carryovers should be taken into account in the computation of S's net inside attributes rather than an estimate of what the value of realizable losses are after factoring in any applicable limitation. Although the anti-abuse rules are not a perfect solution to dealing with limited losses in the computation of the net inside attributes of S because of the subjectivity involved, they allow taxpayers to deal with the already complex rules in the Proposed Stock Loss Regulations in an efficient and timely manner, understanding that should the taxpayer act egregiously, the computation of the net inside attribute amount is subject to challenge by the government through the anti-abuse rules.

ii. Complexity

For many consolidated groups, S will be the "parent" of a subgroup of corporations all operating within the same business line of that consolidated group. The sale of the stock of S thus indirectly will result in the disposition of its direct or indirect subsidiaries, although their stock will not be transferred loss stock for purposes of the Proposed Stock Loss Regulations. In order for the Basis Reduction Rule to work properly at the S level, noneconomic basis down the chain has to be "wrung out" of the system (at least for purposes of calculating the Disconformity Amount). Otherwise, there would be no Disconformity Amount where noneconomic stock basis is duplicated through one or more tiers.[95]

[95] See the example in Part II.D.iii.b above.

The Proposed Stock Loss Regulations achieve this effect by requiring that S make "tentative" adjustments to the stock basis of those non-transferred subsidiaries for purposes of the Disconformity Amount.[96] In effect, S must apply the Basis Reduction Rule on a hypothetical basis to the stock of all of its subsidiaries. Where there are multiple tiers of non-transferred shares, the tentative adjustment is made at the lowest tier and then successively at the next highest tier until the taxpayer reaches S.[97] This rule effectively requires that the group calculate its basis in the stock and assets of each subsidiary that is directly or indirectly underneath S.[98]

In theory, taxpayers should have available the information necessary to readily make the calculations demanded by the tentative basis adjustment rule. In practice, this requirement is likely to impose a heavy compliance burden on groups with multi-tiered or complicated corporate structures. As described above, in our experience, stock basis calculations are likely to prove particularly problematic. Stock basis studies are complicated and costly. To determine stock basis, taxpayers often have to employ experts to engage in stock basis studies. As a result, taxpayers typically will do so only when tax liability is impacted by stock basis (e.g., when such stock is sold). Moreover, the rule appears to demand a level of precision that may be difficult to achieve given the inadequacy of intercompany accounting systems in many corporate groups and the difficulty of accessing data from older corporate records relating to historic subsidiaries (if such records still exist at all).

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[96] Prop. Treas. Reg. § 1.1502-36(c)(6)(i).

[97] Prop. Treas. Reg. § 1.1502-36(c)(6)(iii).

[98] Typically, a group would not have to calculate stock basis of lower tier subsidiaries with any precision; it simply will have to determine whether there is an ELA in the stock of any such subsidiary that would be recaptured upon the disposition of the group's S stock.

The complexity associated with the rules for tiers in the Basis Reduction Rule is compounded by the fact that, as discussed below, a different set of rules exists for applying the Attribute Reduction Rule in the same context. Thus, a group will calculate its net inside attribute amount under two different methods for purpose of the two rules.

We recommend that the government consider permitting a consolidated group to elect to determine the net inside attribute amount for purposes of the Basis Reduction Rule by treating S and its direct and indirect subsidiaries as a single entity, disregarding intercompany debt and stock within the subgroup. Treas. Reg. § 1.1502-91(g)(1) and (g)(2)(i) provide a model for making the calculation. Moreover, since taxpayers typically maintain a tax basis balance sheet (or information that allows them to create one with reasonable effort) consistent with their obligations under FASB Statement No. 109, *Accounting for Income Taxes*, taxpayers are much more likely to be able to determine the net inside attribute amount in this fashion with greater precision and without undue complexity or effort. In contrast to stock basis determinations, detailed asset basis information generally exists, such as in the form of fixed asset registers. For those companies that do not maintain tax basis balance sheets, they generally can estimate their tax basis balance sheet accurately and without undue burden by adjusting the GAAP basis balance sheet to take into account the subsidiaries' deferred income tax assets and liabilities.

On the whole, the election would tend to favor the government (as compared to the proposed Basis Reduction Rule) because the net inside attribute amount for a

subsidiary would tend to be lower than its outside stock basis.[99] However, the election might still be attractive to a group in order to achieve certainty of results and avoid costly basis studies. To reduce selectivity and the difficult of applying different tiering regimes under the Basis Reduction and Attribute Reduction Rules, the government could condition this election on the taxpayer making a similar election for purposes of determining the net inside attribute amount under the Attribute Reduction Rule (see discussion below).

VI. SPECIFIC COMMENTS ON THE ATTRIBUTE REDUCTION RULE – PROP. TREAS. REG. § 1.1502-36(d)

As discussed above, we support the adoption of a consolidated return rule broadly addressing loss duplication on the basis that such a rule (i) is consistent with underlying single entity principles, (ii) addresses a systemic imbalance in current law in which taxpayers generally can be expected to duplicate losses and minimize gain duplication, and (iii) is a necessary backstop to the Basis Reduction Rule. Moreover, in principle, consistent with our position in the Peaslee Letter, we believe that the Attribute Reduction Rule appropriately addresses external loss duplication by denying a duplicative asset loss to the buyer, rather than disallowing the initial stock loss of the seller.

Our principal objection to the Attribute Reduction Rule is rooted in its focus on determining whether there is greater duplication in lower-tier stock basis or asset basis. As described below, the rules adopted in the Proposed Stock Loss Regulations in this regard result in inappropriate results in some circumstances and a great deal of

[99] In a situation in which S's basis in a lower-tier subsidiary is less than the subsidiary's net inside attribute amount, the election would provide a benefit to the group. However, the same result presumably could be reached with proper foresight and planning; the group could simply liquidate the subsidiary under Section 332, thereby eliminating the lower outside stock basis from the disconformity calculation.

complexity in many cases. Our instinct is that, in a number of cases, the precision demanded by the Attribute Reduction Rule in its proposed form with respect to stock basis determinations is likely to prove unattainable. We believe that the Attribute Reduction Rule should be more tightly focused on duplication in lower-tier inside attributes, such as NOLs and asset basis. Our concerns, as well as our recommended modifications, are discussed below.

A. Tiering

In our discussion of the Basis Reduction Rule, we noted that S is often the parent of a subgroup of corporations and that such subgroups often are multi-tiered. The Attribute Reduction Rule contains a complex set of mechanics to address tiered structures, introducing a number of new concepts solely for the purpose of applying attribute reduction (e.g., "deemed basis", the "conforming limit rule" and the "basis restoration rule"). The overall thrust of these rules is to determine the existence and amount of loss duplication by reference to the greater of S's basis in the stock of each of its lower-tier subsidiaries and the net inside attribute amount of each such lower-tier subsidiary's assets. Where there are multiple tiers, analysis begins at the lowest tier and proceeds upward ("bottom up"). Once the attribute reduction amount is so determined, attribute reduction is applied first at the S level and then down the chain ("top down") in a manner reminiscent of, but using different rules than, the so-called "look-through" rule of Treas. Reg. § 1.1502-28(a)(3). In this way, the regulations are designed so that loss duplication can be eliminated whether it exists in the stock of a lower-tier subsidiary or in its assets, and attribute reduction can be appropriately directed to the lower-tier subsidiary where it resides.

As an initial matter, we note that in certain cases the Attribute Reduction Rule will not effectively prevent loss duplication, principally as a result of the interaction of the Basis Reduction Rule and the conforming limit rule. Under the conforming limit rule, S1's net inside attributes essentially cannot be reduced below S's basis in its S1 stock (determined after the basis in such stock has been reduced under the Attribute Reduction Rule). Because S's basis in its S1 stock may reflect noneconomic basis – the Basis Reduction Rule only reduces M's basis in its S stock and noneconomic basis may be replicated down a chain of subsidiaries -- the conforming limit rule may artificially preserve duplicative asset basis.

> Example. M forms S with $100 of cash. S has no other assets or operations. S acquires S1 stock for $100 and no Section 338 election is made with respect to such acquisition. S1 has one asset (A1) with a basis of $20 and a value of $100. S1 sells A1 for $100. M's basis in its S stock, and S's basis in its S1 stock, both increase by $80 to $180. S1 invests the $100 of proceeds in another asset (A2). A2 subsequently declines in value to $40. M sells the S stock for $40.
>
> Under the Basis Reduction Rule, M's basis in its S stock is reduced to $100. The amount of the reduction is the lesser of the NPA ($80) and the Disconformity Amount ($80). The Disconformity Amount is determined under the tiering rule of Prop. Treas. Reg. 1.1502-36(c)(6) to be $80 because S's basis in its S1 stock is tentatively reduced by $80 to $100 for purposes of calculating the Disconformity Amount. However, the tentative reduction does not apply for any other purpose, so that S's basis in its S1 stock is not reduced for purposes of the Attribute Reduction Rule. After application of the Basis Reduction Rule, M recognizes a $60 loss on the sale of its S stock.
>
> Under the Attribute Reduction Rule, S reduces its basis in its S1 stock by $60, which is the lesser of M's net stock loss ($60) and the aggregate inside loss ($140). After such reduction, S's basis in its S1 stock is $120. Under the conforming limit rule, S1 is not required to reduce the basis in its assets ($100) because S1's basis in its assets is less than S's basis in its S1 stock (even after applying the Attribute Reduction Rule at the S level). Therefore, M's $60 stock loss continues to be duplicated in both S's basis in its S1 stock and S1's basis in its assets.

As with the tiering rule for the Basis Reduction Rule, we also believe that the tiering rule for the Attribute Reduction Rule is very complicated and that the government should consider modifications to the tiering rule to make it more administrable, if somewhat less precise. A principal concern with the tiering rule for the Attribute Reduction Rule is that it requires that taxpayers know, or have the ability to readily and accurately determine, the stock basis of numerous subsidiaries that are in S's subgroup in a complicated corporate structure. It is true that such basis is supposed to be determinable from information that taxpayers are supposed to have or to generate in the course of preparing tax returns. However, in reality, we believe that the process of determining stock basis for many subsidiaries is likely to prove time-consuming and expensive. Moreover, given uncertainties created by intercompany accounting systems in practice, a tiering regime that relies on stock basis calculations to a substantial extent will be prone to error. Admittedly, some of the same complexities and uncertainties exist with respect to determining M's basis in its S stock. But requiring stock basis determinations with precision down the chain greatly adds complexity and uncertainty because (i) there may be numerous lower-tier subsidiaries, and (ii) determining stock basis of lower-tier subsidiaries requires sorting out the basis effects of intercompany relationships solely between members of S's subgroup, which effects would not have to be sorted out to determine M's basis in S. In addition, the complexity involved in applying the attribute reduction tiering rule will be multiplied by the requirement that the taxpayer must also apply a different set of tiering rules under the Basis Reduction Rule.

We believe that the goal of eliminating loss duplication can be achieved in a better, more administrable fashion by focusing on inside attributes, rather than

determining whether there is greater duplication in inside attributes of lower-tier subsidiaries or in the basis in their stock. Under this approach, the attribute reduction amount would be determined by reference to the net inside attribute amount for the S subgroup, determined by treating S and its direct and indirect subsidiaries as a single entity, disregarding intercompany debt and stock within the subgroup for this purpose.[100] Once the attribute reduction amount is so determined, inside attributes would be reduced using the allocation methodology described below, but again treating the S subgroup as a single entity.

Determining loss duplication through this methodology would avoid the result described in the preceding example. That is, S1 would be required to reduce its basis in its asset A2 by $60 to $40, thereby precluding duplication of M's stock loss in S1's asset basis. Moreover, a principal advantage of this tiering methodology is that it relies on data as to asset basis, rather than stock basis calculations, and in our experience asset basis data is likely to be more readily available and reliable.

> *Example.* M owns the sole outstanding share of S stock with a basis of $250 and a value of $50. M sells the S stock for $50 recognizing a loss of $200. S's only assets are a machine with a basis of $90 and shares of S1. S1 owns assets with a basis of $30 and shares of stock of S2. S2 owns assets with a basis of $30. Assume that S, S1, and S2 have no other attributes and have no debt.
>
> Attributes must be reduced by the lesser of "net stock loss" and "aggregate inside loss." The net stock loss is $200 since all of S's stock is transferred. The aggregate inside loss would be determined treating the S subgroup as a single entity and disregarding S's ownership of its S1 and S1's ownership of its S2 stock. The aggregate inside loss is $100 ($150 net inside attribute amount – the sum of the bases of the assets owned by S, S1, and S2 other than stock of another member -- less the $50 S stock value). Accordingly, the attribute reduction amount is $100 and the basis in the assets of the subgroup would be reduced under the methodology described below.

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[100] To a significant extent, the 1991 Final LDR determined loss duplication in this manner. *See* Treas. Reg. § 1.1502-20(c)(2)(iv).

It is less clear to us what should be the impact of the Attribute Reduction Rule on lower-tier stock basis. Several possibilities exist. First, any reduction of asset basis in a lower-tier subsidiary could be treated as noncapital, nondeductible expense for purposes of Treas. Reg. § 1.1502-32, requiring a reduction in the basis of lower-tier stock basis, but not the basis of M in its S stock (the "Tier-Up Rule"). Second, regulations could mandate that, at least in a deconsolidating transfer of S stock, stock basis of lower-tier subsidiaries would be conformed to their respective net inside attribute amounts following the attribute reduction allocation, if any (the "Mandatory Basis Conformity Rule"). Third, the alternative tiering regime described above (i.e., treating S and its subsidiaries as a single entity) could be made elective, but regulations could require lower-tier stock basis conformity (as described in the preceding sentence) if the alternative regime were elected (the "Elective Basis Conformity Rule").

The Tier-Up Rule would eliminate the most overt form of loss duplication where basis is duplicated in both stock and assets down the chain of subsidiaries. Moreover, it would not require the adoption of any new mechanics, as it would rely on existing rules in Treas. Reg. § 1.1502-32. However, it would permit duplication in lower-tier stock basis to be preserved where such duplication is not replicated in asset basis, including in circumstances where such stock basis is noneconomic, in whole or in part. The failure to wring out duplicative stock basis may position a buyer to take advantage of the under-inclusivity of the Disconformity Amount, described above. Moreover, preserving duplicative stock basis may be viewed as particularly troublesome in that the utilization of such basis by a buyer of S stock may not be subject to limitation under Section 382 because of the subgrouping rules of Treas. Reg. § 1.1502-91(g).

The Mandatory Conforming Basis Rule would address the shortcomings of the Tier-Up Rule in the sense that it would wring out of the system duplicative lower-tier stock basis in the hands of the buyer. This result would seem particularly appropriate to the extent that lower-tier stock basis is noneconomic. A potential downside of this approach is that basis in the stock of a lower-tier subsidiary may be reduced by an amount greater than is necessary to avoid loss duplication (i.e., where the net inside attribute of the lower-tier subsidiary is lower than the amount of stock basis that would remain applying the tiering rule in the Proposed Stock Loss Regulations). It can be argued that, in any event, the buyer has no entitlement to this stock basis and, accordingly, the result is justified. Nevertheless, such a result, at least when imposed on a mandatory basis, may be viewed as being too harsh.

In considering the Elective Conforming Basis Rule, we recognize that the existence of an alternative, elective regime could be viewed as adding complication because it adds another tiering regime to the one already in the Attribute Reduction Rule. On the one hand, it means that taxpayers, if they wish to determine which rule is most advantageous to them, would have to digest and apply two sets of rules. For its part, the Service would have to be prepared to apply either regime. On the other hand, the alternative does not require any additional data not required under the proposed version of the Attribute Reduction Rule. Moreover, the alternative rule reduces complexity in a transactional sense by giving taxpayers the ability to avoid the regime proposed in the current version of the regulations if they so choose and apply an alternative regime that is more likely to completed with a reasonable expenditure of time, effort, and cost. To reduce the complexity of having different tiering regimes under the Basis Reduction Rule

and the Attribute Reduction Rule, if the alternative is elected, taxpayers could be required to use the same tiering method for both rules.

We did not reach a consensus on proposing one of the three lower-tier stock basis rules discussed above. However, we believe that the adoption of each of these alternatives is preferable to adopting the tiering rule in the proposed Attribute Reduction Rule.

B. Allocation Methodology

We are also concerned that the attribute reduction amount ordering rules add complexity that may outweigh the benefits of precision. As described above in part III.C. above, the attribute reduction amount is applied first to reduce or eliminate NOL carryovers, capital loss carryovers, and deferred deductions, then reduce or eliminate the loss in the basis of publicly traded property to the extent of such loss, then reduce or eliminate the loss in the basis of other assets proportionately according to the basis in each property. Any excess attribute reduction amount has no further effect unless the subsidiary has a liability that has not been taken into account (i.e., a contingent deduction); if there are contingent liabilities, the excess attribute reduction amount is suspended and applied at the time such contingent liabilities are taken into account. According to the Preamble, the reason that the basis of publicly traded property, unlike that of other assets, is reduced by the actual amount of loss inherent in such basis is that such property can be readily and easily valued.[101] Nevertheless, determination of the reduction amount with respect to publicly traded property by reference to the actual loss in such publicly traded property (which requires a determination of the fair market value

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[101] Preamble, para. F 4..

of such property) and determination of the reduction amount with respect to other property by reference to the respective tax bases of such property requires taxpayers to conduct a bifurcated analysis. Further, the determination of the reduction amount with respect to property other than publicly traded property by reference to its basis leaves open the possibility of excess reduction amount which, as described above, is applied in only in the event there are contingent liabilities and then only at the time such liabilities are taken into account.

We recommend that the government consider a simpler allocation methodology that should be more familiar to taxpayers. Essentially, our proposal would be to require that the attribute reduction amount is first applied to reduce or eliminate NOLs, capital loss carryovers, and deferred deductions. Any remaining attribute reduction amount would then reduce the subsidiary's basis in its assets under a "reverse Section 1060 methodology" -- that is, basis reduction would be applied to the basis in the asset classes described in Treas. Reg. § 1.338-6 in reverse order, thereby allocating the attribute reduction amount in a manner similar to the treatment of a decrease in a buyer's "adjusted grossed up basis" under Treas. Reg. § 1.338-7. Any excess attribute reduction amount after asset basis reduction would be disregarded, avoiding the complexity of the suspension account contemplated in Prop. Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(1). Unlike the ordering rule in the Proposed Stock Loss Regulations, a reverse Section 1060 methodology is based on existing ordering principles in the Internal Revenue Code, does not rely on stock basis determinations, and avoids complexities involved in determinations of whether property is publicly traded or tracking contingent liabilities. In addition, it can be argued that the stacking rule – first reducing the basis in intangibles,

such as goodwill and going concern value – makes sense from an economic standpoint because these assets often are the assets that lose their value in circumstances where loss duplication is prevalent (e.g., M paid a premium for S's business).

C. Protective Elections

Putting aside the complexity of applying its provisions, the Attribute Reduction Rule creates transactional complexity for buyers and sellers of stock of a consolidated subsidiary. The amount of S's remaining attributes may not be known at the date of contract or closing because financial and tax results for the year of sale can only be estimated at that point. Post-closing purchase price adjustments (e.g., for changes in working capital or pursuant to indemnities) may change the amount of stock loss. Moreover, tax attributes may be subject to change because of the results of a later audit by the Service. Since the amount and nature of S's attributes to which a buyer will effectively succeed are thus uncertain, the parties may have difficulty pricing the transaction.

As an initial matter, to protect the unwary buyer, the baseline rule could be changed to provide that the seller would be deemed to elect under Prop. Treas. Reg. § 1.1502-36(d)(6) to reduce stock basis, unless the parties jointly elect to reduce inside attributes. However, treating the reduction of stock basis as the default rule seems inconsistent with the result in *Rite Aid*. Moreover, it shifts risk from the unwary buyer to the unwary seller.

Over time, the marketplace is likely to develop standard mechanisms and contractual protections to allocate risks between the parties appropriately. Therefore, the issue is whether the regulations can be modified to include provisions facilitating the adjustment of the marketplace to the Attribute Reduction Rule. In this regard, we would

support the inclusion in final regulations of provisions sanctioning protective stock basis reduction elections under Prop. Treas. Reg. § 1.1502-36(d)(6)(i) and protective attribute reattribution elections under Prop. Treas. Reg. § 1.1502-36(d)(6)(iii). These protective elections would be made jointly and could only be revoked by mutual agreement. For example, the parties could elect that, if the attribute reduction amount as finally determined exceeds a specified amount (e.g., because outside stock loss turns out to be higher than expected), all or a portion (as determined by an objective formula) of the excess would result in a reduction of stock basis, rather than of inside attributes. Similarly, the parties could elect that, if the attribute reduction amount as finally determined is higher than a specified amount (i.e., because inside attributes turn out to be higher than expected), the all or a portion of the excess (as determined by an objective formula) would result in a reattribution of attributes to the seller.

VII. SPECIFIC COMMENTS ON THE APPLICATION OF SECTION 362(e)(2) IN THE CONSOLIDATED RETURN CONTEXT -- PROP. TREAS. REG. § 1.1502-13(e)(4)

As described above, although concerned about the complexity and administrative burden associated with the application of Section 362(e)(2) in the consolidated return context, the government concluded in the Preamble that it could not simply eliminate the application of Section 362(e)(2) to intercompany Section 351 transfers. Instead, the application of Section 362(e)(2) is suspended until the occurrence of a "Section 362(e)(2) application event." During the interim, the group is required to identify the amount and location of basis in the transferred assets that would have been eliminated had Section 362(e)(2) applied at the time of the Section 351 transaction (or capital contribution) – i.e.,

the "Section 362(e)(2) amount" – and to track any diminishment in the Section 362 amount over time as a result of basis recovery.

We do not support the adoption of the rules of Prop. Treas. Reg. § 1.1502-13(e)(4). As an initial matter, it adopts a tracing regime. Though perhaps unavoidable to some extent, the use of tracing in this context seems inconsistent with the general rejection of tracing as unadministrable in the context of eliminating noneconomic stock loss. To be sure, in the first instance, tracing appears to be somewhat more manageable in the Section 362(e)(2) context because, for example, of the general absence of concerns about redetermination events. However, the mechanics of tracing in Prop. Treas. Reg. § 1.1502-13(e)(4) are still quite complex, because (i) events at both the subsidiary and shareholder levels must be tracked, (ii) there are multiple types of circumstances that can result in a reduction of the Section 362(e)(2) amount, and (iii) there are complex interactions with other provisions in the consolidated return regulations, including Prop. Treas. Reg. § 1.1502-36 itself.[102] On balance, we do not believe that the interests of the government and taxpayers are best served by adopting a tracing regime with a new set of mechanics.

This is not to say that we do not support any continuing application of the principles underlying Section 362(e)(2) in the consolidated return complex. We would, however, go about achieving them in a different manner.

Our principal concerns with entirely eliminating the application of Section 362(e)(2) are two-fold. First, we share the government's concern that consolidated

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[102] *See* Prop. Treas. Reg. § 1.1502-13(e)(4)(ii)(C).

taxpayers should not, as a general matter, be entitled to engage in loss duplication to a greater extent than separate return filers.

> *Example.* *M* owns the only share of S stock outstanding. S owns a single asset, Asset A, which is a tract of land with a basis of 0 and a value of $100. S has no liabilities. M's basis in the stock of S is $0. M contributes Asset B, a different tract of land, to S in exchange for the issuance by S of an additional share of S stock. Asset B has a basis of $200 and a value of $100. The transfer qualifies under Section 351(a). Absent the application of Section 362(e)(2), S's basis in Asset B is $200 and M's basis in the new share of S stock is also $200. Some time later, M sells the new share of S stock for $100.
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> Because there have been no investment adjustments with respect to the S stock following the asset contribution, the Basis Redetermination Rule does not cause a reallocation of adjustments. Because there have been no NPA with respect to the new S share, there is no basis reduction in the share under the Basis Reduction Rule. There is no attribute reduction under the Attribution Reduction Rule because the S does not have any aggregate inside loss; the basis and value of its assets are $200.
>
> Accordingly, in absence of the application of Section 362(e)(2), M would recognize a $100 loss with respect to the sale of the new share of S stock. Outside of the consolidated return context, M could not achieve this result because of Section 362(e)(2).

Second, to a certain extent, Section 362(e)(2) prevents taxpayers from planning into scenarios that take advantage of the under-inclusivity of the Basis Reduction Rule.

> *Example.* Assume the same facts as in the preceding example. However, instead of selling just the new S share, M sells both the old and new share. M recognizes a $100 gain on the old share and a $100 loss on the new share. However, the purchaser would be in a position to exploit the under-inclusiveness of the Basis Reduction Rule by later selling Asset A, retaining Asset B, and then selling the stock of S.

One method of dealing with such concerns would be to adopt an anti-abuse rule. Such a rule, for example, could require a basis reduction pursuant to Section 362(e)(2) if the taxpayer engages in an intercompany Section 351 transaction with a view to avoiding the principles of Section 362(e)(2) or exploiting the under-inclusivity of the Disconformity Amount.

We believe that relying on an anti-abuse rule would be preferable to adopting Prop. Treas. Reg. § 1.1502-13(e)(4). However, we also realize that, as with any purpose-based anti-abuse rule, the Service may have difficulty policing the anti-abuse rule described above and has a legitimate reason to prefer a more mechanical rule.

One possible alternative that the government might consider is the following rule. If members engage in an intercompany Section 351 transaction where there is a net loss inherent in the assets transferred by the transferor member, the transferor would recognize, but would not take into account, an amount of loss equal to the Section 362(e)(2) amount. Such loss would be taken into account under the normal intercompany transaction rules of Treas. Reg. § 1.1502-13.[103]

One advantage of this proposal is that it would prevent loss duplication without relying on a determination of the taxpayer's subjective intent. Mechanically, no loss duplication would result, because the transferor would take a basis in the transferee's stock received equal to its fair market value and the transferee's aggregate basis in the assets received would be equal to their aggregate fair market value. It is true that the proposed alternative would require valuations. However, valuations also are required under Prop. Treas. Reg. § 1.1502-13(e)(4), and the alternative proposal, unlike Prop. Treas. Reg. § 1.1502-13(e)(4), would not create any new tracing mechanics because it would rely on the existing matching and acceleration rules of the consolidated intercompany transaction regulations.

[103] The recognized loss would be considered to be allocable to the loss assets transferred on a pro rata basis pursuant to Section 362(e)(2)(B).

VIII. GAIN DUPLICATION

As discussed in part III.E above, we did not reach a consensus on whether the addition of rules addressing gain duplication would create balance or imbalance in the system. If the government chooses to address gain duplication, we suggest that it consider allowing the buyer and the seller (M) to make a "partial" Section 338(h)(10) election. Pursuant to this election, M would recognize an amount of deemed asset sale gain necessary to eliminate any gain on its sale of the stock of S; no stock loss would be recognized by M. The buyer would receive a corresponding step up in the basis of S's assets and such step up would be exempted from the application of the consistency rules of Treas. Reg. § 1.338-8.

> *Example.* M buys all of S's stock for $100 and no election is made under Section 338. S's assets have a basis of zero. S's assets appreciate to $150 and M sells the stock of S for $150. Under the proposal, the buyer and M may jointly make a "partial" Section 338(h)(10) election. Such election causes M to recognize $50 of asset sale gain. Because M's basis in its S stock is increased to $150 pursuant to Treas. Reg. § 1.1502-32 as a result of the asset sale gain, M realizes no gain or loss on the stock sale.

One issue in applying a partial Section 338(h)(10) election would be determining how to allocate the gain and step up among S's assets. Following the normal ordering rules of Treas. Reg. § 1.338-6 may seem to be too generous as it would allocate the step-up to the higher priority classes (generally involving shorter-lived assets). Using a reverse Section 1060 methodology, which would allocate the step-up first to goodwill and going concern value, would avoid this concern and would be symmetrical with our proposed modifications to the allocation rules of the Attribute Reduction Rule.

IX. OTHER COMMENTS

A. Intercompany Transfers of Loss Stock

As described above, the application of the Proposed Stock Loss Regulations would be triggered (including the Attribute Reduction Rule) upon an intercompany transfer of stock.[104] We believe that triggering these rules in such circumstances will lead to surprising and inequitable results (e.g., immediate reduction in the basis of assets following an intercompany stock transfer) at odds with single entity principles underlying the consolidated intercompany transaction regulations and their stated objective of preventing intercompany transactions from distorting CTI.[105] We recommend deferring the application of the rules of Prop. Treas. Reg. § 1.1502-36 in these circumstances, as was done in the 1991 Final LDR.[106] While intercompany stock transfers should not trigger a basis redetermination, basis reduction, or attribute reduction as a general principle, if the government believes that deferral under the intercompany transaction regulations would lead to anomalies, we suggest that it identify them and address them with specific clarifications about how that regime interacts with the rules of Prop. Treas. Reg. § 1.1502-36.

B. Effective Date Relief

The regulations are proposed to be effective for all transfers on or after the date that final regulations are published in the Federal Register. We recommend that the final regulations include a grandfather rule so that existing law (rather than the new final regulations) apply to any transfer of loss stock made pursuant to a contract binding on the

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[104] Prop. Treas. Reg. § 1.1502-36(a)(4).

[105] *See* Treas. Reg. § 1.1502-13(a)(1).

[106] Treas. Reg. § 1.1502-20(a)(3).

date the final regulations are published. Various aspects of the Proposed Stock Loss Regulations, and the Attribute Reduction Rule in particular, can obviously have a substantial impact on the buyer of loss stock (e.g., absent the seller making an election, the rules can reduce a target company's tax basis in its assets) and the seller of loss stock (e.g., reduce the basis in the transferred loss stock or reattribute target company tax attributes). In many cases, a buyer and seller will have competing interests as to what elections available under the rules should be made. Moreover, the rules could impact which party effectively bears the cost of an adjustment made after closing (e.g., a post-closing adjustment that increases the target company's pre-closing income could cause a further reduction in the target company's losses or basis).

We expect that in many cases the buyer and seller of stock of a member of a consolidated group will negotiate contractual provisions relating to the application of the stock loss regulations to their transaction (e.g., whether the seller will make various elections available under the final regulations and whether payments between the parties will be required if an adjustment to a target company's pre-closing taxes causes a loss or tax basis expected by one party to be rendered unavailable). However, it is obviously difficult if not impossible to negotiate those provisions without knowing what exactly the final stock loss regulations will say. Moreover, this report recommends that certain additional material elections be available to the parties, and the Treasury Department and the Service have indicated that changes are being considered to the Proposed Stock Loss Regulations, including the Attribute Reduction Rule.

It is obviously desirable for taxpayers, when entering into a transaction, to be able to understand the tax consequences of the transaction. In furtherance of this goal, and in

light of the still evolving state of the Proposed Stock Loss Regulations, we recommend that the final regulations grandfather transactions effected pursuant to contracts binding on the date that the final regulations are published.

X. CONCLUSION

The Tax Section commends the government for producing a sophisticated and generally balanced conceptual framework for resolving the difficult problems of noneconomic stock loss and loss duplication in the consolidated return context. As a whole, the framework provided by the Proposed Stock Loss Regulations is an improvement on current law and reaches a reasonable systemic balance. However, we do have serious concerns about the ability of taxpayers to comply with some of the proposed rules, most particularly Attribute Reduction Rule and the Section 362(e)(2) rules, with a reasonable expenditure of time, effort, and cost. Our suggestions are intended to improve this framework so that it produces better results in certain circumstances and a more administrable regime on an overall basis. With these modifications, we believe that finalization of the Proposed Stock Loss Regulations would bring a long and difficult chapter in the development of the consolidated return regulations to a reasonable close.