

Working with the Final Unified Loss Rules The Devil We Now Know

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January 23, 2009

I) Introduction

Back in early 1997 shortly after the "check-the-box" regulations were finalized, Larry Axelrod wrote a thought-provoking article responding to a question that many reasonable tax directors and practitioners might have begun asking themselves: Are Consolidated Returns Obsolete?¹ The premise was pretty straightforward. By converting all their subsidiaries into disregarded entities, businesses could now theoretically achieve the single-entity federal tax results previously available only through a consolidated return while enjoying the liability limitation of separate legal entities and simultaneously avoiding all the costs, complexities, and uncertainties associated with the consolidated return rules. Why wouldn't business people simply organize their affairs through disregarded entities?

It would surprise no tax practitioner to learn that Larry's answer to that simple question was "it depends." We'll spend a bit of time in Part II taking a closer look at the considerations that Larry identified. (Which considerations remain true today? Were any big topics omitted from Larry's piece but which belong in that debate?). If we had to boil the answer down to a single factor, it would be this: groups would probably choose not to convert all their subsidiaries to disregarded entities because in the process they would lose the high "outside" basis in member stock, thereby increasing the tax costs associated with subsequent dispositions.

Two facts indicate that Larry's prediction was accurate. (1) Most groups that existed in 1997 have not undergone wholesale liquidations. (2) Most groups that have been created since 1997 have chosen to keep their subsidiaries intact and elect to file consolidated rather than liquidate every entity and file a single stand-alone return.

But what would happen if more and more buyers started making Sec 338(h)(10) elections, eliminating the "inside-outside" basis disparity that may be paralyzing existing groups? Would tomorrow's tax director and CFO still choose to put up with all the baggage that comes with the consolidated return regime? And, more interestingly, what sort of changes would have to take place in the tax law to cause that behavioral shift? What combination of incentives and disincentives could policy-makers and administrators put in place to induce buyers and sellers to systematically favor asset deals over stock? Would it take a single, sweeping legislative change? (Equalizing tax rates

¹ 97 TNT 3-78 (Jan 6, 1997).

between ordinary income and capital gains? Reducing the recovery period for intangibles from 15 years to 10 or 5? Amending Sec. 382 to make acquired tax attributes much less useful in the buyer's hands?) Could this change come about as a result of a series of small, incremental rule changes within the existing statutory framework?

This article's main thesis is that the final Unified Loss Rules may well prove to be a decisive turning point in that process. For the reasons discussed in Part III, more and more domestic corporations may well choose to purchase assets (actually or via Sec 338(h)(10) elections) rather than stock. Then in Part IV we conclude with some observations about the implications of that trend.

II) Are Consolidated Returns Obsolete? A Closer Look, A Decade Later.

Larry's article walked through a variety of tax technical rules, some in subchapter C and some under the consolidated return regulations, noting how those rules would apply to a consolidated group versus a similarly-situated stand-alone filer with numerous disregarded subsidiaries.

- If the parent converted only some of its subsidiaries to disregarded entities it could achieve "selective consolidation";
- If all the subsidiaries liquidated for tax purposes, the "parent" could use its stock to acquire a target corporation's stock or assets in tax-free transactions although some kinds of reorganizations would not be possible;²
- Transactions between members of a consolidated group sometimes do not mirror pure stand-alone results (i.e. unexpected character conversion), but transactions between disregarded entities would produce no tax consequences and also avoid challenge under anti-abuse rules;

If the ring-side judges had to score the fight at the end of that discussion, many would probably go with "stand-alone / disregarded" status. But in the next section Larry emphasized the key disadvantage of converting every subsidiary into a disregarded entity: assuming those subsidiaries were solvent, those conversions would all qualify for tax-free treatment, thereby eliminating the "outside" basis in the subsidiaries' stock and leaving only the "inside" asset basis.

That's a price groups might be prepared to pay if the subsidiaries had all previously been acquired in Sec 338(h)(10) transactions. That election would have ensured "inside-outside" basis symmetry upon acquisition, and the consolidated return "investment adjustment" regulations would have preserved that parity up through the time of liquidation.³ Since the common parent would take a carryover basis in the subsidiaries'

² Since that article was written the regulations under Sec. 368 have expanded the scope of Sec. 368(a)(1)(A) reorganizations to include certain mergers with disregarded entities (as well as mergers of certain foreign entities under foreign law). See Reg. 1.368-2(b), added by TD 9242, 71 FR 4269-01 (1/26/06).

³ See Preamble to proposed and final investment adjustment regulations, CO-30-92, 57 FR 54957 (11/23/92) and TD 8560, 59 FR 41666 (8/15/94).

assets and that was also equal to the "outside" basis in the stock,⁴ the group might rationally proceed with those wholesale liquidations. The group would recognize the same amount of gain or loss whether it sells stock or assets, and the differences become harder to spot.⁵

Before moving on to other "inside-outside" scenarios one point is worth emphasizing. If the goal is getting from "consolidated" to "stand-alone" filing status, every member of the group will have to liquidate. If even one "regarded" subsidiary remains, the group will remain in existence and will be required to continue filing consolidated returns.⁶

Returning now to the "inside-outside" investigation, what if some of the group's members had previously been acquired in taxable stock purchases *without* a Sec. 338(h)(10) election? Those subsidiaries would have entered the group with some inside-outside basis difference, and (once again) the "investment adjustment" rules would have preserved that inequality up through the moment of liquidation. We must then consider two possibilities: either the subsidiary joined the group with a "net built-in gain" in its assets (i.e. outside stock basis exceeded net asset basis), or the opposite (subsidiary has "net built-in loss" and inside basis exceeds outside stock basis).

If the group ever decided to sell a subsidiary with a built-in gain in its assets, it would have the option of selling stock and recognizing less gain as compared to an asset sale (or a Sec. 338(h)(10) election). Since the buyer in a taxable transaction typically prefers a stepped-up fair value basis in the target's assets (producing greater depreciation deductions along with Sec. 197 amortization deductions for goodwill which might have little or no tax basis in the target's hands prior to the transaction), the resulting tension between buyer and seller frames an obvious negotiation (How much extra is the buyer willing to pay to achieve the desired asset basis step-up?).⁷ But if the subsidiary was previously liquidated, that outside basis would have disappeared and, with it, the negotiating leverage.

⁴ Sec. 334(b).

⁵ Gain or loss from the sale of stock will virtually always be capital, while the comparable gains and losses from the sale of the underlying assets will produce a mix of capital and ordinary items. That mix is complicated by a host of recapture rules such as Secs. 1231 and 1245. Other rules that convert capital gain to ordinary income include Sec. 1248 (treating a portion of the US shareholder's gain as an imputed dividend from the CFC whose stock is sold).

⁶ In principal a group could follow an intermediate approach, liquidating some members while leaving others intact. This would reduce but not completely eliminate the complexities of filing consolidated returns.

⁷ The proper application of financial accounting rules is obviously beyond the scope of this article, but it is appropriate to take note of some important accounting consequences in addition to the technical tax consequences. In most acquisitions, the "book basis" in the acquired corporation's assets is re-set to fair value under the "purchase accounting" rules. Because there has been no realization event, the adjusted basis of those assets remains unchanged for federal income tax purposes. If the tax basis is less than the book basis, the group will recognize more tax gain upon a later sale of those assets than book gain. The tax associated with that additional gain must be recorded as a deferred tax liability on the Target's books at the time of acquisition.

Unfortunately this dynamic is not entirely symmetric. If there's a net *loss* built in to a subsidiary's assets when it liquidates, the "outside" stock basis is eliminated and the high "inside" asset basis is preserved. Would a buyer be willing to pay more to purchase the stock of a target corporation with built-in losses rather than buying the assets directly and taking a stepped-*down* fair value basis in those assets? Theoretically those additional future deductions have some present value but Sec. 382 curtails that value pretty severely.⁸ As a practical matter, buyers are typically unwilling to pay extra for built-in losses, so the current owner has little incentive to preserve the outside basis in the stock of members with built-in losses.

There's one more class of subsidiaries to consider - those previously acquired in some kind of tax-free transaction. In some cases the acquirer may have started with a carryover basis in the subsidiary's stock, determined by reference to the basis in the hands of the former shareholders.⁹ In other cases, the beginning basis in the subsidiary's stock may have been equal to the subsidiary's net inside asset basis.¹⁰ This "inside-outside" basis parity will be preserved up through the moment of liquidation, so just as with the original Sec. 338(h)(10) scenario there is no obvious disincentive to a tax-free liquidation.

While we're thinking about exit strategies let's note another interesting consequence that follows if a group converts all its members to disregarded entities. The issue concerns the seller's tax attributes. If the transaction is taxable, the buyer will of course not expect to inherit any of the seller's attributes. If the seller happens to have any tax attributes, none of those attributes would be allocated to the assets being sold, so the entire amount of losses, credits, etc would stay behind in the seller's hands. Absent some pre-existing restriction, those losses could generally offset the seller's net gain on the asset sale. The same results flow when a consolidated group sells a subsidiary and the parties elect Sec. 338(h)(10) treatment. The group can use its attributes to offset any gain recognized on the deemed sale of the subsidiary's assets. Any attributes allocable to that subsidiary stay behind in the selling group as a result of the deemed liquidation.¹¹

Before we move on to a discussion of the unified loss rules, it's worth pausing to consider whether there might be any additional "big picture" factors not mentioned in Larry's article, factors that could play a part in the strategic decision whether to liquidate all the members via check-the-box elections.

⁸ Assuming this transaction is taking place between unrelated parties, the acquisition of this "loss corporation" will constitute an "ownership change" and thus give rise to an annual "Section 382 limitation" which restricts the rate at which those "recognized built-in losses" can be claimed. Sec. 382(a).

⁹ The acquirer takes a carryover basis in stock received in a Sec. 351 transaction (Sec. 362(a)) as well as in a Sec. 368(a)(1)(B) reorganization (Sec. 362(b)).

¹⁰ The acquirer's basis in "target" stock that's acquired in certain so-called "triangular" reorganizations may be determined by reference to the basis in the hands of the target's former shareholders or by reference to the target's net inside asset basis. Reg. 1.358-6(c).

¹¹ An asset sale (or Sec. 338(h)(10) transaction) also avoids the complexity and potential detriment of the "circular basis adjustment" rule under Reg. 1.1502-11(b). That rule generally prevents a group from using the losses allocable to a departing member.

Intercompany Transactions

Even if a group has "inside-outside" basis parity across the board, might the liquidation of all the subsidiaries trigger some other adverse tax consequence under the intercompany transaction rules? To find out we'll divide the world into four quadrants. The property sold in the previous intercompany transaction was either "stock of a member" or "something else." And the intercompany transaction either took place under the current rules (in tax years beginning on or after July 12, 1995) or under the former rules. We'll first examine what happens with respect to intercompany gains and losses relating to property other than member stock under the current and then the former rules. Then we'll examine what happens under both sets of rules when the gain or loss relates to member stock.

A) Current Rules - Something Else

Example 1. Calendar-year, domestic corporation P is the parent of a consolidated group that includes members S and B. In 1997, S sold an asset to B, recognizing either gain or loss. Assume some of S's "intercompany item" has already been taken into account but some amount remains "deferred." What happens if S liquidates into P? If B liquidates into P? If P no longer files a consolidated return?

Answer: provided those liquidations qualify for tax-free treatment under Sec. 332, P will step into S's shoes and inherit the remaining balance of S's intercompany item.¹² Even after the P group goes out of existence and P starts filing a separate return, P will continue to apply the "matching" and "acceleration" principles to determine when to take the remaining portion of S's intercompany item into account.¹³

B) Former Rules - Something Else

Example 2. If the sale of assets from S to B took place before 1996, the group would have to apply the rules that existed under the former intercompany transaction regulations to determine when S's deferred gain or loss should be restored.¹⁴ P would inherit S's deferred gain or loss if S's liquidation qualifies under Sec. 332.¹⁵ Likewise B's liquidation would not trigger restoration of that deferred gain or loss, as long as that liquidation qualifies under Sec. 332.¹⁶ And P could continue deferring that gain or loss even if the group ceased to exist and P

¹² Reg. 1.1502-13(j)(2).

¹³ Reg. 1.1502-13(j)(6). This continued deferral has some strings attached. Any remaining intercompany items must be taken into account immediately before P becomes a member of another affiliated group, or P becomes any kind of "non-includible" corporation described in Sec. 1504(b).

¹⁴ Former Reg. 1.1502-13(c)(1)(i), prior to the promulgation of TD 8597, 60 FR 36671 (7/12/95). See Reg. 1.1502-13(l)(4) (making it clear that former rules generally continue to govern the treatment of intercompany transactions arising in taxable years that began before July 12, 1995).

¹⁵ Former Reg. 1.1502-13(c)(6).

¹⁶ Former Reg. 1.1502-13(f)(2)(ii)(a).

started file stand-alone returns.¹⁷

In sum, if we're analyzing intercompany gains and losses that relate to anything other than stock of a member the results are the same, and benign, whether the gain or loss arose before or after 1996. So this is not a reason to avoid converting all the members into disregarded entities.

C) Current Rules - Member Stock

Example 3. Same facts as Example 1 (intercompany sale in 1997) except that the asset happened to consist of all the stock of T, another member of the group.¹⁸

The analysis is slightly more complicated so we'll slow down just a bit.

Will S's gain remain deferred if B liquidates into P? Yes. If B's liquidation qualifies under Sec. 332 then P will take a carryover basis in the T stock¹⁹ and continue applying the "matching" and "acceleration" rules. If B's liquidation is taxable, then the T shares will move from B to P in another "intercompany transaction." P will take a fair value basis in the T stock and P can still apply the "matching" and "acceleration" rules to determine when to take the inherited "intercompany item" into account.²⁰

Will S's gain remain deferred if S liquidates into P? Yes, provided S's liquidation qualifies under Sec. 332. P will be a "successor person" with respect to S and will thereafter take that intercompany item into account under the normal rules.²¹

Will S's gain (now in P's hands) remain deferred if T then liquidates into P? No. If the liquidations of S, B, and T occur in precisely the right sequence, S's gain (now in P's hands) can be permanently excluded from gross income (rather than merely deferred) thanks to a favorable rule added to the intercompany transaction regime back in March, 2008.²² If the liquidations occur in the wrong sequence,

¹⁷ It's not obvious how to prove this result under the Former regulations, but noted commentators agree with the conclusion. See, e.g., Hennessey et al., *The Consolidated Tax Return* (6th ed.) Para. 6.03[2][d][ii].

¹⁸ If the sale of T stock from S to B took place before July 24, 1991, the consequences would have been radically different, because that transaction would have been subject to Sec. 304 rather than Sec. 1001. Reg. 1.1502-80(b). For ease of discussion our hypothetical transaction took place in 1994, after Sec. 304 had been shut off inside consolidated groups and before the current intercompany transaction regulations took effect.

¹⁹ Sec. 334(b).

²⁰ There's a separate question about whether the gain or loss recognized by B upon the taxable distribution of the T shares to P is currently recognized. We'll set that aside and continue to focus on the fate of the original intercompany item, because we're trying to figure out whether there's anything in the design of the intercompany transaction rules that may operate as a disincentive preventing groups from liquidating all their members.

²¹ Reg. 1.1502-13(j)(1).

²² Reg. 1.1502-13T(c)(6)(ii)(C).

the deferred gain is taken into account.²³

D) Former Rules - Member Stock

Example 4. If the sale of T stock from S to B occurred in a pre-1996 consolidated return year, the story starts out the same but ends very differently. As before, the results of these various events must generally be determined under the former intercompany transaction regulations. The tax-free liquidation of S and B would not require restoration of S's deferred gain or loss.²⁴ However, T's liquidation would trigger the deferred gain,²⁵ and there was no mechanism available under those rules to prevent that result.²⁶ This result is very different from the result under current law, and thus appears at first blush to represent a potentially serious impediment to the wholesale LLC conversion strategy. But the story is not quite finished.

The current intercompany transaction regulations contain some taxpayer-friendly relief rules that prevent restoration of gains deferred with respect to member stock in certain so-called "stock elimination transactions."²⁷ For example, if S previously sold T stock to B and T later liquidates tax-free, S's gain can remain deferred if B causes T's assets to be reincorporated.²⁸ The drafters of the current regulations acknowledged that it seemed inappropriate for certain groups to have access to those relief provisions (if the intercompany sale of T stock occurred after 1995) while other groups were denied access (if the sale occurred before 1995), so they gave consolidated groups a one-time opportunity to elect into the new regime.²⁹

Suppose a group made that election back in 1995 and now it wants to liquidate S, B, and (most critically) T. Can that group apply the newly-added rule and permanently exclude that gain from P's income? Yes.³⁰

²³ It would seem the group has a pretty strong argument for some kind of relief in a private ruling, particularly if every member of the group is liquidating. This would seem an appropriate occasion to exercise the so-called "Commissioner's discretionary rule" under Reg. 1.1502-13(c)(6)(ii)(C), and a forceful reason against repealing that rule, as the IRS and Treasury apparently intend. See preamble to TD 9383, 73 FR 18160-01 (3/7/08) ("absent compelling comments, the IRS and Treasury Department anticipate ultimately eliminating the Commissioner's Discretionary Rule").

²⁴ Former Reg. 1.1502-13(c)(6)(i).

²⁵ Former Reg. 1.1502-13(f)(1)(vi).

²⁶ See TAM 9644003.

²⁷ Reg. 1.1502-13(f)(5).

²⁸ Reg. 1.1502-13(f)(5)(ii)(B).

²⁹ Reg. 1.1502-13(l)(3). That election had to be attached to the group's 1995 consolidated return. For further discussion of issues surrounding that election, see Friedel, *Whither the Group's Election? Certain Elections May Terminate When a Group Goes Out of Existence*, 27 J. Corp. Tax'n 223 (2000).

³⁰ See PLR 200850015 (Representation (o)) (indicating that the group made an "(l)(3)" election with its 1995 return).

Is that new rule also available if the group did not make that election? Unclear.³¹

In sum, the restoration of intercompany gains and losses that relate to stock of a member are not the same under the two sets of rules, and are certainly not benign. It's possible for gains arising after 1995 to be permanently eliminated (if the group follows the prescribed sequence precisely). It's also possible for gains arising before 1996 to be eliminated if the group made an "(1)(3)" election with its 1995 return and it executes the plan correctly. But as the law stands today if the group executes the liquidations in the wrong sequence, or if the gains arose before 1996 and the group did not make an "(1)(3)" election, those gains will be triggered. And since the gains in question can be material, this factor could certainly be a serious obstacle that prevents a group from converting all its members to disregarded entities.

SRLY Restrictions

When Larry wrote his article in 1997, the landscape of consolidated return rules restricting the use of attributes had recently changes but was still dramatically different than it is today. Back then, if a corporation carried an NOL forward into a consolidated group, two sets of rules limited the group's use of that loss.

Example 5. P files a calendar-year consolidated return with members S-1 and S-2. On June 15, 1997 P acquires all the stock of domestic Target ("T") for cash. T was previously filing a stand-alone return. It generated an NOL in 1996, of which \$1 million is carried into the P group. Assuming the acquisition caused an "ownership change," the P group could use that NOL carryforward as fast as the Section 382 limit allowed. In addition, that loss was subject to the separate return limitation year ("SRLY") restrictions under Reg. 1.1502-21(c), meaning that loss could only offset T's income.³²

In 1999 the IRS and Treasury severely scaled back the SRLY limit on NOL carryforwards by shutting off the SRLY rules where they "overlap" with Sec. 382.³³ Under the current regime, the SRLY rules always restrict the use of attributes that are carried *back* (because carrybacks are not subject to Sec. 382), and the SRLY rules generally continue to restrict the use of attributes that are carried forward into a consolidated group if Sec. 382 does not apply to those carryforwards.

³¹ Since this new "permanent exclusion" rule was not part of the original regulations promulgated back in 1995, it seems unfair to now prevent certain groups from enjoying the benefit because they failed to make elect into other aspects of the regulations. Accordingly it would seem appropriate to give consolidated groups another opportunity to make an "(1)(3)" election.

³² Larry's article appeared in January, 1997. The SRLY rules underwent a pretty significant facelift just six months earlier, with the former "year-by-year, member-by-member" rules giving way to "cumulative, subgroup" concepts. TD 8677, 61 FR 47821 (6/26/96). But the larger point remains: until the advent of the "overlap" rule in 1999, discussed below, the SRLY rules continued to restrict the use of losses regardless of how that limit was measured.

³³ TD 8825, 64 FR 36175 (7/2/99). This "overlap" concept was later extended to a range of other attributes. TD 8884, 65 FR 33753 (5/25/00).

Example 6. FC is a foreign corporation that owns all the stock of domestic corporations P and T. P owns all the stock of S and they join in filing a consolidated return using the calendar year; T files a stand-alone return, also on a calendar-year basis. T generates a loss of \$1 million up through December 31, 2005. On that date FC contributes all the stock of T to P in a transaction that does not qualify as a "reverse acquisition."³⁴ T's loss is SRLY-limited to the P group because T did not undergo an ownership change on its way into the group. As a result, P must establish a "SRLY register" and track T's cumulative contribution to the group's taxable income.

For each of 2006, 2007, and 2008, T generates a taxable loss of \$300,000, all of which is currently absorbed against income of P and S. At the end of 2008 there is a \$900,000 deficit in T's SRLY register.³⁵ Before the P group can absorb any of the \$1 million loss carryforward T must generate \$900,000 of taxable income to fill that hole. Thereafter, if T generates additional income, its cumulative contribution to the group's consolidated taxable income will be positive and the group can absorb the SRLY-limited loss to that extent.

What if T were to liquidate into P on December 31, 2008? If the liquidation were tax-free under Sec. 332 P would inherit T's \$1 million NOL under Sec. 381(a). P would also qualify as a "successor person" under the SRLY rules and inherit T's \$900,000 register deficit.³⁶ The group would still be unable to absorb any of that \$1 million NOL unless and until P subsequently generated \$900,000 of taxable income, filling that hole.

But what if S also liquidated into P on December 31, 2008? In that case the P group would cease to exist (because no member would still be affiliated with P on January 1, 2009³⁷) and P would file a stand-alone return for 2009. Since the SRLY rules no longer apply, the SRLY register should become irrelevant, and P should be able to use the \$1 million loss immediately in 2009.

While perhaps somewhat uncommon, this example illustrates how a group could be better off if all its subsidiaries liquidated (or converted into disregarded entities) vis-à-vis the timing of attribute utilization.

In summation, if an existing group is contemplating the wholesale liquidation of all its members (via check-the-box elections), two significant factors (preserving high outside stock basis, and avoiding the restoration of gains deferred with respect to member stock prior to 1996) are likely to inhibit that choice while one factor (eliminating SRLY registers, thereby accelerating the ability to use losses or other attributes) makes the choice attractive.

³⁴ The contribution of S to P fails as a "reverse acquisition" because the P stock is worth more than the S stock. Reg. 1.1502-75(d)(3). If the transaction were a reverse acquisition, S's loss carryforwards would not be SRLY-limited thanks to an exception in Reg. 1.1502-1(f)(3).

³⁵ Reg. 1.1502-21(c)(1)(i).

³⁶ Reg. 1.1502-1(f)(4) and -21(f)(1).

³⁷ Reg. 1.1502-75(d)(1).

III) Enter the Final Unified Loss Rules

We all know the conventional way to discuss a new set of rules. Start at the beginning, move through definitional issues, then march through the substantive provisions, usually in sequence (paragraph (a), then (b), etc.). Other articles will surely attack the unified loss rules from this traditional direction, focusing mostly on the group selling stock of a member. We'll take a different approach and examine the rules entirely from the buyer's perspective.

Faced with the standard "should we buy stock or assets" issue, we'll explore what sort of difficulties are likely to confront the buyer who chooses to buy stock as a result of the unified loss rules. As we'll see, additional challenges await the buyer when that stock is subsequently sold. Together these "problems now, problems later" issues create a pincer movement that drives the buyer towards an asset / (h)(10) transaction up front.

A) Problems Now.

Your client (P), the common parent of a consolidated group, purchased all the stock of X Corporation from Seller (the parent of an unrelated group) on December 31, 2008. X owns all the stock of a domestic subsidiary, Y. P paid \$10 million of cash in a fully taxable deal. Just after you've stashed the deal toy on your bookcase the client calls you to discuss some issues surrounding the opening balance sheet. Seller provided a schedule of NOL carryforwards that X and Y carried out of its group, and a balance sheet showing the tax basis in X's and Y's assets. The total amount of NOLs apportioned to X and Y is \$1 million, and those losses were generated in 2005 while X and Y were part of Seller's group.

The client plans to record a deferred tax asset with respect to the NOL and is wondering whether it's appropriate to record a valuation allowance against that asset. She asks you to describe what might happen to limit the group's enjoyment of those NOLs. In addition, the carve-out balance sheet shows a sub-consolidation of the combined assets held by X and Y. (Not surprisingly, there's no information about X's tax basis in the Y stock.) That balance sheet appears to reflect built-in gain (tax basis less than fair value). The client will record a deferred tax liability associated with those assets and she wants to understand what might happen to increase that opening liability amount.

In the good old days before September 17, 2008 (when the unified loss rules took effect), the list of threats to X's or Y's tax attributes was fairly well-understood. Typical considerations included the following items.

1) Threats to acquired NOLs.

a. Amount

- i. Will Seller file an amended return 2005 return and report a smaller consolidated NOL, thereby reducing the amount apportioned to X and Y?
- ii. Even if the amount of consolidated NOL reported on an amended 2005 return is unaffected, the amount apportioned to X and Y would be affected if their separate company activity is adjusted on that return.³⁸
- iii. What if Seller files amended consolidated returns for years before or after 2005 that reflect greater taxable income? This would result in a larger amount of the 2005 CNOL being absorbed, leaving a smaller amount available to apportion to X and Y.
- iv. The same threats could also arise if those returns are affected by IRS audit adjustments.

b. Sec 382 limit

- i. The calculation of the annual Sec. 382 limitation ought to be relatively straightforward, since P purchased all the X stock for \$10 million cash.³⁹ Hopefully P has already made the proper adjustments to value in arriving at that limitation, including adjustments under the anti-stuffing rule of Sec. 382(l)(1),⁴⁰ excess non-business assets under Sec. 382(l)(4), and corporate contractions under Sec. 382(e)(2).

³⁸ Reg. 1.1502-21(b)(2)(iv). The percentage of Seller's consolidated NOL (CNOL) apportioned to X and Y would also be affected if any of the events noted in Reg. 1.1502-21(b)(2)(iv)(B)(2) occurs. For example, suppose some of that 2005 CNOL had been apportioned to Z, another member of the group, and Z carried that loss back to 2004 when Z had filed a stand-alone return. That carryback was absorbed in full, resulting in a refund. In 2009, after Seller has sold the X stock to P, the IRS completes an audit of Z's 2004 return and disallows numerous deductions. As a result, Z is able to absorb more of the 2005 carryback. This indirectly affects the percentage of the 2005 CNOL that is apportioned to X and Y when they're sold in 2008. In this case, the amount of loss apportioned to X and Y would likely increase, so our client would be less inclined to complain. But what if the facts reversed and the IRS audit reduced Z's 2004 taxable income? A smaller amount of 2005 carryback would be absorbed, and this would indirectly reduce the amount of CNOL apportioned to X and Y.

³⁹ Assuming for the sake of simplicity a long-term tax exempt interest rate of 5% and no adjustments to value, the annual Sec. 382 limit based on a \$10 million purchase price would be \$500,000/year. If we also ignore any increases to that base limit attributable to recognized built-in gain, this limit will permit the P group to absorb the full \$1 million of NOLs attributable to X and Y after two years.

⁴⁰ The IRS and Treasury have recently issued taxpayer-favorable guidance that reverses the presumption regarding so-called "stuffing transactions" under Sec. 382(l)(1). See Notice 2008-78, 2008-41 IRB 851 (9/26/08).

- ii. The problem is more likely to relate to ownership changes that P doesn't know about. For example, what if the entire Seller group experienced an ownership change in 2006? In that case the 2005 losses allocable to X and Y were already subject to a consolidated Sec. 382 limitation before they left Seller's group. Did P remember to ensure that Seller elected to apportion some of its consolidated Sec. 382 limit to X and Y?⁴¹
- iii. Let's assume P knew about that prior ownership change and that Seller apportioned some amount of its Sec. 382 limit to X and Y. What if in the course of auditing Seller's returns for 2006 or later the IRS challenges Seller's computation of its consolidated Sec. 382 limitation? If there was a smaller annual limitation to apportion, is any of the decrease clawed back from X or Y? The answer may depend on how the 2008 apportionment election attached to Seller's return was worded.

2) Threats to the basis in assets

- a. The same amended returns and potential IRS audit adjustments could obviously affect the basis in assets that X and Y owned as they left Seller's group.

The key point to note here is what's not on that list. Nowhere do we see questions concerning whether Seller recognized a gain or a loss on the sale of X's stock, or if a loss was recognized, how much of that loss was allowed or disallowed. But those questions are now very much the buyer's concern under the unified loss rules. So we must add more threats, including:

1) Did Seller recognize a loss on the sale of X's stock?

- a. Is there any contingent consideration or purchase price adjustment in the agreement? If so, the amount of loss that Seller recognized might be reduced as payments are made.

2) What was Seller's basis in the X stock before the sale?

- a. Think anew about the impact of amended returns or IRS audit adjustments. If for example Seller files an amended 2005 return that reports the same amount of CNOL but, within that limit, it shifts some deductions from Z to X or Y, this could affect Seller's basis in the X stock under the investment adjustment rules.

⁴¹ Reg. 1.1502-95(c)(2).

- b. Any other adjustment that increases Seller's basis in X's stock would affect Seller's loss. And the greater Seller's loss, the greater amount of attributes that X and Y must eliminate as they depart Seller's group.

What is it about the unified loss rule that requires X or Y to reduce their tax attributes just because Seller recognizes a loss? The answer lies in the government's concern over what it regards as inappropriate "loss duplication." If Seller claims a loss on the sale of X's stock, the government has concluded that the departing member should be prevented from claiming a comparable loss after it has left the group. It accomplishes this goal by reducing the departing member's tax attributes immediately before it leaves the seller's group.

This attribute reduction regime represents a dramatic and fundamental shift in the architecture of the consolidated return rules. In some ways this result is similar to the approach the government followed in the original "loss disallowance rules" (LDR, Reg. 1.1502-20), with one crucial difference. The original loss disallowance rules tried to police duplication by preventing the seller from claiming losses that were available to the departing member. These unified loss rules, by contrast, allow the seller to claim its loss and strip "duplicated" attributes out of the departing member.

How much attribute reduction is required? The seller must calculate two amounts. The smaller of those two amounts determines the amount of attributes that must be purged from the departing member.⁴² The first amount is the "net stock loss."⁴³ This is exactly what it sounds like: the amount by which the basis of the transferred member stock exceeds value. (In the taxable disposition under scrutiny this is simply the amount of loss that Seller recognizes, after reducing its basis in the X stock by the appropriate amount.⁴⁴) The second amount is the departing member's "aggregate inside loss."⁴⁵ This is a composite number that's designed to capture the sum of (i) the built-in loss in the member's assets plus (ii) the member's tax attributes (ordinary and capital losses plus deferred deductions).⁴⁶

Once the Seller determines the lesser of (i) net stock loss or (ii) aggregate inside loss, it proceeds to reduce the attributes of X and Y as they leave the group. The unified loss rules provide a default attribute reduction ordering rule similar to Sec. 108(b), but with some important differences. Under the unified loss default rule the first attribute that suffers a "haircut" is capital losses, then ordinary NOLs, then deferred deductions, then

⁴² Reg. 1.1502-36(d)(2)(i). The attribute reduction rule generally does not apply if the smaller of these amounts is less than five percent of the value of all the shares transferred in the transaction. Reg. 1.1502-36(d)(2)(ii). However the selling group can elect to turn the attribute reduction rule back on. Id. The form and manner of making that election are set forth at Reg. 1.1502-36(e)(5).

⁴³ Reg. 1.1502-36(d)(3)(i)(A).

⁴⁴ We'll explore the basis reduction amounts more fully below.

⁴⁵ Reg. 1.1502-36(d)(3)(i)(B).

⁴⁶ Reg. 1.1502-36(c)(5). Note that tax credits are ignored in this calculation.

basis in assets (following an inventive "upside down Sec. 1060" sequence.)⁴⁷

With these additional threats, how can the tax director get comfortable that the amount of acquired NOLs (deferred tax assets) is correct? Or that the basis in the assets won't subsequently be adjusted? It turns out there is a way, but it may be difficult to get the seller to agree. Recall that all these attribute reduction threats are designed to prevent inappropriate duplication. The drafters of these unified loss rules realized that they didn't really need to choose which taxpayer (seller or departing member) gets the single tax benefit, as long as it's only one. So if the seller formally elects to claim no loss on the sale, the departing member can carry its losses and deferred deductions and high-basis assets out of the group without concern.⁴⁸ As thoughtful as that is, it's difficult to envision why the Seller under these facts would choose to sell stock and claim no loss if it could have simply sold assets, recognized gain, and used the NOLs that would have been apportioned to X and Y on their way out.

Of course there's another way to eliminate all this uncertainty: make a Sec. 338(h)(10) election, take a stepped-up fair value basis in all the acquired assets with no NOLs, and don't look back.

B) Problems Later

a. P sells X stock

Having just acquired all the X stock without an (h)(10) election, let us now consider what further excitement awaits our favorite client when it later decides to sell this business. We need some more facts.

Suppose X and Y together generated \$3 million of taxable income during the four years they were in P's group (2009 - 2012). We'll also assume the group was sufficiently profitable that it was able to absorb the full \$1 million of losses that X and Y carried out of Seller's group. During 2009 X declared and paid to P a dividend of \$2.5 million. In addition, P periodically loaned money to X to fund operations. Those loans were advanced as open account intercompany debt. There is a written debt instrument, a fixed maturity date, and adequate stated interest at a fixed rate. X has accrued and paid the proper amount of interest every year (and those interest deductions have been taken into account as part of the \$3 million total taxable income figure noted above). X has also made all principal payments on time as required under the note. As of December 31, 2012 the outstanding principal amount of that intercompany debt is \$2.2 million.

⁴⁷ Reg. 1.1502-36(d)(4)(i). If the attribute reduction amount is smaller than the sum of the departing member's "soft" attributes (losses plus deferred deductions), the seller can elect to reduce those attributes in some different amounts. *Id.* The time and manner of making that election is set forth at Reg. 1.1502-36(e)(5).

⁴⁸ Reg. 1.1502-36(d)(6)(i)(A). It's also possible to eschew only part of the available loss, although this leaves the buyer exposed to risk of subsequent attribute elimination.

Based on that activity, P's adjusted basis in X's stock at the end of 2012 would be \$9.5 million computed as follows: beginning basis of \$10 million plus \$3 million of taxable income⁴⁹ minus \$2.5 million on account of the intercompany dividend paid in 2009⁵⁰ minus \$1 million on account of the NOLs absorbed.⁵¹ In addition, the adjusted basis of the X receivable in P's hands is \$2.2 million, equal to the face amount of the debt. Because interest rates have risen relative to the fixed rate under the note, however, that receivable is worth only \$2 million.

P is negotiating with Buyer, the parent of an unrelated consolidated group. The parties have not decided between a stock or asset transaction, and they have also not agreed on a purchase price. If the transaction is structured as a stock deal it could be a sale of either the X stock or the Y stock (because Y holds most of the operating assets). Buyer has requested that P clean up X's intercompany debt so that X and Y are debt-free at closing. The CFO asks our favorite client to determine how much gain or loss is expected for tax purposes based on a range of possible values.

If P capitalizes the \$2.2 million receivable, its basis in the X stock will go up by \$2.2 million (from \$9.5 million to \$10.7 million) and the value of the X stock will go up by the same amount.

Our client may be quite surprised to learn that, under these facts, P will be prohibited from claiming at least \$2 million of loss on the sale of X stock, and that disallowed number might be \$2.2 million. Those numbers come out of the following sensitivity analysis: if Buyer agrees to pay anything between \$8.7 million and \$10.7 million, P will not be entitled to claim any loss. If the price is \$8.5 million P may or may not be able to claim a \$200,000 capital loss. If the price is less than \$8.5 million, P will definitely be entitled to some loss. But the first \$2 million worth of loss will not be allowed. How could this be?

The answer lies in the unified loss rules. Immediately before the sale, P must reduce its basis in X's stock by the smaller of two amounts: (i) the "net positive adjustment" and (ii) the "disconformity amount."⁵²

- 1) The "net positive adjustment" amount is the net increase to the basis of the X shares under the consolidated return investment adjustment rules, with some modifications. For this purpose we ignore increases to stock basis attributable to "outside" capital contributions and we also ignore reductions to stock basis attributable to distributions.

If we look again at the activity summarized above, we see only (i) \$3 million of

⁴⁹ Reg. 1.1502-32(b)(2)(i).

⁵⁰ Reg. 1.1502-32(b)(2)(iv).

⁵¹ Reg. 1.1502-32(b)(2)(i).

⁵² Reg. 1.1502-36(c)(2). The device used to deny a loss under these unified loss rules is a direct reduction to the basis of member stock, rather than a disallowance of some recognized loss as we saw under the prior incarnations of loss disallowance (including Former Reg. 1.1502-20 and Former Reg. 1.337(d)-2).

taxable income and (ii) \$1 million of NOL absorption.⁵³ The \$2.5 million distribution is ignored for this purpose, as is the additional basis attributable to the last-minute contribution of intercompany debt. (More on this momentarily.)

- 2) The "disconformity amount" is the amount by which P's basis in the X stock exceeds X's "net inside attribute amount."⁵⁴

We don't have enough information to compute the disconformity amount. For sake of discussion we'll assume the disconformity amount is greater than the net positive adjustment amount.

Why during the earlier sensitivity analysis did we keep waffling about the possibility of claiming \$200,000 worth of loss? The issue concerns the consequences of the last-minute cancellation of X's \$2.2 million intercompany debt. The details are actually surprisingly dense. To avoid losing the momentum of this narrative we have moved those details into an Appendix. For present purposes the key points are as follows:

- 1) If X actually issues additional shares to P upon the cancellation of that debt, X will recognize \$200,000 worth of taxable COD income, driving \$200,000 worth of additional positive investment adjustments and tainting \$200,000 worth of basis in X's stock under the unified loss rules. P would also increase its basis in X's stock by \$2 million as an "outside" capital contribution, but that amount of basis would not be "tainted" under the unified loss rules.
- 2) If X does not issue any additional shares, X should recognize no COD income while P increases its basis in X's stock by \$2.2 million as an "outside" capital contribution, none of which is "tainted."
- 3) The difference between those cases relates to the proper application of the recently-finalized intercompany obligation regulations. Unfortunately it remains unclear whether Sec. 108(e)(6) can apply when intercompany debt is extinguished and the debtor issues no additional shares. These issues are further discussed in the Appendix.

Returning to the immediate task, the tax director is now able to report that the P group will get no tax benefit from the first \$2 million of loss recognized upon the sale of X stock. So naturally the CFO would like to know whether the results can be improved if X contributes its few assets to Y and then X sells the Y stock to Buyer.

b. X sells Y stock

⁵³ Notice that stock basis increases attributable to normal operating income is "tainted" under these unified loss rules. Under the loss disallowance rules that have been in effect since 2001, these kind of basis increases were tolerated: only the increases attributable to the gain from the disposition of built-in gain assets would thereafter be disallowed. See Former Reg. 1.337(d)-2 and Notice 2004-58, 2004-2 CB 520.

⁵⁴ Reg. 1.1502-36(c)(4).

Regrettably this question may be even more difficult to answer. Recall that P previously purchased X stock in a taxable transaction without an (h)(10) election. Seller had no particular reason to compute X's basis in the Y stock at that time, and P had no particular reason to ask for that information. To determine X's basis in the Y stock now, P must go back into the pre-acquisition (Seller) tax years, starting all the way back with the original formation or acquisition of Y . . . you know where this story ends.

In theory, if our client had the information needed to compute stock basis, it would also have the information needed to apply the unified loss rules (i.e. it could determine the "net positive adjustments" with respect to Y's stock dating all the way back to the years when Y was in Seller's group). As a practical matter, however, due to lapse of time, turnover in tax department personnel, incomplete or inaccurate tax return information in Seller's hands, lack of cooperation (or even political strains) between Seller and P, it can be a real challenge for P's tax director to get even a minimal level of comfort regarding the basis of the Y stock, and even harder to get comfortable that the unified loss rules will be applied properly.

At this point, it would be technically correct (but probably unwise) for the tax director to point out that all these difficulties could have been avoided if P had made a Sec. 338(h)(10) election when it acquired X from Seller. P would now be entitled to any loss recognized on the sale of X's stock. (There would be no last-minute reduction to the basis of X's stock because the "disconformity amount" would be zero.) Or X could sell the Y stock and claim a loss (for the same reason). Or P could sell the X stock with an (h)(10) election and trigger the same aggregate loss (since the net "inside" basis in all the assets remains the same as the "outside" basis in the X stock).

IV) Conclusion

The unified loss rules represent a significant and potentially far-reaching shift in the taxation of consolidated groups. Domestic corporations that purchase businesses out of existing consolidated groups now have strong incentives to prefer asset purchases over stock purchases. How strong? Only time will tell. It's not unreasonable to suggest that some buyers might be willing to pay some premium over and above the traditional "present value benefit from basis step-up." What will that extra amount buy them? Certainty and simplicity. First, the buyer will avoid the near-term complexities and uncertainties that are likely to flow from the seller's post-closing adjustments. Second, if the value of the acquired business falls, the buyer is more likely to realize the full tax benefit of losses recognized on disposition. Third, the calculation of allowable loss promises to be far less complex. And if enough buyers systematically eschew taxable stock purchases in favor of asset purchases, maybe they'll go the rest of the way and simply convert all their members to disregarded entities. Now that Larry has retired from private practice and is working for the forces of good, that's probably not such a bad idea.

Appendix

What are the stock basis consequences when intercompany debt is capitalized on the eve of a sale?

Under the recently-revised intercompany obligation rules,⁵⁵ the lender and borrower must go through the deemed satisfaction and reissuance mechanics any time there is a “triggering transaction.” After fighting through a few cross-references and studying one of the examples in the regulations, it becomes fairly clear that a cancellation of subsidiary debt owed to the direct shareholder where no additional shares are issued is not a triggering event hence no deemed satisfaction at fair value. And because the debt is not deemed satisfied for its fair value, the debtor subsidiary must apply Sec. 108(e)(6) to determine the amount for which it is treated as having satisfied its debt. As long as the shareholder’s adjusted basis in the debt is the same as the face amount, the debtor will recognize no COD income and the shareholder will recognize no gain or loss under Sec. 351.

The interpretive journey begins with the term “triggering transaction,” which is defined broadly to include “any intercompany transaction in which a member realizes an amount, directly or indirectly, from the assignment **or extinguishment** of all or part of its remaining rights or obligations under an intercompany obligation . . .”⁵⁶ We are then informed that certain extinguishment transactions are excepted from that broad definition: “if a creditor or debtor realizes an amount in a transaction in which a creditor assigns all or part of its rights under an intercompany obligation to the debtor, * * * the transaction will be treated as an extinguishment and will be excepted from the definition of ‘triggering transaction’ only if either of the exceptions in paragraphs (g)(3)(i)(B)(5) or (6) of this section apply.”⁵⁷

We can quickly dispatch with the second of those two exceptions: -13(g)(3)(i)(B)(6) (entitled “Routine modification of intercompany obligation”) applies when all of the rights and obligations under an intercompany obligation are extinguished in exchange for a newly issued intercompany obligation. In our case the old intercompany obligation is capitalized with no new debt taking its place so that rule clearly does not apply. The remaining possible exception, -13(g)(3)(i)(B)(5), appears as one long sentence in the regulations. We’ll reproduce the full text of the rule below but, for our convenience, we’ll break its three requirements into separate clauses as follows:

- I) All or part of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction (other than an exchange or deemed exchange of an intercompany obligation for a newly issued intercompany obligation),
- II) the adjusted issue price of the obligation is equal to the creditor’s basis in the obligation, and

⁵⁵ TD 9442, 73 FR 79324-02 (12/24/08) (effective for transactions occurring in taxable years beginning on or after December 24, 2008). Reg. 1.1502-13(g)(8).

⁵⁶ Reg. 1.1502-13(g)(3)(i)(A) (emphasis added).

⁵⁷ Reg. 1.1502-13(g)(3)(i)(B).

- III) the debtor's corresponding item and the creditor's intercompany item (after taking into account the special rules of paragraph (g)(4)(i)(C) of this section) with respect to the obligation offset in amount.

The first clause is clearly satisfied when our parent capitalizes debt of its subsidiary. All of the rights and obligations are extinguished in an "intercompany transaction" and the parenthetical rule does not apply.

The second clause is satisfied as long as (i) the intercompany obligation is not an OID instrument (so the parent's basis in the debt is equal to the adjusted issue price) and (ii) there have been no transactions or events causing the parent to reduce its basis in the debt (such as the "basis-less-than-face" events discussed earlier).

The third clause is the tricky one. Even before we know what it means to "take into account the special rules of paragraph (g)(4)(i)(C) of this section," we know that if the parent or the subsidiary realize any items with respect to the obligation, those items have to offset in amount. This "offset" requirement will be met, for example, if the lender recognizes a bad debt deduction, the borrower realizes COD income, and the amount of those two items are the same. This requirement will also be met, for example, if neither member recognizes income or loss.

So what are these special rules of paragraph (g)(4)(i)(C) that must be taken into account when applying that third clause? Those rules shut off assorted Code sections for certain purposes. In particular, for purposes of applying the matching and acceleration rule to a transaction involving an intercompany obligation, "any income, gain, deduction, or loss from the intercompany obligation is not subject to section 108(a), section 354, section 355(a)(1), section 1091, **or, in the case of an extinguishment of an intercompany obligation in a transaction in which the creditor transfers the obligation to the debtor in exchange for stock in such debtor, section 351(a).**"⁵⁸ Stated in a more direct way, Sec. 351(a) does not apply where a member transfers an intercompany obligation to the debtor (thereby extinguishing the debt) and receives the debtor's stock in exchange therefore. Because Sec. 351(a) does not apply, the transferor may recognize gain on the exchange currently: if a loss is recognized, additional restrictions probably come into play to defer or disallow that loss.

One of the examples in the intercompany obligation regulations⁵⁹ illustrates the three requirements under -13(g)(3)(i)(B)(5) and also sheds light on the mysterious "special rules under paragraph (g)(4)(i)(C)." We'll reproduce the example in full here, interspersed with some commentary:

- (i) Facts. On January 1 of year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of year 20. The note is a security within the meaning of section 351(d)(2). As of January 1 of year 3, B has fully performed its obligations but the

⁵⁸ Reg. 1.1502-13(g)(4)(i)(C) (emphasis added).

⁵⁹ Reg. 1.1502-13(g)(7), Example 6.

fair market value of the B note is \$130, reflecting a decline in prevailing market interest rates, and S transfers the note to B in exchange for \$130 of B stock in a transaction to which both section 351 and section 354 applies.

Several observations are in order before we reproduce the rest of the example. First, why are we told that the B note is a “security” within the meaning of section 351(d)(2)? In order to enjoy non-recognition treatment under the normal rules of Sec. 351, the transferor must transfer “property” to a corporation and it must be in “control” of that corporation immediately after the transfer. Stock which is received in exchange for something other than “property” can’t qualify under Section 351(a). Section 351(d) sets for three items that are not considered “property” for purposes of Section 351: the second of three is “indebtedness of the transferee corporation which is not evidenced by a security.”⁶⁰ So the drafters of this example have gone out of their way to make it clear that the transfer of the B note back to B in exchange for \$130 worth of B stock could qualify under Sec. 351(a).

The second requirement under Sec. 351(a), that the transferor(s) “control” the transferee immediately after, is also satisfied in this case, although that conclusion is far from clear to the untrained eye. Under the separate return standards, S would be in “control” of B only if S owned 80% of B’s voting stock and 80% of all other classes immediately after the transaction.⁶¹ How did the drafters reach that conclusion based on S’s ownership of \$130 worth of B stock? They didn’t, but two additional background facts must be understood to see why. First, there’s a rule in the consolidated return regulations that allows members to aggregate stock ownership for purposes of satisfying Sec. 351(a).⁶² Second, the examples throughout the intercompany transaction regulations are built on a standard fact pattern. P is the common parent of the group; S and B are members owned entirely by P.⁶³ Because S is treated as owning all the B shares actually owned by P, S is in “control” of B immediately after exchanging the B note for \$130 worth B stock regardless what percentage of B shares S owns directly and the exchange therefore qualifies under Sec. 351(a).

Lastly, we are also told that the exchange of the B note for B stock qualifies under Section 354. This kind of exchange can constitute a “recapitalization” under Sec. 368(a)(1)(E) in which the creditor (S) recognizes no gain or loss under Sec. 354 and transfers its basis in the B note over to the B shares under Sec. 358.

With those points in hand we can now proceed with the balance of the example.

(ii) No deemed satisfaction and reissuance. As a result of the satisfaction of the note for more than its adjusted issue price, B takes into account \$30 of repurchase premium under §1.163-7(c).

⁶⁰ Sec. 351(d)(2).

⁶¹ Sec. 351(c), cross-referencing Sec. 368(c).

⁶² Reg. 1.1502-34.

⁶³ Reg. 1.1502-13(c)(7) (“For purposes of the examples **in this section**, . . . P owns all of the only class of stock of subsidiaries S and B, . . .”) (emphasis added).

That's the same result we previously saw under the separate company rules discussed in Part 1 above.

Although the transfer of the B note is a transaction to which both section 351 and section 354 applies, under paragraph (g)(4)(i)(C) of this section, any gain or loss from the intercompany obligation is not subject to either section 351(a) or section 354, and therefore, S has a \$30 gain under section 1001.

Here's where we see the special rules of (g)(4)(i)(C) in action. Even though the exchange of B's note for B shares would ordinarily have qualified under both Sec. 351 and 354, both of those Code provisions are turned off under -13(g)(4)(i)(C) (since this is an extinguishment transaction and S received B shares in exchange for the note). As a result, S's \$30 of gain must be currently recognized.

Because the note is extinguished in a transaction in which the adjusted issue price of the note is equal to the creditor's basis in the note, and the debtor's and creditor's items offset in amount, the transaction is not a triggering transaction under paragraph (g)(3)(i)(B)(5) of this section, and the note is not treated as satisfied and reissued under paragraph (g)(3)(ii) of this section.⁶⁴

At last, we learn that we have satisfied all three requirements of -13(g)(3)(i)(B)(5), meaning the exchange of B's note for B shares is **not** a "triggering event" and the note is therefore **not** deemed satisfied under -13(g)(3)(ii).⁶⁵

The first one or two times the average practitioner reads this example, he or she might conclude that the whole point was to show that S and B recognize neither income nor deduction because B's note is not deemed satisfied. That would be particularly reasonable if he or she had first read the final regulation's preamble, which explains many reasons why the government had decided to exempt several categories of transactions from the complexities of deemed satisfaction. By the third or fourth time through the example, however, he or she might notice something odd: the reason there's no deemed satisfaction is that it would be redundant. Because the regulations have shut off Sections 351 and 354, S actually recognizes \$30 of gain upon receipt of the B stock and B actually recognizes an ordinary \$30 retirement premium deduction. Why bother requiring a deemed satisfaction if the actual transaction produces the desired results?

To summarize what we've learned during our wanderings, when an intercompany debt is extinguished and no additional shares are issued there's no deemed satisfaction (and the parties are left with the results of their actual transaction) if three requirements are met: (1) all of the rights of the intercompany obligation are extinguished, (2) the adjusted issue

⁶⁴ The rest of the example addresses ancillary points that are less interesting for our purposes. For the sake of completeness we'll summarize those conclusions here: (1) the character of S's \$30 of Sec. 1001 gain is redetermined to be ordinary income pursuant to Reg. 1.1502-13(c)(4)(i) (so it can be offset by B's \$30 ordinary retirement premium deduction); and (2) the B stock received by S will **not** be considered "section 1245 property" because the normal rules under Sec. 108(e)(7) are also shut off pursuant to Reg. 1.1502-13(g)(4)(i)(D) (and therefore when S later sells that B stock at a gain it need not worry about some of that gain being recharacterized as ordinary income under the Sec. 1245 recapture rules).

⁶⁵ Reg. 1.1502-13(g)(3)(i)(B).

price of the obligation equals the creditor's basis in the obligation, and (3) after taking into account the special rules of (g)(4)(i)(C) (shutting off various Code sections), the debtor's corresponding item and the creditor's intercompany item with respect to the intercompany obligation offset in amount.⁶⁶

When a parent capitalizes its subsidiary's debt and takes back no additional shares, the first requirement is met (because the obligation is extinguished) and the second is usually met (unless the debt is an OID instrument or the lender has previously been required to reduce the basis of the intercompany receivable). So it comes down to the third requirement. If the shareholder owns all the stock of the creditor / subsidiary and it receives no additional shares upon cancellation of the debt, will Sec. 351 apply to prevent recognition of gain or loss in the shareholder's hands? In the facts of the regulation's example above, Sec. 351 was shut off under the special rules of -13(g)(4)(i)(C). But that rule only shuts off Sec. 351 in extinguishment transactions "in a transaction in which the creditor transfers the obligation to the debtor *in exchange for stock in such debtor*" (emphasis added). Because our debtor is not issuing any shares, the "shut off" rule does not apply and Sec. 351 therefore prevents the shareholder from recognizing gain or loss.⁶⁷

Alternatively, at least in the case where the debt is worth less than the shareholder's basis, the shareholder may be precluded from claiming a current deduction. If the debtor corporation is wholly-owned by the Lender and it remains insolvent before and after its debt is cancelled, the Lender / Shareholder ought not to claim a bad debt deduction even if actually receives additional shares in exchange for the debt. This point was succinctly stated by the Second Circuit: "Where a parent corporation voluntarily cancels a debt owed by its subsidiary in order to improve the latter's financial position so that it may continue in business, we entertain no doubt that the cancellation should be held a capital contribution and preclude the parent from claiming it as a bad debt deduction."⁶⁸

In addition, Sec. 108(e)(6) tells the debtor subsidiary that it is treated as having repaid the debt in full (i.e. as having repaid the debt with an amount of money equal to the shareholder's basis in the debt, which we previously established as being equal to the obligation's adjusted issue price, else we wouldn't have satisfied the second requirement to avoid a "trigger event"). And because the debtor's corresponding item (zero, pursuant to Sec. 108(e)(6)) and the creditor's intercompany item (zero, pursuant to either Sec. 351(a) or Lidgerwood) offset in amount, we have satisfied the third requirement under -13(g)(3)(i)(B)(5) in this extinguishment transaction, the capitalization is therefore not a

⁶⁶ Reg. 1.1502-13(g)(3)(i)(B)(5).

⁶⁷ Of course it is possible to argue that the debtor could be deemed to have issued shares for this purpose, thereby satisfying the requirements of -13(g)(4)(i)(C) and shutting off Sec. 351(a). If the drafters wanted to make sure Sec. 108(e)(6) would not apply, there are two much more appropriate methods to accomplish that result. One would have been to expressly deem shares to be issued under the appropriate operating rules; the other would have been to amend Reg. 1.1502-80 and making it clear that Sec. 108(e)(6) does not apply inside consolidated groups. Absent either of these clear fixes, the party claiming "deemed stock issuance" for this purpose would appear to have the harder argument by far.

⁶⁸ See, e.g., Lidgerwood Mfg. Co. v. Comm'r, 229 F.2d 241 (2nd Cir. 1956). That case has been frequently cited in numerous cases and IRS rulings.

“triggering event,” and the debt is therefore not deemed satisfied for its fair value immediately before the cancellation.