2012

Federal Income Tax Issues of Financially Troubled Corporations

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CHAPTER 3

FEDERAL INCOME TAX ISSUES OF FINANCIALLY TROUBLED CORPORATIONS

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FEDERAL INCOME TAX ISSUES OF FINANCIALLY TROUBLED CORPORATIONS

3.1.0 Introduction

This chapter first considers IRC §382, focusing on IRC §382(l)(6) and the segregation and aggregation rules. It next reviews the "SRLY" rules, which are found in Regulation §1.1502-21, before considering IRC §108, including how it applies to a consolidated group. If finally discusses the loss limitation rules of Regulation §1.1502-36.

3.2.0 IRC Section 382—Limitation on NOL Carryforwards and Certain Built-In Losses Following Ownership Change

3.2.1 General

.1 Application

IRC §382 applies if a loss corporation, loss group, or loss subgroup undergoes an *ownership change*. [See generally IRC §382(a).] The date that the ownership change occurs is called the *change date*, and use of the loss corporation's *pre-change losses* is limited for any *post-change year* (i.e., a taxable year ending after the change date). [*Id.* at (d)(2), defining post-change year, and (j), defining change date]

.2 IRC Section 382 Limitation

After an ownership change, the amount of a loss corporation's pre-change loss that may be used annually is limited to the IRC §382 limitation, which equals (A) the loss corporation's value, generally determined immediately before the ownership change, multiplied by (B) the federal long-term tax-exempt rate. [IRC §382(b)(1); see also *Id.* at (g), defining ownership change.]

.3 Definitions

(A) A pre-change loss is a net operating loss (NOL) or NOL carryforward of the "loss corporation" that arose in (or is allocable to) a period before the ownership change. [*Id.* at (d)(1); see also *Id.* at (h)(1)(B), treating certain built-in losses as pre-change losses.]

(B) A loss corporation is a corporation that is entitled to use an NOL carryover or has an NOL for the taxable year in which the ownership change occurs. [*Id.* at (k)(1)] It also includes a corporation with a net unrealized built-in loss. [*Id.* See also Reg. §1.382-2(a)(1)(i), defining a loss corporation.]

(C) An ownership change occurs if the percentage of loss corporation stock (or stock of the parent of the loss group or subgroup) owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the testing period, which is three years or, if shorter, the period since the last ownership change. [IRC §382(g), defining ownership change; *Id.* at (i), defining testing dates and providing that the period does not begin until the first day of the first year for which there is a carryforward of losses; see also Reg. §1.382-2T(d)(3)(ii), providing that if the loss corporation has net unrealized built-in loss on the testing date, the testing period cannot begin before the earlier of the first day of the first year (1) for which there is a loss carryforward or (2) in which net unrealized built-in loss first accrued.] For this purpose, however, the loss corporation's IRC §1504(a)(4) stock (i.e., its pure vanilla preferred stock) is disregarded. [IRC §382(k)(6)]

3.2.2 Valuing Loss Corporation

.1 General

The value of the corporation generally is the value of its stock, including any IRC §1504(a)(4) stock, immediately before the ownership change. [IRC §382(e)(1); but see *Id.* at (e)(3), providing that in determining the value of a foreign loss corporation only items connected with U.S. trades or businesses are taken into account.] This value may be reduced, however, if the loss corporation (A) has substantial nonbusiness assets, (B) redeems its stock in connection with the ownership change, or (C) receives a capital contribution in contemplation of the ownership change.

.2 Anti-Stuffing Rule

The last point is addressed in IRC §382(l)(1), which provides an "anti-stuffing" rule. The loss corporation's value is reduced by any capital contribution made "as part of a plan, a principal purpose of which is to avoid or increase" the IRC §382 limitation. [IRC §382(l)(1)(A); see also *Id.* at (l)(1)(B), stating that a principal purpose is presumed for contributions within two years after the ownership change, except to the extent provided in regulations.] Notwithstanding the literal language of IRC §382(l)(1)(B), that principal purpose is *not* presumed solely because the capital contribution is made within two years preceding the ownership change. [Notice 2008-78, 2008-2 CB 851, eliminating the presumption] Generally, a finding of principal purpose is based on the facts and circumstances. [*Id.*] Under a series of safe harbors, however, the anti-stuffing rule does not apply to contributions made (A) on formation of the corporation (if the incorporated assets did not have a net unrealized built-in loss), (B) before its first loss year, or (C) in exchange for stock issued for services. [See HR Rep. No. 841, 99th Cong., 2d Sess. II-189, describing those exceptions; Notice 2008-78, 2008-2 CB 851, also excluding many contributions made more than six months before the ownership change if those contributions were also made before there was an agreement, understanding, arrangement, or substantial negotiations regarding the transaction that resulted in the ownership change.]

.3 Nonbusiness Assets

Under IRC §382(l)(4), if at least one-third of a loss corporation's assets are "nonbusiness" assets (i.e., assets held for investment), the value of the loss corporation is reduced by the net value of those assets. [IRC §382(l)(4)(A)–(D)] For this purpose, the net value of nonbusiness assets is the value of those assets minus the share of the loss corporation's debt attributable to those assets. [IRC §382(l)(4)(A)] That attributable share of debt equals (A) the loss corporation's debt multiplied by (B) the percentage of its assets that are nonbusiness assets. [IRC §382(l)(4)(D)]

.4 Look-Through Rule

In applying this one-third test, if the loss corporation owns a *50-percent subsidiary*, a look-through rule applies. [IRC §382(l)(4)(E)] For this purpose, a subsidiary is a 50-percent subsidiary if the loss corporation owns at least 50 percent of the total voting power and value of the subsidiary's stock. [*Id.*] Under the look-through rule, the loss corporation determines its nonbusiness assets by taking into account a ratable share of the subsidiary's assets and disregarding the subsidiary stock and securities. [*Id.*]

.5 Redemption Rule

The anti-stuffing and nonbusiness asset rules both attack steps taken to inflate the value of a loss corporation *before* an ownership change. In contrast, the redemption rule considers *post-change* redemptions of a loss corporation's stock that diminish its value. Under the redemption rule, the value of the loss corporation is reduced to account for any redemption or other corporate contraction that occurs "in connection with" an ownership change. [IRC §382(e)(2)]

3.2.3 IRC Section 382(l)(5)—Title 11 or Similar Case

.1 General

If IRC §382(l)(5) applies to the loss corporation, IRC §382(a) does not limit the corporation's use of its pre-change losses (at least initially) because of the ownership change. [See IRC §382(l)(5)(A); but see *Id.* at (l)(5)(B) for a reduction in certain NOL and excess credit carryforwards.] Except as noted below, IRC §382(l)(5) provides that IRC §382(a) does not apply to limit the use of pre-change losses of a loss corporation because of an ownership change if both of the following requirements are met.

(A) The loss corporation is under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change.

For example, IRC §382(l)(5) may apply if the assets of a financially troubled target are transferred in a reorganization described in IRC §368(a)(1)(G) (an acquisitive "G" reorganization). An acquisitive G reorganization must meet the following statutory requirements: (1) the target must transfer substantially all of its assets to the acquirer; (2) the transfer must occur in a Title 11 or similar case; and (3) as part of the plan of reorganization, the target must distribute all of its property, including the qualified stock or securities and other property received in the transaction. [IRC §368(a)(1)(G); see also IRC §354(b) for the distribution and "substantially all" requirements.]

(B) Shareholders and "qualified" creditors of the old loss corporation immediately before the ownership change own stock of the new loss corporation immediately thereafter that possesses at least 50 percent of its vote and value. [IRC §382(l)(5)(A); see also Reg. §1.382-9(b).]

The only stock taken into account for this purpose is stock that the shareholders and creditors acquire in the new loss corporation because they were shareholders or creditors in the old loss corporation. [IRC §382(l)(5)(A)] In determining whether those 50-percent tests are met, stock described in IRC §1504(a)(4) (broadly, pure vanilla preferred stock) is disregarded. Note that even if IRC §382(l)(5) preserves the use of a loss corporation's NOL carryovers, they may be limited under other rules. [See, e.g., IRC

§269(a)(1), providing for the disallowance of tax benefits if persons acquire control of a corporation for the principal purpose of tax avoidance; and Reg. §1.269-3(d), providing that control of a loss corporation is acquired for the principal purpose of tax avoidance if it is acquired in connection with an ownership change to which IRC §382(l)(5) applies, unless the corporation continues more than an insignificant, active business.]

Bisk point *In addition, the continuity of business requirement of IRC §382(c) does not apply with respect to the ownership change. [Reg. §1.382-9(m)(1)]*

.2 Transfer of Stock to Qualified Creditor

For this purpose, stock is transferred to a qualified creditor to the extent the following two requirements are met.

(A) First, the stock must be transferred in satisfaction of indebtedness in a transaction that is ordered or approved by the court in the Title 11 or similar case. [IRC §382(l)(5)(E); Reg. §1.382-9(d)(1), defining a qualified creditor]

(B) Second, the indebtedness must have (1) been held by the creditor since at least 18 months before the filing of the Title 11 or similar case, or (2) arisen in the ordinary course of the old loss corporation's business and always have been held by the creditor. [IRC §382(l)(5)(E); see also Reg. §1.382-9(d)(2)(i) for a refinement of the statutory rule; *Id.* at (d)(2)(ii), stating that ownership is determined without applying the attribution rules; *Id.* at (d)(2)(iv), defining ordinary course indebtedness as debt incurred by the loss corporation in the "normal, usual, or customary conduct of business," whether or not an ordinary or capital expenditure; examples include trade debt, a tax liability, a liability for employment compensation, a tort liability, and any liability incurred to pay an IRC §162 expense.]

.3 Limitations

(A) This IRC §382(l)(5) benefit has several costs, however.

(1) First, if the loss corporation undergoes another ownership change within two years after the ownership change, the IRC §382 limitation for the second ownership change is zero. [IRC §382(l)(5)(E); see also IRC §382(n)(1), providing that IRC §382(l)(5) cannot apply to the second ownership change and that the IRC §382 limitation for the second ownership change is zero.]

(2) Second, if IRC §382(l)(5) applies, it may require a significant reduction in the pre-change losses and excess credits that can be carried forward to post-change years. [An excess credit is defined in IRC §383(a)(2) (i.e., any unused business credit of the loss corporation under IRC §39 and any unused minimum credit under IRC §53).] Those carryforward amounts must be computed by assuming that the loss corporation cannot deduct any interest accrued on debt converted to stock as part of the Title 11 or similar case. [IRC §382(l)(5)(B)]

This deduction limitation applies only to interest accrued during (1) any taxable year ending during the three-year period preceding the change year and (2) the portion of the change year ending on the change date. [Id. See also Id. at (l)(5)(C), coordinating this loss-reduction rule and IRC §108(e)(8) by providing that IRC §108(e)(8) does not take into account any interest described in IRC §382(l)(5)(B); thus, the eliminated interest cannot also create COD income).] This three-year interest "hair cut" rule complements the qualified creditor rule.

(B) Thus, IRC §382(l)(5) may be unattractive to many loss corporations, particularly those with substantial interest-bearing debt that is exchanged for stock under the reorganization plan. [Note that most corporations are accrual-basis taxpayers that accrue interest on their debt. See IRC §448(a), providing that a C corporation generally must use the accrual method. *Cf. Id.* at (c), providing an exception for a corporation with less than $5 million of annual gross receipts.] Recognizing that concern, Congress allows a loss corporation to elect out of IRC §382(l)(5). [IRC §382(l)(5)(H); Reg. §1.382-9(i), providing that the election is irrevocable and must be made by the due date (including extensions) of the loss corporation's return to that year that includes the change date.]

3.2.4 IRC Section 382(l)(6)— Special Rule for Insolvency Transactions

.1 General

(A) If IRC §382(l)(6) applies to an ownership change, the IRC §382 limitation is computed by specially valuing the loss corporation. Then, the value equals the smaller of (1) the value of the loss corporation's stock immediately after the ownership change, or (2) the gross value of the loss corporation's pre-change assets. [Reg. §1.382-9(j); see also *Id.* at (m)(2), noting that the continuity of business requirement of IRC §382(c) applies to the ownership change.]

(B) IRC §382(l)(6) applies if an ownership change occurs pursuant to a plan or reorganization in a Title 11 or similar case and IRC §382(l)(5) does not apply, by election or otherwise. [Reg. §1.382-9(j)]

(C) For this purpose, the loss corporation's stock includes all of its stock, including its IRC §1504(a)(4) stock, if any. Further, in valuing the loss corporation stock, the redemption and nonbusiness asset rules apply, but the anti-stuffing rule does not. [Reg. §1.382-9(k)(1)-(5), also providing that the rule relating to foreign loss corporations applies; see also Reg. §1.382-9(k)(6) for an anti-abuse rule that applies if loss corporation stock was issued as part of a plan, one of the principal purposes of which was to increase the IRC §382 limitation without subjecting the stock investment to entrepreneurial risk; Reg. §1.382-9(n)(2), providing that if IRC §382(l)(6) applies to an ownership change and a second ownership occurs within the next two years, the value of the loss corporation for the second ownership change is not reduced under the anti-stuffing rule for any increase in value taken into account under IRC §382(l)(6) because of the first ownership change.] In addition, for loss corporation stock issued in connection with the ownership change, its value cannot exceed the value of the consideration received by the loss corporation for that issuance. [Reg. §1.382-9(k)(7), taking into account cash and noncash property received, including indebtedness of the loss corporation]

Because the anti-stuffing rule does not apply to reduce the value of the loss corporation's stock, an infusion of cash by new investors as part of the reorganization plan may maximize the IRC §382 limitation when IRC §382(l)(6) applies.

.2 Valuing Loss Corporation's Pre-Change Assets

In valuing the loss corporation's pre-change assets, their value is determined immediately before the ownership change. [Reg. §1.382-9(l)(1), adding that their value is determined without regard to liabilities] In valuing those assets, the redemption rule does not apply. [*Id.* at (l)(2)] The value of the pre-change assets is reduced, however, by the value of any capital contributions or nonbusiness assets to which the anti-stuffing and nonbusiness asset rules apply. [*Id.* at (l)(4)-(5); see also *Id.* at (l)(3), providing that if the loss corporation is a foreign corporation, only those assets connected with a U.S. trade or business are taken into account.]

.3 Consolidated Groups

(A) No regulations have been issued that describe how IRC §382(l)(6) [or IRC §382(l)(5) for that matter] apply to consolidated groups. A single-entity approach would be consistent with the consolidated computation of income and loss [and arguably follow language under *United Dominion Indus, Inc. v. United States*, 532 U.S. 822 (2001)]. A separate-corporation approach would be consistent with each member having distinct creditors and being entitled to separate bankruptcy protection. Perhaps a single-entity approach would be appropriate if the common parent is in bankruptcy or a subgroup approach would be appropriate if a subgroup parent was in bankruptcy.

(B) In any case, as a general matter, the better view is that a single-entity approach should apply. First, the consolidated IRC §382 regulations in general apply a single-entity approach (Reg. §1.1502-91), determine ownership changes in general by reference to the common parent, a single-entity approach [Reg. §1.1502-91(b)(1)(i) for the parent-change method], and determine a consolidated IRC §382 limitation, also a single-entity approach (Reg. §1.1502-93).

(C) Further, a single-entity approach is used in applying the redemption rule, the anti-stuffing rule, and the nonbusiness asset rule. In applying the redemption rule under IRC §382(e)(2), redemptions and corporate contractions that do not effect a transfer of value outside of the loss group are disregarded. In applying the anti-stuffing rule of IRC §382(l)(1), capital contributions between members are disregarded. Finally, the nonbusiness asset rule of IRC §382(l)(4) is applied on a group-wide basis, not separately to members. [Reg. §1.1502-93(b)(2)(i); see also *Id.* at (b)(2)(ii) for an anti-duplication rule.]

(D) Finally, generally applying the single-entity approach is consistent with the broad but unstated principle in the consolidated return regulations that the regulations should be tax-neutral in the following sense: In choosing between the single-entity and separate-corporation approaches, we should generally choose the approach (or combination of approaches) that is least likely to affect a consolidated group's nontax economic choice to transfer assets between its members or to acquire, form, liquidate, or sell members.

Example 3.1—Basic Application of IRC Section 382(l)(6)

T has $150 of liabilities and its gross assets have a $100 value. Under a bankruptcy plan, T's old equity is cancelled, new equity is issued to a buyer for $100, and the lenders receive $100 in full satisfaction of their claims. (Thus, $50 of their claims are cancelled.) Assume that the federal long-term tax-exempt rate is 4 percent.

The Buyer's purchase of T stock is an ownership change, because a 5-percent shareholder (i.e., the Buyer) has increased its ownership interest in T by more than 50 percentage points (in fact, by 100 percentage points). IRC §382(l)(6) applies to an ownership change if it occurs pursuant to a plan or reorganization in a Title 11 or similar case, and IRC §382(l)(5) does not apply, by election or otherwise. [Reg. §1.382-9(j)] This ownership change occurs pursuant to a Title 11 case, and IRC §382(l)(5) does not apply because T's historic creditors and shareholders retain no interest in T (and, thus, less than a 50-percent interest).

When IRC §382(l)(6) applies to an ownership change, the IRC §382 limitation is computed by specially valuing the loss corporation. Then, the value equals the smaller of (1) the value of the loss corporation's stock immediately after the ownership change, or (2) the gross value of the loss corporation's pre-change assets. [Reg. §1.382-9(j); see also Id. at (m)(2), noting that the continuity of business requirement of IRC §382(c) applies to the ownership change.]

In this case, both amounts are the same. T's stock value immediately after the ownership change and the gross value of its pre-change assets are both $100. Thus, the IRC §382 limitation equals $100 times the long-term tax-exempt rate of 4 percent or $4.

Example 3.2—Consolidated Application of IRC Section 382(l)(6)—Common Parent Bankrupt

P, the common parent of a consolidated group, is bankrupt with $50 of liabilities. Its only asset is 100 percent of the S stock worth $30. S has assets worth $100 and liabilities of $70. Buyer acquires all P stock for $30, and the P creditors receive $30 in satisfaction of $30 of their debt, cancelling the remaining debt.

Does IRC §382(l)(6) apply to the P group on a consolidated basis? The Buyer's purchase of P stock is an ownership change, because a 5-percent shareholder (i.e., the Buyer) has increased its ownership interest in P by more than 50 percentage points (in fact, by 100 percentage points). IRC §382(l)(6) applies to an ownership change if it occurs pursuant to a plan or reorganization in a Title 11 or similar case, and IRC §382(l)(5) does not apply, by election or otherwise. [Reg. §1.382-9(j)] This ownership change occurs pursuant to a Title 11 case, and IRC §382(l)(5) does not apply because P's creditors and shareholders retain no interest in P (and, thus, less than a 50-percent interest). Thus, IRC §382(l)(6) applies to the ownership change.

That provision should apply on a consolidated basis. Under PLR 201051019 (12/23/10), the Service concluded that IRC §382(l)(5) (and by extension IRC §382(l)(6)) applied on a consolidated basis when a common parent and a disregarded entity owned by a subsidiary, but no other members, were in bankruptcy. The apparent rationale was that a group's change in ownership generally is determined using the parent-change method (i.e., focusing on the change in ownership in the common parent's stock), so that if the *common parent was in bankruptcy (and had an ownership change), the group should as well, and should account for that change on a consolidated basis. Note that any other result would lead to a host of unanswered questions, including how to apply a combined separate and consolidated approach to a consolidated net operating loss (CNOL). A consolidated approach also makes a lot of sense when the common parent is in bankruptcy, its subsidiaries are all wholly owned, no losses are SRLY limited, and the common parent's creditors can look to any group asset to satisfy their liabilities. (The SRLY rules are described in the next section.) Finally, there is a strong bias for a consolidated approach, since even bankrupt subsidiaries remain group members until actually deconsolidated. [Rev. Rul. 63-104, 1963-1 CB 172]*

In this case, the value taken into account to determine the IRC §382 limitation will be $30, the smaller of the $30 P stock value immediately after the ownership change and P's gross asset value of at least $30 (the value of the S stock). Could the gross asset value be determined on a consolidated basis, therefore taking into account S's gross asset value (and disregarding the S stock value to prevent double counting)?

That question is relevant if Buyer acquires $100 worth of P stock (and perhaps the P group uses $70 of that amount to pay off S's liabilities). In valuing the loss corporation's stock, the anti-stuffing rule does not apply, but the value of the loss corporation's stock issued in connection with the ownership change cannot exceed "the cash and the value of any property (including the indebtedness of the loss corporation) received by the loss corporation in consideration for the issuance of the stock." [Reg. §1.382-9(k)(4) and (7)] Thus, if the Buyer buys $100 worth of P stock, even though it stuffs $70 as part of that purchase, the stock value will equal $100, since the anti-stuffing rule does not apply and cash paid for the issuance of stock in connection with the ownership change can increase stock value.

The gross asset value, however, is just $30, unless S's assets can be taken into account, and the current Service position, apparently, is that they cannot be. That position, however, seems inconsistent with the general approach in the consolidated IRC §382 regulations. A single-entity approach is used in applying the redemption rule, the anti-stuffing rule, and the nonbusiness asset rule. In applying the redemption rule under IRC §382(e)(2), redemptions and corporate contractions that do not effect a transfer of value outside of the loss group are disregarded. In applying the anti-stuffing rule of IRC §382(l)(1), capital contributions between members are disregarded. Finally, the nonbusiness asset rule of IRC §382(l)(4) is applied on a group-wide basis, not separately to members. [Reg. §1.1502-93(b)(2)(i); see also Id. at (b)(2)(ii) for an anti-duplication rule.]

Further, if a separate-corporation approach is applied, similarly situated groups could be treated differently. For example, if S was a disregarded entity rather than a subsidiary (or if S liquidated before the Buyer made its purchase), it seems clear that S's gross assets would be taken into account. Thus, presumably if S converted to a disregarded entity (or liquidated) before the ownership change, P's gross assets (whether or not a consolidated approach was used) would be $100. To promote neutrality, a consolidated approach arguably should be adopted, because approach makes it less likely to affect a consolidated group's nontax economic choice to form or liquidate a member.

There are, however, some arguments that favor a separate determination of gross assets [coupled with a generally consolidated approach to IRC §382(l)(6)]. First, if a subsidiary has minority shareholders, it is more difficult to justify taking its gross asset value into account. Second, if the creditors of the subsidiary are unrelated to the common parent's creditors, the common parent's creditors would have an interest in the subsidiary assets that was subordinate to the subsidiary's creditors, suggesting that common parent's gross assets (reflecting the bankruptcy rights) should account for that subordinate position (i.e., take into account only the stock or net asset value). Finally, if somehow a contribution by the common parent to the subsidiary increased the gross asset value, that increase seems inconsistent with the rule that the anti-stuffing rule should apply in determining gross asset value.

Example 3.3—Consolidated Application of IRC Section 382(l)(6)—Subsidiary Bankrupt

The common parent of a consolidated group, P, owns all stock of S, a bankrupt member. S has $150 of liabilities and gross assets worth $100. Buyer acquires $100 of P stock in exchange for the S debt (which Buyer had recently purchased for $100).

Can IRC §382(l)(6) apply, and does it apply on a consolidated basis? IRC §382(l)(6) can apply only if there is an ownership change. Suppose first that the Buyer receives less than 50 percent of the P stock, so that there has been no ownership change of P. Has there been an ownership change of S?

Revenue Ruling 59-222, 1959-1 CB 80, suggests that S may have undergone an ownership change. In that ruling, a corporation, Buyer, wished to acquire all stock of an insolvent corporation, L. Buyer issued its stock to L, and because all historic L stock was cancelled, Buyer became L's sole shareholder. L's liabilities were in part satisfied and in part simply cancelled, with its creditors receiving cash and Buyer stock. L's creditors (or at least its debenture holders) were deemed to exchange their debt for L stock and then exchange the L stock for Buyer stock (even though in form Buyer transferred its stock to L and L exchanged that stock directly for the L debt).

If the approach of Revenue Ruling 59-222 applies, Buyer, as S's creditor, would first be deemed to exchange the S debt for S stock, an exchange that would result in an ownership change of S. Because P would not also undergo an ownership change, presumably IRC §382(l)(6) could apply, if at all, only to S separately. [See Reg. §1.1502-96(b), applying an IRC §382 limitation to a subsidiary's pre-change losses by considering, among other things, its attributable share of a group's CNOL.]

Further, if the Buyer is deemed first to receive S stock, S, at least for a moment in time, will be disaffiliated from the P group. Under IRC §1504(a)(3), if a corporation ceases to be a consolidated group member, it generally cannot be included in a consolidated return filed by the group (or a group with the same common parent or its successor) until the 61st month beginning after the taxable year that includes the disaffiliation.

It is likely, however, that if IRC §1504(a)(3) otherwise would apply, it may be automatically waived by the Service under the procedure described in Revenue Procedure 2002-32, 2002-1 CB 959. The revenue procedure provides for an automatic waiver of IRC §1504(a)(3)(A) if the deconsolidated corporation is included in a timely filed consolidated return (including extensions) of the acquiring group for the acquisition year and *an appropriate statement is filed with that return. [Rev. Proc. 2002-32 at §5.01] Among other things, the statement must include a representation that the common parent (and any successor) was not an S corporation, disregarded entity, real estate investment trust, or regulated investment company at any time between deconsolidation and reconsolidation. [Id. at §5.03] The statement must also include various taxable income amounts for the acquiring group and deconsolidated corporation, among others. [Id. at §5.08-5.11] Finally, the statement must include an analysis of the effect of deconsolidation and a representation that the deconsolidation and subsequent reconsolidation did not provide a tax benefit that would not have been secured absent those events, something that should be easy to demonstrate since the two events were essentially simultaneous. [Id. at §5.12-5.14]*

Bisk point

Some suggest that even if Buyer is deemed to own S shares for an instant, S arguably does not become a nonmember because of the "end-of-the-day" rule under Regulation §1.1502-76(b)(1)(ii). Under that rule, if a subsidiary ceases to be a member, it ceases to be a member as of the end of the day of cessation. It is not clear, however, that the end-of-the day rule is intended to have this effect, since it is primarily an administrative rule to deal with the allocation of tax items between consolidated and separate periods.

Suppose instead that when Buyer acquires P stock, it acquires at least a 50-percent interest in that stock, so that P also undergoes an ownership change. Could IRC §382(l)(6) be applied on a consolidated basis? Without discussing this issue, PLR 88-49-061 (9/15/88) suggested that a consolidated approach should apply. If P voluntarily submits itself to the jurisdiction of the bankruptcy court, that enhances the argument for consolidated treatment, at least as long as S's creditors do not receive S stock. [See, e.g., PLR 9216020 (1/1/92); PLR 9229039 (4/23/92).]

If S converts to a disregarded entity (or is a disregarded entity), the analysis changes. Assuming that Proposed Regulation §1.108-9 reflects current law, the disregarded entity is not considered the taxpayer in applying IRC §108(a)(1)(A) or (B) (the insolvency or bankruptcy rules). Thus, those rules cannot apply unless the owner is bankrupt or insolvent (and presumably could apply if the owner had filed for bankruptcy, but the disregarded entity had not). Unanswered (although implied from this treatment) is whether the liabilities of the disregarded entity should be treated as nonrecourse debt to the owner, for example, in applying Tufts and valuing the disregarded entity's property under IRC §7701(g), which provides that for purposes of determining gain or loss connected with property subject to nonrecourse debt, the property's value is deemed to be not less than the amount of the debt. [See Commissioner v. Tufts, 461 U.S. 300 (1983).]

3.2.5 Segregation and Aggregation Rules

.1 General

IRC §382 applies if a loss corporation undergoes an "ownership change," which occurs if the percentage of loss corporation stock owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the testing period (generally three years). [IRC §382(g), defining ownership change; *Id.* at (i), defining testing dates] For this purpose, however, the loss corporation's IRC §1504(a)(4) stock (i.e., its pure vanilla preferred stock) is disregarded. [IRC §382(k)(6)]

.2 Five-Percent Shareholder

A 5-percent shareholder includes any individual owning (actually and constructively) 5 percent or more in value of corporate stock at any time during the testing period. [IRC §382(k)(7); Reg. §1.382-2T(g)(1)(i)] These 5-percent shareholders are determined by applying the attribution rules of IRC §318. [See generally *Id.* at (l)(3) for the attribution rules; see also *Id.* at (l)(3)(A)(ii), applying IRC §318(a)(2), which attributes stock from entities to their owners without regard to any 50-percent limitation and generally treating stock attributed thereunder as no longer held by the entity.]

.3 Public Groups

(A) Groups of non-5-percent shareholders are also treated collectively as 5-percent shareholders under the aggregation and segregation rules. These shareholder groups are called "public groups." Note that transactions between members of a single public group or between members of separate public groups are disregarded. [Reg. §1.382-2T(e)(1)(ii)]

(B) Generally, under the aggregation rule, each individual that holds (directly and through attribution) less than 5 percent of the loss corporation's stock is aggregated into a "residual" public group that is treated as a single 5-percent shareholder. [Reg. §1.382-2T(j)(1), describing aggregation rules, with special rules to account for the ownership of a loss corporation by higher tier entities; *Id.* at (j)(1)(iv)(C), treating a public group of shareholders as a 5-percent shareholder without regard to whether the group owns 5 percent or more of the stock of the loss corporation] If a corporation actually and constructively owns at least 5 percent of the loss corporation's stock but none of its individual shareholders are 5-percent shareholders, those individuals are generally aggregated as a separate public group. [IRC §382(g)(4); Reg. §1.382-2T(j)(1)(iv)] In contrast, if a corporation owns less than 5 percent of the loss corporation's stock, its individual shareholders are included in the residual public group. [*Id.*]

(C) Certain transactions can also segregate less than 5-percent shareholders into separate public groups. If the loss corporation is a party to an equity structure shift (i.e., typically, an acquisitive reorganization), the new non-5-percent shareholders will be a separate public group. [Reg. §1.382-2T(j)(2)(iii)(B)(*i*)] Further, if the loss corporation issues its stock in a public or private offering, the new non-5-percent shareholders also form a separate public group, with two important exceptions, the "small issuance" and "cash issuance" exceptions. [*Id.* at (j)(2)(iii)(B)(*ii*)]

.4 Small Issuance Exception

(A) Generally, the regulations do not apply the segregation rules to stock issued in a "small issuance." [Reg. §1.382-3(j)(2)] The small issuance exception does not apply, however, to an equity structure shift, unless it is a recapitalization under IRC §368(a)(1)(E). [*Id.* at (j)(6)] A small issuance is a stock issuance that does not exceed the small issuance limitation. That limitation, at the option of the loss corporation, is determined either (1) on a corporate-wide basis as 10 percent of the total value of loss corporation stock outstanding at the beginning of the year [excluding IRC §1504(a)(4) stock], or (2) on a class-by-class basis as 10 percent of the number of shares of the class outstanding at the beginning of the year. [*Id.* at (j)(2)(ii) and (iii)]

(B) This exception does not apply to a small issuance to the extent that the issuance, together with any small issuances previously made that year, exceeds the small issuance limitation. [*Id.* at (j)(2)(i)] Further, the class-by-class rule cannot apply if during the taxable year more than one class of stock is issued in a single issuance (or two or more issuances treated as a single issuance). [*Id.* at (j)(2)(iii)(D)]

.5 Cash Issuance Exception

If the small issuance exception does not apply, the cash issuance exception may. Under the latter exception, if a loss corporation issues stock to the public for cash, any existing public group is deemed to acquire a percentage of that newly issued stock equal to one-half of the percentage it owned immediately before the issuance. [*Id.* at (j)(3)(i)] Note that if a loss corporation acquires its stock for property, its public groups are segregated so that stock acquired from a public group member is deemed acquired from a new public group separate from the groups existing immediately before the transaction. [Reg. §1.382-2T(j)(2)(iii)(C)(*1*); see also *Id.* at (j)(2)(iii)(C)(*2*), Ex. (2), applying this "redemption" rule to a recapitalization in which common stock of a loss corporation was exchanged for its preferred stock.] For this purpose, property includes IRC §1504(a)(4) stock. [Reg. §1.382-2T(j)(2)(iii)(C)(*1*)]

Bisk point *The cash issuance exception does not apply when the small issuance exception applies. [Id. at (j)(3)(iii)]*

Example 3.4—Cash-Issuance Exception

L, a loss corporation with NOL carryovers, has one class of stock, 60 percent of which is owned by a residual public group and 20 percent each by two unrelated individuals, A and B. To continue operations, L needs an infusion of cash, and it sells newly issued stock to the public for cash, and the new stock constitutes 75 percent of all outstanding stock (so that the aggregate amount paid for the stock is three times L's pre-offering value). Assume that neither A nor B acquire L stock (actually or constructively) and that the issuance results in no new 5-percent shareholders. Also assume that no group or persons had a formal or informal understanding to make a coordinated acquisition of the L stock. [Cf. Reg. §1.382-3(a)(1)(i), providing an anti-abuse rule to treat such a group as an entity, resulting in a separate public group.]

Except to the extent the cash issuance exception applies, the stock issued in the public offering is treated as acquired by a separate public group. Under the cash issuance exception, however, the existing public group is deemed to acquire in the public offering a fraction of the newly issued stock equal to one-half of the percentage that it owned immediately before the issuance. Thus, the existing public group is deemed to acquire 30 percent (one-half of 60 percent) of the newly issued stock. Because the newly issued stock constitutes a 75-percent block of stock, the existing public group is deemed to acquire a 22.5-percent block of stock (30 percent of 75 percent), and the remaining 52.5-percent block is considered owned by a separate public group.

Thus, the public issuance results in an ownership change, because the new public group has increased its percentage interest in L by 52.5 percentage points. Note that after the stock issuance, the L stock is owned 37.5 percent by the existing public group (22.5 percent plus

15 percent, which is one-quarter of 60 percent), 5 percent by each of A and B (one-quarter of 20 percent) and 52.5 percent by the new public group.

Could the result in this example be improved if, for example, B exchanged her L common stock for L common stock warrants and L preferred stock described in IRC §1504(a)(4)? The preferred stock would not be treated as stock in measuring whether L had an ownership change. [IRC §382(k)(6)(A)] However, would the warrants be treated as stock (i.e., deemed to be exercised)?

.6 Options Treated as Exercised

Under Regulation §1.382-4(d)(2), an option may be considered exercised when issued to determine if an ownership change then occurs if on that date it satisfies an ownership, control, or income test. [Reg. §1.382-4(d)(2)(i)] To satisfy any of these tests, the option must be issued with a principal purpose to avoid or ameliorate the impact of an ownership change of the loss corporation. [See *Id.* at (d)(3), (d)(4)(i)(A), and (d)(5).] In addition, to satisfy the ownership test, it must provide the holder with a substantial portion of the ownership of the underlying stock. [*Id.* at (d)(3)] To satisfy the control test, the holders of the option and related persons must also directly and indirectly own more than 50 percent of the loss corporation, assuming that all options held by them are exercised. [*Id.* at (d)(4)(i)(B)] Finally, to satisfy the income test, the option must also facilitate the creation of income or value before the exercise or transfer of the option. [*Id.* at (d)(5); Id. at (d)(6(iv), adding that additional factors taken into account in applying the income test include whether the loss corporation engages in income or acceleration transactions in connection with the issuance or whether the holder of the option or a related person makes a loan or capital contribution to the loss corporation; see also *Id.* at (d)(6)(i), noting that relevant for each of the tests is the likelihood that the option will be exercised.]

Example 3.5—Cash Issuance Exception; Use of Warrants

The facts are the same as in Example 3.4, except that before the public offering, B exchanges her L stock for a new class of L preferred stock, which is IRC §1504(a)(4) stock, and some L common stock warrants. The preferred stock can be redeemed only for cash, and B's preferred stock and warrants equal (or exceed) the value of B's common stock. The warrants can be exercised only for cash and will not entitle the holder to any voting or dividend rights or any participation rights in L's management. Further, when the warrants are issued, it will be more likely than not that they will never be exercised. Finally, assume that the warrants will not facilitate the creation of income or value for L.

The warrants issued to B should not be deemed exercised, assuming that the following is true. First, B, who is unrelated to any other L shareholder, will not control L if her warrants (and other options) are exercised. Further, the warrants give her no dividend or voting rights and no right to participate in L's management. Finally, the warrants will not facilitate the creation of income or value for L. Because it is also more likely than not that the warrants will not be exercised, they meet none of the ownership, control, or income tests, and should not be deemed exercised. [See also PLR 200126002 (7/1/11), reaching this conclusion under comparable facts.] Because B's L preferred shares are IRC §1504(a)(4) stock, B should not be considered to own any L stock immediately before the public offering. [See Id., reaching this conclusion.]

Because B is not considered to own L stock, the pre-offering exchange by B prevents the public offering from causing L to undergo an ownership change. Further, B's pre-offering exchange also did not result in an ownership change.

As a result of B's exchange, the other shareholders will increase their percentage interests in L by 20 percentage points (i.e., the public group from 60 percent to 75 percent and A from 20 percent to 25 percent). Because the increase is less than 50 percentage points (and assuming no prior changes in the testing period), the exchange will cause an ownership change.

In the public offering, L sells newly issued common stock to the public for cash, and the new stock has a value equal to three times L's pre-offering value. Thus, it comprises 78.95 percent (75/95ths) of the outstanding L common stock. [IRC §382(k)(6)(A), disregarding IRC §1504(a)(4) stock for this purpose] The stock issued in the public offering comprises 75 percent by value of all outstanding L stock. Because B's stock comprises 20 percent of L's pre-offering value, it comprises just 5 percent (25 percent of 20 percent) of its post-offering value. Further, because B's stock is disregarded preferred stock, the stock issued in the public offering comprises 75/95ths or 78.95 percent of all relevant L stock (i.e., the L common stock).

Assume that neither A nor B acquire L stock and that the issuance results in no new 5-percent shareholders. Also assume that no group had a formal or informal understanding to make a coordinated acquisition of the L stock.

Except to the extent the cash issuance exception applies, the stock issued in the public offering is treated as acquired by a separate public group. Under the cash issuance exception, however, the existing public group is deemed to acquire in the public offering a fraction of the newly issued stock equal to one-half of the percentage that it owned immediately before the issuance. Thus, the existing public group is deemed to acquire 37.5 percent (one-half of 75 percent, its post-exchange, pre-issuance common stock ownership percentage) of the newly issued stock. Because the newly issued stock constitutes a 78.95-percent block of stock, the existing (or residual) public group is deemed to acquire a 29.61-percent block of stock (37.5 percent of 78.95 percent) in the new public offering, and the remaining 49.34-percent block is considered acquired by a separate public group.

Thus, the public issuance does not result in an ownership change, because the new public group has increased its percentage interest in L by not more than 50 percentage points. Note that after the stock issuance, the L stock is deemed owned 45.4 percent by the residual public group (29.61 percent plus 15.79 percent, which is one-quarter of 60 percent divided by 95 percent), 5.26 percent by A (which is one-quarter of 20 percent divided by 95 percent) and 49.34 percent by the new public group. For this purpose, B's preferred stock and warrant are disregarded.

3.3.0 SRLY Rules

3.3.1 General

Regulation §1.1502-21(c) limits the consolidated group's use of a member's NOL carryover or carryback that arose in a separate return limitation year (SRLY). The SRLY rules are intended to prevent a group from acquiring a loss corporation and freely using its NOL carryovers to offset subsequent group income.

.1 Cumulative Contribution

Subject to the overlap rule in Regulation §1.1502-21(g), the total amount of a member's SRLY losses that may be included in the CNOL cannot exceed the member's aggregate contribution to consolidated taxable income (CTI), determined by taking into account only the member's items of income, gain, deduction, and loss. [Reg. §1.1502-21(c)(1)(i)] This CTI amount (the "cumulative contribution") is computed without regard to the CNOL deduction and takes into account any of the member's losses and deductions actually absorbed by the group. [*Id.* at (c)(1)(i)(A) and (B)] (Thus, the loss does not have to be absorbed by the member nor does it have to be a loss that the member could have absorbed in the absorption year if it had filed separate returns.) Further, in making this computation, the consolidated return years taken into account include only those years that the member has continuously included in the group, but exclude (1) for a carryover, any year ending after the carryover year, and (2) for a carryback, any year ending after the year in which the loss arose. [*Id.* at (c)(1)(i)(C), generally not taking into account a consolidated taxable year beginning before January 1, 1997, in determining this cumulative contribution]

.2 Separate Return Limitation Year

Generally, a SRLY is any separate return year (SRY) of a member or its predecessor, and a SRY is a taxable year for which the member files a separate return or joins in the filing of a consolidated return with another group. [Reg. §1.1502-1(f)(1), defining a SRLY; *Id.* at (e), defining a SRY] SRLYs do not include a SRY of the corporation which is the common parent for the consolidated return year to which the tax attribute is carried. [*Id.* at (f)(2)(i), providing an exception, however, if the corporation became the common parent following a transaction described in Reg. §1.1502-75(d)(2)(ii) or (3); see also *Id.* at (f)(3), describing the rule if a group continues following a reverse acquisition under Reg. §1.1502-75(d)(3).] It also does not include a SRY of a corporation (or its predecessor) that was a member of the affiliated group for each day of the SRY. [*Id.* at (f)(2)(ii) and (iii)] As "the context may require," a predecessor is a transferor of assets to a member (the successor) to which IRC §381 applies or, for transactions that occur after 1996, in which the successor takes a transferred basis. [Reg. §1.1502-21(f)(1), adopting the predecessor and successor definitions in Reg. §1.1502-1(f)(4), "as the context may require"; Reg. §1.1502-1(f)(4), also providing for transactions that occur before June 25, 1999, that the transferred basis rule applies only if the aggregate basis of the transferred property differs materially from its aggregate value and that no more than one member may be a predecessor or successor of another member]

3.3.2 Overlap Rule

.1 General

The SRLY limitation does not apply if the overlap rule applies, and an overlap occurs for an NOL carryover if a corporation becomes a consolidated group member (the "SRLY event") within six months of an IRC §382 ownership change with respect to the carryover (the "IRC §382 event"). [Reg. §1.1502-21(g)(1); *Id.* at (g)(2)(ii)(A); see also *Id.* at (g)(2), applying the definitions and nomenclature found in IRC §382 and Reg. §1.1502-90 through §1.1502-99.] Further, if the overlap rule applies and the SRLY event follows the IRC §382 event, the overlap rule also applies to any "interim" NOL carryover (i.e., one that arises between the two events). [*Id.* at (g)(2)(ii)(B)]

.2 Application

The overlap rule's application depends on the timing of the SRLY and IRC §382 events. If the SRLY event occurs on the date of, or following, the IRC §382 event, the overlap rule applies beginning with the taxable year that includes the SRLY event. [*Id.* at (g)(3)(i)] If the SRLY event precedes the IRC §382 event, the overlap rule applies, starting with the first taxable year that begins after the IRC §382 event. [*Id.* at (g)(3)(ii)] Thus, the SRLY limitation applies to the affected loss carryover during the interim period after the SRLY event, but before the first taxable year that begins after the IRC §382 event.

Bisk tip *The SRLY rule may apply separately to each NOL carryover at the time of a SRLY event, while IRC §382 applies collectively to all NOL carryovers at the time of the IRC §382 event. Because of the SRLY rule's separate application, the overlap rule must be applied separately for each SRLY loss.*

3.3.3 SRLY Subgroups

.1 General

If there is a SRLY subgroup connected with a SRLY, the subgroup carries that loss back and forward under the principles of the general rule. [*Id.* at (c)(2), adding that a SRLY subgroup may exist for a carryover or carryback arising in a year that is not a SRLY with respect to another group] Thus, the SRLY limitation is computed by taking into account the subgroup's tax items, not just the loss member's items. A separate SRLY subgroup is determined for each carryover and carryback, and a member may belong to more than one SRLY subgroup. [*Id.* at (c)(2)]

.2 Carryback SRLY Subgroup

For a carryback, the SRLY subgroup includes the loss member and each other corporation that has been "continuously affiliated" with the loss member from the year to which the loss is carried through the loss year. [*Id.* at (c)(2)(ii)] Thus, the composition of a carryback SRLY subgroup may change depending on the carryback year. A carryback subgroup computes its SRLY limitation by taking into account the tax items of each subgroup member through the loss year. [See *Id.* at (c)(1)(i)(C)(*2*).]

.3 Carryover SRLY Subgroup

(A) For a carryover, a SRLY subgroup includes the loss member and each other member that was a member of the former group that becomes a member of the group "at the same time" as the loss member. [*Id.* at (c)(2)(i)] Note that a SRLY subgroup need not have a subgroup "parent." Also, there is no explicit requirement that a member other than the loss member be a member of the former group when the loss arose. [But see *Id.* at (c)(1)(i)(C), in computing the SRLY limitation for a single corporation, including only the years that the member was continuously included in the group's consolidated return.] It is not altogether clear whether the "same time" requirement requires that subgroup members join a group simultaneously.

(B) A corporation remains a member of a carryover SRLY subgroup until it ceases to be affiliated with the loss member. A carryover subgroup computes its SRLY limitation by taking into account the tax items of a subgroup member only for any consolidated return year during which it remains a member. Further, it takes items into account only through the carryover year. [*Id.* at (c)(1)(i)(C)(*2*)]

3.3.4 SRLY Subgroups and Overlap Rule

.1 General

The overlap rule applies to the SRLY subgroup as a whole and not separately to each member if the following requirements are met: (A) there is a SRLY subgroup and an IRC §382 subgroup and (B) the members of both subgroups are coextensive. [*Id.* at (g)(4)(i), providing more specifically that all members of the IRC §382 subgroup must be members of the SRLY subgroup and all members of the SRLY subgroup must be members of the IRC §382 subgroup] If the SRLY event follows the IRC §382 event for a SRLY subgroup, the SRLY limitation does not apply to a carryover arising between the two events only if all members of the SRLY subgroup for the interim carryover are also members of a SRLY subgroup that has a noninterim NOL carryover subject to the overlap rule. [*Id.* at (g)(4)(ii)] Thus, the two SRLY subgroups do not have to be coextensive; the interim subgroup just has to be a subset of the noninterim one.

.2 Loss Subgroup

An IRC §382 subgroup [termed a "loss subgroup" in Regulation §1.1502-91(d)] is "[t]wo or more corporations" that have all of the following characteristics.

(A) They were affiliated with each other in another group (the "former group"), whether or not the former group was a consolidated group.

(B) They bear a subgroup relationship to one another through a subgroup parent immediately after they become members of the current group.

Bisk point

This requirement is deemed met if the common parent so elects. [See Id. at (d)(4), describing the election and Reg. §1.1502-96(e) for the time and manner of making the election.]

(C) At least one of the members carries over an NOL that did not arise, or is not treated as arising, in a SRLY with respect to the former group. [Reg. §1.1502-91(d)(1), defining a loss subgroup; see also *Id.* at (d)(3), defining a loss subgroup parent as a corporation bearing the same relationship to the subgroup as the common parent bears to an affiliated group.]

Example 3.6—SRLY Subgroups and Overlap Rule

The following example illustrates how SRLY and IRC §382 subgroups may differ, presenting a trap for the unwary.

P, S, and T join in filing a consolidated return in 2010. During that year, the P group has a $10 loss, all attributable to S. In 2011, M acquires the S and T stock, and S and T join the M consolidated group. Assume that S and T have undergone an ownership change, so that S's $10 loss is subject to an IRC §382 limitation.

S and T are a SRLY subgroup, so that the SRLY limitation, if it applies, can be determined on a subgroup basis. For a carryover, a SRLY subgroup includes the loss member and each other member that was a member of the former group that becomes a member of the group "at the same time" as the loss member. [Reg. §1.1502-21(c)(2)(i)] Because S and T were *members of the P group and simultaneously became members of the M group, they are members of a SRLY subgroup.*

S and T are not members of an IRC §382 (or loss) subgroup, however, unless the M group makes the election described in Regulation §1.1502-91(d)(4). [See 3.3.4.2 for the characteristics of an IRC §382 subgroup.]

Although S and T were affiliated with each other in the P group and S carries over a loss that arose in the P group and was not a SRLY loss with respect to the P group, neither S nor T bear a subgroup relationship to one another (i.e., neither is the parent of the other).

The subgroup requirement is met, however, if the common parent of the acquiring group (i.e., M) so elects. If the election is made, the overlap rule applies, because the SRLY and IRC §382 subgroups are coextensive. [Reg. §1.1502-21(g)(4)(i), providing that all members of the IRC §382 subgroup must be members of the SRLY subgroup and all members of the SRLY subgroup must be members of the IRC §382 subgroup] Then, the SRLY rule does not apply and the M group can take S's loss into account subject to the IRC §382 limitation. If, however, the election is not made, the subgroups will not overlap, and both the SRLY and IRC §382 limitations will apply.

.3 Fold-In Rule

(A) Presenting another trap for the unwary, members in SRLY and IRC §382 subgroups may also differ because of the fold-in rule. The fold-in rule applies to a member (or loss subgroup) with a SRLY loss when the member (or subgroup) joined the consolidated group if (1) the member (or subgroup) has an ownership change within six months of joining a group; or (2) the member (or subgroup) does not have an ownership change for the five-year period after it has joined the group. [Reg. §1.1502-96(a)(1)]

(B) If the fold-in rule applies, the group no longer has to separately track a SRLY loss (i.e., the loss carryover is treated as not having arisen in a SRLY with respect to the group) on the earlier of the change date (but not before it becomes a member of the consolidated group) or the last day of the five-year period. [*Id.* at (a)(2)(i)] This rule applies only to determine whether there is an ownership change with respect to the loss carryover after the fold-in event occurs. [*Id.* See also *Id.* at (a)(2)(ii) for a corresponding fold-in rule for net unrealized built-in loss.] Note that although the fold-in rule applies to determine any IRC §382 subgroup for a subsequent ownership change, there is no comparable fold-in rule to determine the SRLY subgroup, leading to the potential trap illustrated by the following example.

Example 3.7—Fold-in Rule

F, a foreign corporation, owns all stock of X and Y. X owns all X1 stock and Y owns all Y1 stock, and X and Y are each common parents of a consolidated group. During Year 1, the Y group has a $100 consolidated NOL, all attributable to Y1.

On January 1 of Year 2, F contributes the Y stock to X. The loss is treated as a SRLY loss, because it arose in the Y group and Y1 was not then affiliated with X. [See IRC §1504(b)(3), providing that foreign corporations are not includible corporations.] Y and Y1 form a SRLY subgroup for the carryover of the Year 1 loss, because they were both members of the Y group and joined the X group at the same time. [Reg. §1.1502-21(c)(2)] Because F's contribution *of the Y stock to X does not result in an ownership change, and use of the Y group's CNOL is not limited by IRC §382, the overlap rule does not apply, and the SRLY limitation applies.*

Suppose that on June 1 of Year 6, P, a domestic corporation unrelated to F, buys all X stock, and X, X1, Y, and Y1 join the P consolidated group. Assume that P's purchase results in an ownership change of X and Y. Because five years has not elapsed since Y and Y1 joined the X group, the fold-in rule does not apply and the X group must continue to separately track the Year 1 loss. Although X, X1, Y, and Y1 were affiliated with each other in the X group with X as a possible subgroup parent, they do not form an IRC §382 subgroup for the Year 1 loss, because that loss remains a SRLY loss with respect to the X group. However, Y and Y1 form an IRC §382 subgroup for that loss, because the loss was not a SRLY loss for the Y group, Y and Y1 were affiliated in that group, and immediately after P purchases the X stock, Y and Y1 remain affiliated with Y as a subgroup parent. [See Reg. §1.1502-91(d)(1).] Y and Y1 are also a SRLY subgroup for the Year 1 loss. Because the two subgroups are coextensive and P's purchase is both a SRLY event (Y and Y1 becoming members of the P group) and an IRC §382 event, the overlap rule applies and P's use of the loss is limited by only IRC §382.

Suppose, instead, that P acquires the X stock on June 1 of Year 7, but the facts are otherwise the same. Because five years has elapsed since Y and Y1 joined the X group, the fold-in rule applies and the X group no longer separately tracks the Year 1 loss for purposes of IRC §382. In other words, in determining any IRC §382 subgroup for the loss carryover, it is not treated as a SRLY loss to the X group. Now, X, X1, Y, and Y1 form an IRC §382 subgroup, because the loss is no longer a SRLY loss for the X group, all four corporations were affiliated in that group, and immediately after P purchases the X stock, the four corporations remain affiliated with X as a subgroup parent. However, the fold-in rule does not apply to determine any SRLY subgroup, and Y and Y1 remain SRLY subgroup members. Because the IRC §382 and SRLY subgroups are not coextensive, the overlap rule does not apply, and the use of the loss is subject to both the IRC §382 and SRLY limitations.

Finally, suppose that the X group incurred a consolidated NOL in Year 3, also entirely attributable to Y1, that P acquires the X stock on June 1 of Year 7, and that the facts are otherwise the same. Even though the loss carryover was incurred less than five years before P buys the X stock, the overlap rule applies to the Year 3 loss, because it is not a SRLY loss for the X group. X, X1, Y, and Y1 form an IRC §382 subgroup, because the loss is not a SRLY loss for the X group, all four corporations were affiliated in that group, and immediately after P purchases the X stock, the four corporations remain affiliated with X as a subgroup parent. Those four corporations also form a SRLY subgroup, because they were all members of the X group, in which the loss arose, and joined the P group at the same time. Because the two subgroups are coextensive and P's purchase is both a SRLY event (the four corporations becoming members of the P group) and an IRC §382 event, the overlap rule applies and P's use of the loss is limited by only IRC §382.

3.4.0 IRC Section 108—Income From Discharge of Indebtedness

3.4.1 General

.1 Order of Tax Attribute Reduction

If a taxpayer excludes cancellation of indebtedness (COD) income under the bankruptcy or insolvency exception of IRC §108, the debtor must reduce its attributes. [IRC §108(b)] Generally, the debtor must reduce the following attributes in the following order:

(A) Any NOL for the cancellation year and any NOL carryforward to that year

(B) Any general business credit carryover to or from that year

(C) Any minimum tax credit available as of the beginning of the taxable year immediately following the cancellation year

(D) Any net capital loss for the cancellation year and any capital loss carryforward to that year

(E) The debtor's basis in property

(F) Any passive activity loss or credit carryover of the debtor from the cancellation year

(G) Any foreign tax credit carryover to or from the cancellation year

.2 Reduction Amount

For each dollar of excluded COD income, 33-1/3 cents of credits or one dollar of other attributes are reduced. [IRC §108(b)(3)]

.3 Ordering Rules

(A) In reducing NOLs and NOL carryforwards (or the net capital loss and capital loss carryforwards), any cancellation-year amount is reduced first, and any carryforwards are then reduced, beginning with losses carried from earliest year. [*Id.* at (b)(4)(B)] Reductions of the general business credit carryover to or from the cancellation year (or the foreign tax credit carryover to or from that year) are made as they are taken into account generally for tax purposes. [*Id.* at (b)(4)(C)]

(B) Those reductions are made only after the debtor's federal income tax is determined for the cancellation year. [IRC §108(b)(4)(A); see also Reg. §1.108-7(e), *Ex. 1,* illustrating this point.] Thus, NOLs and net capital losses for the cancellation year are carried back and utilized in earlier years before any attribute reduction. [Reg. §1.108-7(b); *Id.* at (e), *Ex. 2,* illustrating that point] Note that if the excluded COD income exceeds the available attributes, the excess is permanently excluded from the debtor's gross income. [Reg. §1.108-7(a)(2)]

.4 Election to Apply Reduction First to Basis of Depreciable Property

The debtor may also elect to apply the attribute reduction first to the basis of depreciable property. [IRC §108(b)(5)(A); Reg. §1.108-4, describing the election; see IRC §108(b)(5)(C), sensibly noting that in applying IRC §108(b), the attribute reduction required by IRC §108(b)(1) is reduced by any IRC §108(b)(5) basis reduction; see also *Id.* at (d)(5), providing that depreciable property has the same meaning as when used in IRC §1017; IRC §1017(b)(3)(B), defining depreciable property as any property of a character subject to the allowance for depreciation but only if an IRC §1017 basis reduction reduces the amount otherwise allowable for depreciation for the period immediately following the reduction; Reg. §1.1017-1(e), laying out this rule and noting that a lessor cannot reduce a leased property's basis if the lessee is obligated to restore to the lessor any loss due to depreciation during the lease, because the lessor cannot depreciate that property; IRC §1017(b)(3)(E), giving the debtor an election to treat as depreciable property any real property described in IRC §1221(a)(1) (i.e., held for sale in the ordinary course); Reg. §1.1017-1(f), describing the election; IRC §108(d)(9), providing that the election must be made on the debtor's tax return for the cancellation year and can be revoked only with the Service's permission.] The basis amount to which this election applies cannot exceed the aggregate adjusted basis of the debtor's depreciable property as of the beginning of the year immediately following the cancellation year. [IRC §108(b)(5)(B)] Thus, if the basis reduction under IRC §108(b)(5) is less than the excluded COD income, the debtor must reduce its remaining tax attributes, including asset bases, in the order set out in IRC §108(b)(2). [See Reg. §1.1017-1(c)(2).]

Bisk point

Note that if a debtor corporation holds stock in a subsidiary and the debtor and subsidiary are members of the same consolidated group for the cancellation year, the debtor may treat the subsidiary stock as depreciable property to the extent the subsidiary consents to a corresponding reduction in the basis of its depreciable property. [IRC §1017(b)(3)(E); see also IRC §1504(a), defining an affiliated group.] The debtor and subsidiary are affiliated, for example, if the debtor owns subsidiary stock possessing at least 80 percent of its vote and value (disregarding pure, vanilla preferred stock). [See IRC §1504(a)(2).]

3.4.2 Consolidated Rules

Special rules may apply if the debtor is a member of a consolidated group. The consolidated return regulations adopt a hybrid single-entity/separate-corporation approach, and special rules may apply if multiple members have COD income or an election is made under IRC §108(b)(5).

.1 Basic Rules

(A) If a debtor-member excludes COD income from gross income under IRC §108(a), the group reduces its tax attributes as follows: First, the debtor-member reduces its attributes under a "debtor-first" rule. [Reg. §1.1502-28(a)(2)] Second, if the debtor reduces its basis in member stock, under a "look-through" rule or IRC §108(b)(5), that subsidiary member also reduces its attributes. [*Id.* at (a)(3)] Finally, under a "fan-out" rule, if the debtor's excluded COD income exceeds its attributes reduced under the first step, the group reduces its remaining consolidated attributes. [*Id.* at (a)(4)] Excluded COD income that is not applied to reduce tax attributes is sometimes referred to as "black-hole" COD.

(B) Under the debtor-first rule of Regulation §1.1502-28(a)(2), the debtor-member first reduces its separate attributes and its share of consolidated attributes in the order provided in IRC §108 and IRC §1017. [Reg. §1.1502-28(a)(2)(i)] Thus, unless an IRC §108(b)(5) election is made for the debtor-member, it reduces its share of the CNOL, its separate return limitation year (SRLY) losses, and its share of consolidated capital loss before it reduces asset basis. [See IRC §108(b) for the general ordering rules.] Further, the debtor-member first reduces its share of any current-year losses and then reduces carryover losses in the order of the years from which the carryovers arose. [IRC §108(b)(4)(C); see also Reg. §1.1502-28(a)(2)(ii), providing that a debtor's share of a consolidated tax attribute (or its share of a SRLY subgroup loss) is determined under the principles of Reg. §1.1502-21(b)(2)(iv).]

(C) A debtor-member can reduce the basis of an asset (including subsidiary stock and inter-company receivables) only if it holds that asset on the first day of the taxable year that follows the COD event. [IRC §1017(a) (flush language)] It cannot reduce the basis of any asset (including subsidiary stock) below zero. [Reg. §1.1502-28(a)(2)(i)] Further, if the debtor's COD income was excluded under IRC §108(a)(1)(A) or (B), the basis reduction cannot exceed the limit prescribed by IRC §1017(b)(2). [IRC §1017(b)(2), providing that such a basis reduction is limited to the excess, if any, of the taxpayer's remaining aggregate asset basis over its liabilities, each determined immediately after the discharge; see also Reg. §1.1502-28(b)(3), providing that any IRC §1017(b)(2) limitation is determined on a member-by-member basis.]

(D) To the extent that the debtor-member reduces its basis in subsidiary stock, the subsidiary must reduce its tax attributes. First, if the debtor-member elects under IRC §108(b)(5) to reduce its basis in depreciable property before other tax attributes, it may also treat subsidiary stock as depreciable property as long as the subsidiary correspondingly reduces its basis in its depreciable property. [IRC §1017(b)(3)(D)]

(E) If the debtor-member otherwise reduces its basis in subsidiary stock under the debtor-first rule, the subsidiary must also reduce its tax attributes up to that basis reduction under the look-through rule. [Reg. §1.1502-28(a)(3)(ii), treating that reduction as excluded COD income to determine the order and amount of the attributes reduced] The subsidiary is deemed to recognize excluded COD income equal to the basis reduction, and it must reduce its available attributes under IRC §108, IRC §1017, and the debtor-first rule. [*Id.*] If however, that deemed COD amount exceeds the subsidiary's available attributes, the excess does not reduce tax attributes of any other member. [*Id.*] Note that if the subsidiary tax attribute reduced is the basis of another member's stock, the look-through rule applies again to the other member, so that the rule may apply in a cascading fashion down a chain of members that includes the debtor-member.

(F) Finally, under the fan-out rule, to the extent the debtor-member's excluded COD income is not applied to reduce attributes under the debtor-first rule, the excess is applied to reduce the consolidated tax attributes of other members, including the following:

(1) Any remaining consolidated attributes

(2) SRLY attributes of any SRLY subgroup which includes the debtor-member

(3) SRLY attributes of other members if not subject to limitation under the SRLY rules because of the overlap rule

[Reg. §1.1502-28(a)(4)]

(G) Asset basis is not reduced in this final step, and the attribute reduction follows the order described in IRC §108(b)(2) and the principles of Regulation §1.1502-21(b)(1).

(H) A group's basis in subsidiary stock is increased by any positive adjustment (or decreased by any negative adjustment) for the stock. [Reg. §1.1502-32(b)(2)] Positive (or negative) adjustments are made to account for the subsidiary's taxable income or loss, tax-exempt income, noncapital, nondeductible expenses, and distributions on its stock (with positive adjustments for the income items and negative adjustments for the rest). [*Id.*] A debtor-member treats excluded COD income as tax-exempt income, but only to the extent it is applied to reduce tax attributes under Regulation §1.1502-28. [Reg. §1.1502-32(b)(3)(ii)(C), also providing that any amount treated as excluded COD income under the look-through rule is not treated as excluded COD income for purposes of Reg. §1.1502-32(b)(3)(ii)(C)] Further, a member treats a loss or basis reduced under the debtor-first or fan-out rules (but not the look-through rule) as a noncapital, nondeductible expense. [Reg. §1.1502-32(b)(3)(iii)(A)] Finally, the reduction of a credit or a common parent's loss is not treated as a noncapital, nondeductible expense. Thus, if a subsidiary has excluded COD income and the subsidiary's credits are reduced under the debtor-first rule or another member's attributes are reduced, the group will enjoy a net increase in its basis in its subsidiary stock because of the excluded COD income.

Example 3.8—Applying Regulation Section 1.1502-28

P is the common parent of a consolidated group that includes S1, S2, and S3. P owns all S1 stock with a $100 excess loss account and all S2 stock with a $100 basis. S2, in turn, owns all of the S3 stock with a $50 basis.

P has $150 of excluded COD income. In relevant part, the P group has a $90 CNOL, of which $20 is attributable to P, $20 to S1, and $50 to S2. S1 has a $60 SRLY NOL, and S3 has a $30 SRLY NOL. Neither S1 nor S3 is part of a SRLY subgroup.

Under the debtor-first rule, P accounts for $120 of the $150 of excluded COD income, reducing its $20 attributable share of the CNOL to $0 and its $100 basis in the S2 stock to $0. [Reg. §1.1502-28(a)(2)] Under the first application of the look-through rule, S2 is deemed to have $100 of excluded COD income. It reduces its $50 attributable share of the CNOL to $0 and also reduces its $50 basis in its S3 stock to $0. [Id. at (a)(3)] Under the second application of the look-through rule, S3 is deemed to have $50 of excluded COD income. It reduces its $30 SRLY NOL to $0. [Id.] S3's remaining $20 of deemed excluded COD income has no effect.

Of the remaining $30 of excluded COD income, $20 is applied to reduce S1's $20 attributable share of the CNOL under the fan-out rule. [Id. at (a)(4)] The remaining $10 of excluded COD income is black-hole COD.

S1's SRLY NOL is not a consolidated attribute and is not reduced under the fan-out rule. Note that P's excess loss account in S1's stock increases by $20, from $100 to $120, to account for the reduction of S1's attributable share of the CNOL. [See Reg. §1.1502-32(b)(3)(iii)(A), treating the reduction as a noncapital, nondeductible expense.]

.2 Allocations Among Multiple Members

(A) If in a taxable year, more than one member has excluded COD income, the debtor-first and look-through rules under Regulation §§1.1502-28(a)(2) and (3) apply to each of those members before any consolidated attribute reduction occurs under Regulation §1.1502-28(a)(4). [Reg. §1.1502-28(b)(1)(i)] (This rule favors separate-corporation over single-entity attribute reduction.) Further, if one of those members is a higher-tier member of another, the debtor-first and look-through rules apply first to the higher-tier member before applying to the lower-tier member. [Reg. §1.1502-28(b)(1)(ii)] In applying those rules to the higher-tier member, the limitation under IRC §1017(b)(2) on the reduction of asset bases is computed by assuming that the liabilities of the lower-tier member that gave rise to its excluded COD income were not discharged. [*Id.*] One member is a higher-tier member of a second member if the first member is the common parent or if investment adjustments for the second member's stock would affect investment adjustments for the first member's stock. [*Id.*]

(B) An allocation rule also applies if multiple members have excluded COD income that is not applied to reduce tax attributes. If the total of those "remaining" COD amounts exceeds the consolidated attributes available for reduction under the fan-out rule [Reg. §1.1502-28(a)(4)], a pro rata portion of each such member's remaining COD amount is applied to reduce those consolidated attributes. [Reg. §1.1502-28(b)(1)(iii)] This allocation rule affects the investment adjustments that higher-tier members may enjoy in the stock of a member with a remaining COD amount, because excluded COD income is treated as tax-exempt income under Regulation §1.1502-32 only to the extent it is applied to reduce attributes of any member. [Reg. §1.1502-32(b)(3)(ii)(C)]

(C) If more than one higher-tier member reduces the basis of subsidiary stock in a taxable year, the stock basis reductions are applied to reduce the attributes of the subsidiary under the look-through rule in proportion to the excluded COD income resulting from the basis reductions. [Reg. §1.1502-28(b)(1)(iv)] This rule affects the extent to which a higher-tier member may be exposed to IRC §1245 recapture because of a basis reduction in its subsidiary stock. [See Reg. §1.1502-28(b)(4), providing that a basis reduction in subsidiary stock is treated as a deduction allowed for depreciation in applying IRC §1245 "only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced" under IRC §1017(b)(3)(D) or the look-through rule.]

(D) Finally, a priority rule applies when subsidiary attributes may be reduced under the look-through rule to account for excluded COD income realized in different groups. The rule applies if the following three conditions are met:

(1) The subsidiary is a member of a group (the "first group") on the last day of the taxable year in which a higher-tier member of that group realizes excluded COD income.

(2) On the following day, the subsidiary is a member of another group (the "second group").

(3) The basis of subsidiary stock is reduced under IRC §108, IRC §1017, and Regulation §1.1502-28 to account for excluded COD income of both the higher-tier member of the first group and a higher-tier member of the second group.

[Reg. §1.1502-28(b)(1)(v)]

(E) The look-through rule applies first to account for the excluded COD income that results from the basis reduction in the subsidiary's stock owned by the first group's higher-tier member before it applies to account for the excluded COD income that results from the basis reduction in the subsidiary's stock owned by the second group's higher-tier member. [*Id.*]

3.5.0 Regulation Section 1.1502-36—Unified Loss Rules

3.5.1 General

Regulation §1.1502-36 addresses the creation of noneconomic and duplicated loss within a consolidated group. It has three main rules that may apply on the group's transfer of subsidiary stock at a loss, rules that are technically masterful but extraordinarily complex.

.1 Basis-Redetermination Rule

First, under Regulation §1.1502-36(b), the group may redetermine its basis in transferred and nontransferred subsidiary stock, a rule that complements the investment adjustment rules of Regulation §1.1502-32 and is an analog to IRC §704(c).

Under IRC §704(c), if a partner contributes built-in gain or loss property to a partnership, the built-in gain or loss may be specially allocated back to the contributing partner, an allocation taken into account in determining the partners' bases in their partnership interests. [See IRC §705(a).] Regulation §1.1502-32 does not have a corresponding rule for built-in gain or loss property contributed by a member to a subsidiary in an IRC §351 exchange. In a sense, the basis-redetermination rule of Regulation §1.1502-36(b) acts as the corresponding rule.

.2 Basis-Reduction Rule

(A) Second, the group's loss on subsidiary stock may be disallowed, in whole or in part, under a basis-reduction rule found in Regulation §1.1502-36(c). Technically under that rule, the group reduces its basis of subsidiary stock, with the reduction intended to avoid noneconomic loss.

That rule targets noneconomic stock loss that may arise, for example, in a "son-of-mirrors" transaction. As one variation of that transaction, a consolidated group purchases the stock of a target corporation, and when purchased, the target holds some assets with built-in gain. The target sells those assets at a gain, the group increases its target stock basis to reflect the gain (see Reg. §1.1502-32), and the group then sells the target stock at a loss. Because the stock loss corresponds to the recognized built-in asset gain, if the loss were allowed, the group could eliminate (or at least substantially reduce) the effective tax on the gain, inconsistent with the repeal of the General Utilities doctrine. The basis-reduction rule generally disallows that stock loss.

(B) Even with the basis-redetermination and basis-reduction rules, a group could dispose of subsidiary stock at a loss but the loss could be duplicated in subsidiary tax attributes (like basis). To the extent of that duplication, the attribute-reduction rule, found in Regulation §1.1502-36(d), requires the subsidiary (and perhaps lower-tier corporations) to reduce tax attributes, including NOL carryovers and basis.

3.5.2 Basis-Redetermination Rule

If a member (M) transfers a loss share of a subsidiary (S), the basis-redetermination rule may apply. If it applies, positive adjustments may be reallocated from transferred S loss common stock and negative adjustments may be reallocated from shares of S common stock that are not transferred loss shares. [Reg. §1.1502-36(b)(2)(i)] The amounts reallocated are the *net* positive or negative adjustments for a year. [See *Id.* at (b)(3), *Ex. 4.*] For this purpose, investment adjustments include adjustments for taxable income or loss, tax-exempt income, and nondeductible, noncapitalizable items. [*Id.* at (b)(1)(iii)] The reallocations have the effect of reducing M's basis in the transferred loss shares. The basis-redetermination rule generally does not apply, however, if the group transfers all S shares to one or more nonmembers in one fully taxable transaction (something that often occurs). [*Id.* at (b)(1)(ii)(B), also applying if, in one fully taxable transaction, either the stock becomes worthless under IRC §165 and Reg. §1.1502-80(c), or the stock is in part sold to nonmembers and in remaining part becomes worthless; see also *Id.* at (b)(1)(ii)(A) for an exception to the basis-redetermination rule if there is no disparity among members' bases in shares of S common stock and no member owns S preferred stock with built-in gain or loss.] Thus, the basis-redetermination rule rarely applies.

If the fully taxable exception applies, the group's common parent may elect to apply the basis-redetermination rule, and if stock of more than one subsidiary is transferred, the election may be made for one or more of the subsidiaries. [Id. at (b)(1)(ii)(B); see also Id. at (e)(5)(i) and (ii) for the mechanics of the election.]

3.5.3 Basis-Reduction Rule

.1 General

If M transfers an S share and the share is a loss share after applying the basis-redetermination rule (and other applicable rules of law), the share's basis is reduced (but not below value) by the smaller of (A) its net positive adjustment, or (B) its disconformity amount. [*Id.* at (c)(2)]

Note that the basis reduction should be a nondeductible basis recovery that is treated as a noncapital, nondeductible expense for purposes of Regulation §1.1502-32(b)(2)(iii). [See Reg. §1.1502-32(b)(3)(iii)(B), providing that, if consistent with the purposes of the basis reduction provision and Reg. §1.1502-32, the reduction is treated as a noncapital, nondeductible expense if it is not otherwise taken into account in computing the subsidiary's stock basis and is permanently eliminated in computing the subsidiary's taxable items; see also Reg. §1.1502-36(a)(3)(ii)(A), providing that basis reductions under Reg. §1.1502-36(c) tier up to higher-tier members, implying that the reductions are noncapital, nondeductible expenses under Reg. §1.1502-32.]

.2 Net Positive Adjustment

A share's net positive adjustment equals the sum of all investment adjustments (other than for distributions) reflected in the share's basis (or, if greater, $0). [Reg. §1.1502-36(c)(3)] For this purpose, investment adjustments include the adjustments described in Regulation §1.1502-32(b)(2) for taxable income and loss, tax-exempt income, and noncapital, nondeductible items. [*Id.* at (c)(3)(ii)] These adjustments also include any noncapital, nondeductible expenses arising because of an election under Regulation §1.1502-36(d)(6) to reattribute attributes of S or a lower-tier subsidiary. [Reg. §1.1502-36(c)(3)(ii); see also Reg. §1.1502-32(c)(1)(ii)(A), describing the adjustment.]

.3 Disconformity Amount

A share's disconformity amount is the excess, if any, of (A) M's basis in the share, over (B) the share's allocable portion of S's net inside attribute amount. [*Id.* at (c)(4); see also *Id.* at (f)(1), providing that "allocable portion" has the same meaning as in Reg. §1.1502-32(b)(4)(iii)(B); Reg. §1.1502-32(b)(4)(iii)(B), providing that within each class of stock, each share has the same allocable portion of the relevant amount and allocations among classes are made by considering the terms of each class and other relevant facts relating to the overall economic arrangement. *Cf.* Reg. §1.743-1(d) for the determination of a transferee's share of the partnership's inside basis.]

.4 Net Inside Attribute Amount

(A) S determines its net inside attribute amount as of the transfer. [Reg. §1.1502-36(c)(5), providing that, except as provided in Reg. §1.1502-36, that determination is made by taking into account all other applicable rules, even if the adjustments required by those rules are not deemed effective until after the transfer, such as under Reg. §1.1502-28] That amount equals the sum of S's net operating and capital loss carryovers, deferred deductions, money, and basis in noncash property, reduced by the amount of S's liabilities. [A liability generally means a liability that has been incurred within the meaning of IRC §461(h).] Special rules may apply if S owns lower-tier subsidiary stock. [Reg. §1.1502-36(c)(5); see also *Id.* at (c)(6)(iv).]

(B) A loss carryover is "any net operating or capital loss carryover that is attributable to S, including any losses that would be apportioned to S under the principles of Regulation §1.1502-21(b)(2) if S had a separate return year." [Reg. §1.1502-36(f)(6); see also Reg. §1.1502-21(b)(2)(iv), defining the portion of a consolidated NOL attributable to a member.]

(C) A deferred deduction is any deduction or loss that would have been taken into account under general tax accounting principles as of the time of the transaction but that is deferred, for example, under IRC §267(f), IRC §469, or Regulation §1.1502-13. [Reg. §1.1502-36(f)(2)] It also includes S's share of "deferred" consolidated tax attributes (e.g., its share of any consolidated excess charitable contribution). Finally, it includes equivalent amounts, such as adjustments under IRC §475 or IRC §481. [*Id.*]

Example 3.9—Inheriting Net Positive Adjustment

The basis-reduction rule may apply in unexpected circumstances, as the following example illustrates.

The X consolidated group acquires all T stock from another consolidated group and T owns all S stock with a $100 basis and $100 value. S's assets have a $60 basis and $100 value and T's S stock reflects $40 of net positive adjustments.

S's assets (and T's S stock) decline in value to $60, and T sells the S stock for $60. Absent the basis-reduction rule, T would recognize a $40 loss (i.e., the excess of T's $100 basis in that stock minus the $60 amount realized). The basis-reduction rule eliminates that loss, however. T's basis in the S stock is reduced by the smaller of the disconformity amount [$40 *or the excess of its $100 basis over S's $60 net inside attribute amount (i.e., its $60 asset basis)] and the $40 of net positive adjustments. Thus, T must reduce its S stock basis by $40, eliminating its loss in that stock.*

Bisk point *As Example 3.9 illustrates, a group may be required to take pre-acquisition history into account to determine the application of the basis-reduction rule. It may have to consider not only the history of the acquired target but also the tax history of direct and indirect target subsidiaries, including items generated in multiple predecessor groups.*

3.5.4 Attribute-Reduction Rule

.1 General

If a transferred S share is still a loss share after taking into account the basis-redetermination and basis-reduction rules (and other applicable rules), the attributes of S (and its lower-tier subsidiaries) may be reduced by the smaller of (A) S's net stock loss, or (B) its aggregate inside loss. [Reg. §1.1502-36(d)(3)(i)]

.2 Attribute Reduction Amount

The regulations refer to this amount as the "attribute reduction amount." This rule does not apply absent the group's election, however, if the aggregate attribute reduction amount in the transaction is less than 5 percent of the total value of the shares transferred by members in the transaction. [*Id.* at (d)(2)(ii), providing that the common parent may elect to not have this *de minimis* rule apply] The group may elect to apply the attribute-reduction rule, for example, so that it can reattribute the attributes of S (or a lower-tier subsidiary).

.3 Net Stock Loss

S's net stock loss is computed by looking to the S shares that members transfer in the transaction and equals the excess, if any, of (A) the aggregate basis of those shares over (B) their aggregate value. [*Id.* at (d)(2) and (3)(ii)] For this purpose, the shares' aggregate basis is computed after taking into account any adjustments required under the basis-redetermination and basis-reduction rules. [*Id.* at (d)(3)(ii)(A); *Id.* at (d)(2)(i), applying the attribute-reduction rule after taking into account the basis-redetermination and basis-reduction rules and all other applicable rules of law]

.4 Aggregate Inside Loss

S's aggregate inside loss equals the excess, if any, of (A) S's net inside attribute amount (NIAA) over (B) the value of all outstanding S shares. [*Id.* at (d)(3)(iii)(A)] Thus, this factor takes into account the full aggregate inside loss, rather than just the portion attributable to the transferred shares. As under the basis-reduction rule, S's NIAA generally equals the sum of S's net operating and capital loss carryovers, deferred deductions, money, and basis in non-cash property, reduced by the amount of S's liabilities. [*Id.* at (d)(3)(iii)(B), generally defining those amounts for the basis reduction and attribute reduction rules in the same way; *Id.* at (c)(5)]

Bisk point *For purposes of the attribute-reduction rule, loss carryovers do not include any losses waived under Regulation §1.1502-32(b)(4). [Id. at (f)(6), defining loss carryovers] Also, under a relatively complex rule, S's computation of its NIAA is modified if S holds lower-tier subsidiary stock. [Id. at (d)(5)(i)]*

.5 Reduction of Attributes

(A) If the attribute-reduction rule applies, S first reduces the following categories of attributes:

(1) Capital loss carryovers

(2) NOL carryovers

(3) Deferred deductions

(B) It then reduces the basis of any other property, other than cash and cash equivalents. [*Id.* at (d)(4)(i)] Those reductions are effective immediately before the transfer of relevant S loss share and are *not* treated as noncapital, nondeductible expenses for purposes of Regulation §1.1502-32. [*Id.* at (d)(4)(iii)]

(C) The common parent may specify the allocation of the attribute reduction among the losses and deferred deductions. [*Id.* at (d)(4)(ii)(A)(*1*), providing that the election to specify the allocation is made as provided in Reg. §1.1502-36(e)(5)] Absent that specification, those attributes are reduced as follows: capital loss carryovers are reduced before NOL carryovers, but within either category, carryovers from the earliest years are reduced first. [*Id.*] Deferred deductions are then proportionately reduced. [*Id.*]

(D) If S's attribute reduction amount does not exceed its total attributes in the first three categories, all of the attribute reduction amount must be applied to reduce those attributes. [*Id.*] If S's attribute reduction amount equals or exceeds its total attributes in the first three categories, S eliminates those attributes, and any excess attribute reduction amount reduces S's basis in its noncash assets, including any lower-tier subsidiary stock. If the basis of subsidiary stock is reduced, the subsidiary's attributes may also be reduced under a series of relatively complex rules. [*Id.* at (d)(5)(ii)-(vi)]

.6 Elections to Avoid or Limit Attribute Reduction

(A) A group may avoid or limit attribute reduction through two elections. The group may elect to reduce its basis in transferred S loss shares, or if S becomes a nonmember, the group may elect to reattribute loss carryovers or deferred deductions. [*Id.* at (d)(6)] If the common parent elects both to reattribute a subsidiary's attributes and reduce subsidiary stock basis, the reattribution is given effect before the stock basis reduction. [*Id.* at (d)(6)(iv)(A)]

(B) In making these elections, the group can specify the amount elected (or not elected). The elections can apply only to amounts up to the attribute reduction amount, and no effect will be given to an election for any excess. A protective election may also be made to reduce attributes or basis. It is also possible (and perhaps necessary) to reattribute an IRC §382 limitation to which the reattributed losses are subject. Finally, a stock basis reduction is deemed elected if the stock loss would be permanently disallowed.

(C) If the group elects to reduce its basis in transferred S loss shares, the election applies to each S loss share that members transfer in the transaction. [*Id.* at (d)(6)(v)(A)] The aggregate reduction is allocated among those shares, in proportion to their built-in loss, and a transferring member treats the reduction as a noncapital, nondeductible expense. [*Id.*] As a consequence, the attribute reduction amount is reduced by the amount of this elective reduction, even if those shares remain loss shares after the reduction. [*Id.* at (d)(6)(v)(B)]

(D) If losses are reattributed, the losses that may be reattributed are those that otherwise would be reduced under Regulation §1.1502-36(d)(4). [*Id.* at (d)(6)(iv)(A)] The common parent may specify the attributes to be reattributed, or in the absence of that specification, the attributes will be reattributed in the order specified under the default rule. [*Id.*]

(E) This loss reattribution results in a noncapital, nondeductible expense, which is taken into account under special rules provided in Regulation §1.1502-32(c)(1)(ii)(A). [*Id.*] If S attributes are reattributed, the resulting noncapital, nondeductible expense is allocated entirely to the S loss shares transferred by members in the transaction in proportion to the loss in those shares. [Reg. §1.1502-32(c)(1)(ii)(A)(*1*)] If attributes of a lower-tier subsidiary are reattributed, the resulting noncapital, nondeductible expense is allocated up the chain in such a way that it is fully allocated to the transferred S loss shares (and in proportion to the loss in those shares). [*Id.* at (c)(1)(ii)(A)(*2*), providing, however, that the amount is not allocated to lower-tier subsidiary shares transferred in a recognition transfer as part of the transaction] Any amount allocable to an S loss share then tiers up under generally applicable rules. [*Id.*]

(F) Either election is made by a statement filed with the transferring group's return for the taxable year of the transfer. [Reg. §1.1502-36(e)(5)] No statement by S is required. [*Id.*] Through these elections, the parties may convert what otherwise would be a current capital loss for the seller, or an NOL carryover for the buyer subject to IRC §382, to an NOL carryover for the seller not limited by IRC §382.

Example 3.10—Loss Duplication With NOLs

M forms S, contributing $10 to S for all S stock, and M and S join in filing a consolidated return. S borrows $90 and generates a $40 consolidated loss carryover. S retains $60 of cash.

M transfers the S stock to the creditors and takes a worthless stock deduction. The basis-reduction rule does not apply, because both the disconformity amount and net positive adjustments are $0. [The disconformity amount equals the excess of M's basis in the S stock ($10) over S's net inside attribute amount (i.e., $10 or $60 cash plus $40 NOL minus $90 of liabilities).] Thus, M recognizes a $10 loss.

The attribute-reduction rule applies, however, because that loss is duplicated in S's attributes: Matching M's stock loss, S's aggregate inside loss equals $10 (its net inside attribute amount, computed in the same way as described above) over $0 (the S stock value). Thus, S must reduce its NOL from $40 to $30. The M group may elect, instead, to reduce its stock basis by *up to $10 or reattribute up to $10 of the NOL to the group. Either election will eliminate M's stock loss to the extent of the reduction or reattribution.*

Bisk tip

Because of the attribute-reduction rule, the buyer may be vitally interested in the seller's basis in the stock sold, something that the buyer typically would care little about. Even if the buyer knows that basis, it may be unable to determine the attribute reduction amount at closing, because S's attributes may be subject to later audit adjustment or the purchase price may be later adjusted. Thus, a cautious buyer may request that the seller group make a protective election to reduce stock basis at the time of the sale, to prevent any future attribute reductions in the purchased corporations.

TAX PLANNING FOR PASS-THROUGH ENTITIES

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