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Why Rite Aid is Wrong

Don Leatherman



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WHY *RITE AID* IS WRONG

DON LEATHERMAN*

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INTRODUCTION

On July 6, 2001, in *Rite Aid Corporation v. United States*,¹ the Federal Circuit invalidated all or a portion of Treas. Reg. § 1.1502-20, concluding that it was outside the broad authority delegated by Congress to Treasury under I.R.C. § 1502.² In practically every respect the decision was misguided.

Broadly speaking, Treas. Reg. § 1.1502-20 disallowed a consolidated group's loss on its sale of subsidiary stock.³ Not surprisingly, taxpayers complained loudly when Treasury introduced this "loss disallowance" rule in 1990, but applauded vigorously when Treasury backed off the rule in *Rite Aid*'s aftermath.⁴

1. 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Oct. 3, 2001).

2. This Article generally uses "Treasury" to refer to the personnel in the Department of Treasury, including the Internal Revenue Service (the "IRS"), who work on Treasury regulations. It also uses "Treasury" to refer to those people who litigate tax cases on behalf of the Commissioner or Department of Justice. Finally, it uses "IRS" to also refer to the Bureau of Internal Revenue, which is what the federal tax administrator was called until 1954, and uses the "Code" as shorthand for the relevant federal income tax law.

Note that while at the Internal Revenue Service, I worked on aspects of Treas. Reg. § 1.1502-20, although the basic policy calls on the regulation were made before I did that work.

3. Treas. Reg. § 1.1502-20(a) (2002). A consolidated group is an affiliated group of corporations that elects to file consolidated returns, combining the income and loss of each group member. Treas. Reg. § 1.1502-1(h) (2002); Treas. Reg. § 1.1502-11 (2002). An affiliated group has a common parent and subsidiary members, and the common parent directly or indirectly owns a significant stock interest in each subsidiary. See I.R.C. § 1504(a)(2) (2002) (defining a significant stock interest, broadly speaking, as at least eighty percent of the voting power and value of the subsidiary).

4. See, e.g., Lawrence Axelrod, *Rite Aid—Prescription for Reversal*, 520 PLI/tax 797, 801 n.5 (2001) (listing articles by a number of commentators questioning the validity of the loss disallowance rule); Irving Salem, *Judicial Deference, Consolidated Returns, and Loss Disallowance: Could LDR Survive a Court Challenge?*, 43 TAX EXECUTIVE

Rite Aid is a stunning opinion, not only because it could cost billions in tax revenue but also because the Federal Circuit gave little apparent deference to Treasury in invalidating the regulation.⁵ In its brief opinion, the court embraced the taxpayer's arguments without apparent qualification, missing relevant precedent and substantial arguments that supported the regulation's validity. The court's reasoning was sparse, its proposed test vague, and its conclusion somewhat ambiguous, threatening the validity of other consolidated return regulations and creating added uncertainty in an already complex area of the tax law.⁶ It is almost certain that *Rite Aid* will prompt legislation to restrict its possible reach.⁷

167 (1991) [hereinafter Salem I] (also arguing that the loss disallowance rule was invalid); Mark J. Silverman & Lisa M. Zarlenga, *Rite Aid: A Tough Pill for the Government to Swallow*, 556 PLI/tax 437, 449 (2002) (also noting that the loss duplication rule was one of the regulation's most criticized features); see also Irving Salem, *Rite Aid: Potentially Historic*, 556 PLI/tax 423, 427 (2002) [hereinafter Salem II] (praising Treasury for taking "bold, decisive steps").

The loss disallowance rule was developed over a short span in three regulatory packages. On March 9, 1990, Treasury issued Treas. Reg. § 1.1502-20T, T.D. 8294, 1990-1 C.B. 66. On November 19, 1990, it withdrew Treas. Reg. § 1.1502-20T and proposed Treas. Reg. § 1.1502-20. See CO-93-90, 1990-2 C.B. 696. It finalized the proposed regulations on September 13, 1991. See T.D. 8364, 1991-2 C.B. 43.

With modest modifications, that loss disallowance rule remained in place until replaced by Treas. Reg. § 1.337(d)-2T and Treas. Reg. § 1.1502-20T. See T.D. 8984, 67 Fed. Reg. 11034 (2002), 2002-12 I.R.B. 668; see also T.D. 8998, 67 Fed. Reg. 37998 (2002) (clarifying and amending T.D. 8984). The replacement still requires loss disallowance, but allows a group to take a subsidiary stock loss to the extent the group proves it is an "economic" loss. See Treas. Reg. § 1.337(d)-2T(a)(1) (providing that the loss is generally disallowed); *id.* § 1.337(d)-2T(c)(2) (providing that the loss is allowed "to the extent the taxpayer establishes that the loss . . . is not attributable to the recognition of built-in gain on the disposition of an asset (including stock or securities)"); see also Don Leatherman, *Current Developments for Consolidated Groups*, 555 PLI/tax 793, 803-12 (2002) (for a discussion of Treas. Reg. § 1.337(d)-2T).

The 1990 loss disallowance rule was promulgated by the administration of President George H. Bush. Ironically, perhaps, his son's administration defended the rule in the Federal Circuit and ultimately replaced it. Perhaps, the sins of the father are visited on the son.

5. To support its August 3, 2001 petition for rehearing in *Rite Aid*, the government surveyed 1,600 of 60,000 consolidated groups, and the survey uncovered at least thirty three audits over the past three years with "loss disallowance" issues. Those issues involved about \$1.2 billion of tax. See *Government Seeks Rehearing En Banc in Rite Aid Case*, 176 TAX NOTES TODAY 20, ¶ 10, Sept. 31, 2001, available at 2001 TNT 176-20. Following *Rite Aid*, that dollar amount at stake will grow as additional groups file refund claims. Although too much could be read into the government survey, it seems certain that "loss disallowance" involves billions of potential tax dollars.

6. See also Silverman & Zarlenga, *supra* note 4, at 443 (stating that the Federal Circuit decision "use[d] very broad language to invalidate a legislative regulation and . . . provide[d] little analysis"); Irving Salem, *A Proposal to Resolve the Rite Aid Legislative War*, 98 TAX NOTES 599, 600-01 (2003) (calling the reasoning of the Federal Circuit "flawed" and also stating "[m]y conclusion is that the 'reasoning of *Rite Aid*' is unadministrable, and we are likely to go brain dead before we can articulate what it means").

7. See, e.g., CARE Act of 2002, S. 1924, 107th Cong., § 631 (2002) (proposed legislation prompted by *Rite Aid*). That proposed legislation would add the following

Part I of this Article sets out background, giving an overview of the consolidated return regulations, exploring the standards courts use to test the validity of administrative regulations, and discussing how those standards have been adapted for the consolidated return regulations. Part II describes the loss disallowance rule of Treas. Reg. § 1.1502-20 ("LDR"), including Treasury's justifications for the rule and how it applied to the *Rite Aid* facts. Part III analyzes *Rite Aid*, describing the decisions of the Federal Circuit and lower court and setting out the arguments for and against invalidating at least part of LDR. I conclude that although the question is perhaps close, the Federal Circuit should have found the regulation valid. Finally, Part IV points out the likely impact of *Rite Aid*, including other consolidated return regulations that may be threatened by the case.

I. BACKGROUND

A. *An Overview of the Consolidated Return Regulations*

For federal income tax purposes, a consolidated group is treated sometimes like a single entity and sometimes like a collection of separate corporations.⁸ This "hybrid" approach is intended "clearly to reflect" the income tax liability of the group *and* each member, both during *and* after affiliation and to "prevent avoidance" of that tax liability.⁹ Although "clear reflection" and "avoidance prevention" are vague standards at best, they serve as the only statutory guides Congress offered in granting Treasury its broad authority to craft the consolidated return regulations.¹⁰

sentence to I.R.C. § 1502:

In prescribing such regulations, the Secretary may prescribe rules applicable to corporations filing consolidated returns under section 1501 that are different from other provisions of this title that would apply if such corporations filed consolidated returns.

The proposed legislation would apply to all taxable years. See Irving Salem, *supra* note 6, at 601-03 (criticizing the proposal).

8. See Don Leatherman, *Are Separate Liability Losses Separate for Consolidated Groups?*, 52 TAX LAW. 663, 665-70 (1999) (for a similar discussion).

9. See I.R.C. § 1502 (2002).

10. That grant reads as follows:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

I.R.C. § 1502.

The regulations do not articulate principles to apply these statutory guides, but a careful review reveals that the regulations promote the following two policies of tax-neutrality.¹¹ First, a consolidated group should be neither penalized nor advantaged for federal income tax purposes in forming a new member or transferring assets between members. Second, the group should have no tax incentive or disincentive to acquire a prospective member or dispose of an existing member. The regulations reflect the first policy by sometimes treating a group like a single entity and reflect the second by sometimes treating group members as separate corporations.

Increasingly, the regulations adopt a single-entity approach.¹² Critically, the gross income, gain, loss, and deductions of each member are combined to compute a group's consolidated taxable income ("CTI"),¹³ and a group uses CTI to determine its federal income tax.¹⁴ A consolidated group also uses a single-entity approach to compute many components of its CTI, including its net capital gain,¹⁵ net § 1231 gain or loss,¹⁶ charitable deduction,¹⁷ and dividends received deduction.¹⁸ Further, the group adjusts its basis in subsidiary stock to achieve the following single-entity effect: preventing the subsidiary's income, gain, loss, and deductions "from being taken into account a second time on [the group's] disposition of [the subsidiary's] stock."¹⁹ By treating the group like a single entity, the regulations reduce the significance of each member's separate

11. See *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 837 (2001) (suggesting that a policy of tax neutrality may be relevant in applying the "avoidance prevention" guide). The Court cited *Leatherman*, *supra* note 8, at 681 and in a parenthetical to the cite the Court quoted language that justified applying a single-entity approach in *United Dominion* because of tax-neutrality. *Id.*

12. Andrew J. Dubroff & John Broadbent, *Consolidated Returns: Evolving Single and Separate Entity Themes*, 72 TAXES 743, 747-50, 760, 765-66 (1994) ("The new regulations enhance single entity treatment by treating the members more uniformly as divisions of a single corporation"); see also Bryan P. Collins et al., *Calculation of Consolidated Taxable Income: The Treatment of Specified Liability Losses*, 25 J. CORP. TAX'N 58, 68 (1998).

13. See Treas. Reg. §§ 1.1502-11 and 1.1502-12 (as amended in 1999); see also Dubroff & Broadbent, *supra* note 12, at 763 (describing the ability to combine tax items as the essence of the consolidated return regulations).

14. Treas. Reg. § 1.1502-2 (as amended in 1999).

15. *Id.* § 1.1502-22.

16. *Id.* § 1.1502-23.

17. *Id.* § 1.1502-24.

18. *Id.* § 1.1502-26.

19. See *id.* § 1.1502-32(a)(1) (explaining that the purpose of the basis adjustment rules is to treat the subsidiary member and owning member as a single entity); see also Treas. Reg. § 1.1502-19 (as amended in 1997) (allowing "negative" basis); cf. I.R.C. § 705 (2000) (providing similar adjustments to determine partner's outside basis but not allowing "negative" basis).

existence and make the group's decision to incorporate a business or transfer assets between members more tax-neutral.

Despite the alluring simplicity of a pure single-entity approach, the regulations treat members in some ways like separate corporations.²⁰ This hybrid approach was likely embraced for two major reasons. First (and important for any analysis of *Rite Aid*), under a pure single-entity approach, a group would lose the benefit of a cost basis in acquired member stock, instead taking a stock basis equal to the net inside basis of the acquired member's assets.²¹ Second, Congress allows a subsidiary member to have non-member shareholders,²² an allowance better accommodated by sometimes using a separate-corporation approach.

Thus, the consolidated return regulations respect the separate existence of each member in several fundamental ways. For example, an acquired member generally retains its pre-consolidation tax attributes. Further, a member recognizes gain or loss on an asset sale to another member, although the group generally takes those items into account using a single-entity approach.²³ In addition, subject to an anti-avoidance rule, each member determines its method of accounting as if it filed a separate return.²⁴ Finally, losses may be carried between separate return and consolidated return years, and that carryover or carryback is limited under a separate-corporation approach.²⁵

20. Because the regulations adopt neither a "pure" single-entity nor separate-corporation approach, the dispute in *Rite Aid* (and most other consolidated questions) cannot be resolved merely by saying that a consolidated group is treated like a single entity or like a collection of separate corporations. The consolidated return regulations treat groups both ways, so that either approach describes nothing more than a result under the regulations, not a principle that underlies them. See Axelrod, *supra* note 4, at 812 (arguing that the single-entity effect is a result under the consolidated return regulations, not a principle of the regulations).

21. A corporation's net inside basis is the aggregate adjusted basis of its assets less its aggregate liabilities.

22. See I.R.C. § 1504(a)(2) and (4) (2002).

23. See Treas. Reg. § 1.1502-13(c) (describing the "matching" rule for intercompany transactions, consistent with a single-entity approach). But see *id.* § 1.1502-13(f)(4) (gain on member stock may be recovered under a separate-corporation approach). See generally *id.* § 1.1502-13(a)(2) (providing that the amount and location of a member's items are determined on a separate-corporation basis, while the timing, character, source, and other attributes are determined on a single-entity basis).

24. See *id.* § 1.1502-17(a) (providing the general rule); *id.* § 1.1502-17(c) (providing the anti-avoidance rule). As a corollary, special-status members, such as banks and insurance companies, determine their status separately; see also ANDREW J. DUBROFF ET AL., *FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS*, § 41.01 n.1 (2d ed. 2002).

25. See Treas. Reg. § 1.1502-21(b)(2)(i) (as amended in 2002) (dealing with losses apportioned to a subsidiary and carried to separate return years) and § 1.1502-21(c) (providing that losses carried from separate return years generally can offset

The separate-corporation approach makes more tax-neutral the group's choice to acquire a prospective member or dispose of an existing member. Because the regulations preserve a member's attributes distinct from group attributes, the acquisition of a subsidiary is less likely to affect the character of distributions to the subsidiary's non-member shareholders. Further, by limiting the carryover or carryback of losses between separate-return and consolidated-return years, the regulations limit the opportunity for loss trafficking, making a group's choice to buy or sell a subsidiary more tax-neutral.²⁶

In gauging the validity of a consolidated return regulation, it is not always clear how a court should balance the separate-corporation and single-entity approaches. The balance is most difficult when the two policies of tax neutrality conflict, a conflict arguably presented by *Rite Aid*.

B. Testing the Validity of a Consolidated Return Regulation

Because of that possible conflict, the standard of review employed by the *Rite Aid* court was critically important, particularly the extent to which the court must defer to the Treasury's policy choices in promulgating the regulation in question. This portion of the Article discusses the appropriate standard of review for consolidated return regulations and then analyzes cases that have considered the validity of those regulations.

1. The standard of review

A court's standard of review for regulations may differ for "interpretive" and "legislative" regulations, with courts giving greater deference to legislative regulations.²⁷ The consolidated return

income only of the subsidiary). *But see id.* § 1.1502-21(g) (providing a special rule for cases in which I.R.C. § 382 also applies to the loss). A "separate return year" of a member is a year in which the member filed a separate return or joined in filing a consolidated return with another group. *See id.* § 1.1502-1(e). A "consolidated return year" is any year that is not a separate return year. *See id.* § 1.1502-1(d).

26. *See* CO-078-90, 1991-1 C.B. 757, 759 (stating in a slightly different context that these loss rules should be "neutral").

27. *See, e.g.,* *Chevron, U.S.A., Inc. v. Natural Res. Def. Counsel*, 467 U.S. 837, 843-44 (1984) (stating that "legislative regulations are given controlling weight, unless they are arbitrary, capricious, or manifestly contrary to the statute"); *Schuler Indus. Inc. v. United States*, 109 F.3d 753, 755 (Fed. Cir. 1997) (citing *Chevron* and stating that legislative regulations should be given more deference than interpretive regulations); *Wolter Constr. Co., Inc. v. Comm'r*, 634 F.2d 1029, 1035 (6th Cir. 1980) (noting that those challenging legislative regulations bear a greater burden than those challenging interpretive regulations); *Georgia-Pac. Corp. v. Comm'r*, 63 T.C. 790, 801 (1975) (providing that legislative regulations are overturned only for "weighty reasons" (quoting *Comm'r v. S. Tex. Co.*, 333 U.S. 496, 501 (1948)));

regulations are legislative regulations, because they are issued under a Code section (I.R.C. § 1502) that grants Treasury broad discretion to craft rules for consolidated groups to compute their federal tax items and income tax.²⁸ Under that grant, Treasury prescribes the consolidated return regulations, which specify how a particular Code section should apply to consolidated groups.²⁹ Because those

Carboloy Co. v. Comm'r, 18 T.C. 1028, 1031 (1952) (stating that "Congress placed in [Treasury] more than ordinary discretion"); *cf.* *United States v. Haggard Apparel Co.*, 526 U.S. 380, 392 (1999) (applying *Chevron* in a non-tax case and noting that it would give "controlling weight" to an agency's reasonable interpretation that filled a gap in a statute).

Commentators generally agree that courts give more deference to legislative tax regulations. *See* Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 59 (1996) (stating that courts give legislative tax regulations more deference than interpretive ones); John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 GEO. WASH. L. REV. 35, 44 (1995) (noting that courts historically deferred to an agency's policy choice in a legislative regulation, unless that choice clearly conflicted with the statute or was arbitrary and capricious). *But see* Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 464 (1993) (arguing that *Chevron* made the standard of review for legislative and interpretive regulations the same); Salem I, *supra* note 4, at 171 (arguing that the theoretical difference between legislative and interpretive regulations has been eroded).

28. *See, e.g., Wolter Constr. Co.*, 634 F.2d at 1035 (concluding that the consolidated return regulations were legislative regulations); *Am. Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979) (reaching the same conclusion); *Garvey v. United States*, 1 Cl. Ct. 108, 113 (1983) (reaching the same conclusion); *see also Chevron*, 467 U.S. at 843-44 (describing legislative regulations as "an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation" where "Congress has explicitly left a gap for the agency to fill").

Current I.R.C. § 1502 and its 1928 statutory predecessor contain practically the same grant of regulatory authority, and the 1928 grant authorized legislative regulations, as the following excerpt from relevant legislative history shows:

Many difficult and complicated problems, however, have arisen in the administration of the provisions permitting the filing of consolidated returns. It is obviously of utmost importance that these questions be answered with certainty and a definite rule be prescribed. Frequently, the particular policy is immaterial, so long as the rule to be applied is known. *The committee believes it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them.*

S. REP. NO. 70-760, at 15 (1928) (emphasis added). Since the 1928 grant authorized legislative regulations, the substantially similar current grant should do so as well.

29. Occasionally, however, Congress has specified how a consolidated (or affiliated) group should be treated. Congress has provided:

- (i) For certain purposes that a consolidated must use a single-entity approach (*see* I.R.C. §§ 29(d)(7), 45(d)(4), 168(i)(7)(B)(ii), 172(h)(4)(C), 197(f)(2)(B)(ii), 441(i)(2), 860E(a)(2), 860J(d), and 1092(d)(4)(B)(ii) (2003));
- (ii) For certain purposes that an affiliated group must use a single-entity approach (*see* I.R.C. §§ 163(j)(6)(C), 280G(d)(5), 355(b), 367(a)(5), 384(c)(6), 465(c)(7)(F), 543(d)(6), 584(a), 864(e)(1), and 1092(d)(3)(C)(ii) (2003));
- (iii) Special rules for consolidated groups to apply the provisions on personal holding companies and the accumulated earnings tax (*see*

regulations fill in the gaps left by Congress, they are legislative regulations and merit significant deference.

Courts have stated that a legislative regulation is valid unless it is "arbitrary, capricious, or manifestly contrary to the statute."³⁰ They also have tested such a regulation's validity by considering whether it was "unreasonable and plainly inconsistent with the statute."³¹ The two tests seem nearly identical, particularly since a regulation should be "unreasonable," "arbitrary," or "capricious" only if it is insufficiently moored to the relevant Code provisions.³² At the very least, if a regulation reasonably applies the Code, it must be valid, because it cannot then be "manifestly contrary" or "plainly inconsistent" with the statute or otherwise "arbitrary," "capricious," or "unreasonable."

I.R.C. §§ 542(b) and 562(d) (2003));

- (iv) Rules for life/non-life consolidated groups (*see* I.R.C. §§ 818(e) and 1504(c));
- (v) A rule to treat stock of a subsidiary member of a consolidated group as a depreciable asset under § 1017 (*see* I.R.C. § 1017(d)(3)(D) (2003)); and
- (vi) Special rules targeted at perceived abuses (*see* I.R.C. § 1503(d)-(f) (2003)).

30. *Chevron*, 467 U.S. at 844 (articulating this standard); *see also Schuler Indus.*, 109 F.3d at 755 (applying the *Chevron* standard); *Nichols v. United States*, 260 F.3d 637, 644-45 (6th Cir. 2001) (applying the *Chevron* standard); *Square D Co. v. Comm'r*, 188 T.C. 299, 307 (2002) (applying the *Chevron* standard); *cf. Rite Aid Corp. v. United States*, 255 F.3d 1357, 1359 (Fed. Cir. 2001) (articulating but not appearing to strictly apply the *Chevron* standard).

31. *See, e.g., Wolter Constr.*, 634 F.2d at 1035 (applying this standard); *Georgia-Pac. Corp.*, 63 T.C. at 801 (applying this standard); *Regal, Inc. v. Comm'r*, 53 T.C. 261, 263 (1969) (applying this standard), *aff'd per curiam*, 435 F.2d 922 (2d Cir. 1970); *see also Conn. Gen. Life Ins. Co. v. Comm'r*, 177 F.3d 136, 149 (3d Cir. 1999) (upholding a consolidated return regulation, stating that it was "not so unreasonable to be invalidated by the court on policy grounds"); *First Chi. Corp. v. Comm'r*, 96 T.C. 421, 439 (1991) (stating that a consolidated return regulations were valid "[t]o the extent they are not proven to be beyond the scope of the authority delegated, inconsistent with the statute, or unreasonable"); *Garvey*, 1 Cl. Ct. at 113 (stating that the consolidated return regulation in question would be upheld "unless clearly unreasonable"); *Corner Broadway-Maiden Lane, Inc. v. Comm'r*, 76 F.2d 106, 108 (2d Cir. 1935) (concluding that a group does not consent to consolidated return regulations that are "inconsistent with the statute"); *Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 476 (1979) (concluding that an interpretive regulation was valid, because it implemented the congressional mandate in a reasonable manner); *Rowan Cos. v. United States*, 452 U.S. 247, 252-53 (1981) (applying the same standard to determine the validity of interpretive regulations); *Cottage Sav. Assoc. v. Comm'r*, 499 U.S. 554, 560-61 (1991) (applying the same standard to determine the validity of interpretive regulations, saying it would "defer to [the Commissioner's] regulatory interpretation of the Code as long as [it was] reasonable").

32. *See Coverdale, supra* note 27, at 45-46 n.66 (1995) (concluding that there is little difference between the two tests); *cf. Cent. Pa. Sav. Assoc. v. Comm'r*, 104 T.C. 384, 392 (1995) (asserting that *Chevron* merely "restated" the traditional standard of review for *interpretive* regulations).

Further, a legislative regulation should reasonably apply relevant Code provisions if it is consistent with the language and purposes of those provisions.³³ In testing reasonableness, courts have also considered the following factors, among others:

- (i) Whether the regulation was a substantially contemporaneous interpretation of the statute;
- (ii) The length of time the regulation has been in effect;
- (iii) The reliance placed on the regulation;
- (iv) The consistency of the Commissioner's interpretation of the regulation; and
- (v) The degree of scrutiny that Congress has devoted to the regulation in subsequent reenactments of the statute.³⁴

Note, however, that in preparing a regulation, Treasury often chooses among several alternatives to apply the Code. In testing the validity of the regulation, a court must decide whether Treasury's choice is reasonable, not whether it made the best possible choice.³⁵

2. *A review of the relevant cases*

Courts have struggled to devise a talisman describing when a consolidated return regulation is reasonable (*i.e.*, sufficiently consistent with the Code). In testing the validity of regulations, they have said that:

The consolidated return regulations cannot "deny . . . deductions from income [that] have the effect of increasing taxable income."³⁶

33. See *Nat'l Muffler Dealers Ass'n*, 440 U.S. at 477 (concluding that a valid interpretive regulation must "harmonize[] with the plain language of the statute, its origin, and its purpose"); *Walton v. Comm'r*, 115 T.C. 589, 597-98 (2000) (applying the same standard to interpretive regulations); *Cent. Pa. Savings Assoc.*, 104 T.C. at 390 (applying the same standard). In essence, then, I suggest that the standard of review primarily involves an examination of the language and purposes of the relevant Code provisions; see also *Carboloy Co. v. Comm'r*, 18 T.C. 1028, 1031 (1952) (stating that Treasury must exercise its regulatory power for consolidated return regulations to achieve the overriding purpose of the applicable Code provisions while eliminating distortions of income).

34. See *Nat'l Muffler Dealers Ass'n*, 440 U.S. at 477 (describing these considerations as part of the Court's consideration of an interpretive regulation). Although *National Muffler* considered interpretive regulations, those factors should also aid a court in considering the validity of legislative regulations.

35. See *Atl. Mut. Ins. Co. v. Comm'r*, 523 U.S. 382, 389 (1998) (stating that "the task that confronts us is to decide, not whether the Treasury Regulation represents the best interpretation of the statute, but whether it represents a reasonable one"); *Chevron*, 467 U.S. at 845 (stating that a court must consider whether the administrator's view that [a regulation] is appropriate in the [relevant context] is a reasonable one"); *Nat'l Muffler Dealers Ass'n*, 440 U.S. at 489 (noting that the choice among reasonable interpretations is for the Treasury, not the courts); *Am. Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979) (noting that in promulgating regulations, Treasury may choose among reasonable methods).

36. *Gen. Mach. Corp. v. Comm'r*, 33 B.T.A. 1215, 1219 (1936). See *Comm'r v.*

Consolidated groups must take the “bitter with the sweet” under the regulations.³⁷

Although consolidated groups must consent to the regulations, they do not consent to regulations that are “inconsistent with the statute.”³⁸

The regulations should “conform the applicable income tax law of the Code to the special myriad problems resulting from the filing of consolidated income tax returns.”³⁹

Although these verbal formulae capture facets of valid consolidated return regulations, they do not precisely describe how a court should test a regulation’s validity. Stripped of their context, they wither to slogans or mantras, incomplete at best, generally ineffectual, and often misleading.⁴⁰

Gen. Mach. Corp., 95 F.2d 759, 761 (6th Cir. 1938) (stating that the regulations cannot “amend the [Code] or to require surrender of any part of the statutory privilege as a condition to the grant of permission to file a consolidated return”); *Joseph Weidenhoff, Inc. v. Comm’r*, 32 T.C. 1222, 1242 (1959) (stating that the consolidated return regulations cannot “impose a tax on income that would not otherwise be taxed”); *see also Am. Standard*, 602 F.2d at 261 (citing to and quoting the language noted above from *Weidenhoff*); *Kanawha Gas & Util. Co. v. Comm’r*, 214 F.2d 685, 691 n.7 (5th Cir. 1954) (noting that a regulation cannot invalidate a basic concept of tax law).

Correspondingly, the consolidated return regulations should not exempt income or permit deductions that would *decrease* taxable income. For obvious reasons, groups have not litigated cases where the regulations decrease taxable income.

37. *Georgia-Pac. Corp. v. Comm’r*, 63 T.C. 790, 802 (1975). *See S. Slater & Sons, Inc. v. White*, 119 F.2d 839, 845 (1st Cir. 1941) (noting that the regulation at issue “will sometimes work to the advantage of taxpayers and sometimes to their disadvantage”); *see also Covil Insulation Co. v. Comm’r*, 65 T.C. 364, 375 (1975) (stating that “[t]he burden of the excess loss account provisions [under the consolidated return regulations] must be accepted with the benefit of unlimited access to the subsidiary’s losses.”).

38. *Gen. Mach. Corp.*, 33 B.T.A. at 1219.

39. *Am. Standard*, 602 F.2d at 261; *First Chi. Corp. v. Comm’r*, 96 T.C. 421, 440 (1991) (citing to *American Standard* and quoting the same language); *cf. Regal, Inc. v. Comm’r*, 53 T.C. 261, 267 (1969), *aff’d per curiam*, 435 F.2d 922 (2d Cir. 1970) (noting that Congress gave Treasury discretion to deal with unforeseen problems).

40. For example, Treasury could justify any regulatory approach by saying that a consolidated group must take the “bitter with the sweet.” Although the phrase accurately reflects that a consolidated group may pay more or less tax than a similar affiliated, non-consolidated group, it fails to describe how a consolidated group should be treated in a particular case or why it should be treated that way.

Further, although it may be true that a consolidated return regulation cannot “impose a tax on income that would not otherwise be taxed” or “deny deductions from income that have the effect of increasing taxable income,” these related formulae each presume a comparative model. Typically, however, a court is searching for a reasonable model (*i.e.*, a single-entity, separate-corporation, or hybrid model) when it tests the validity of a consolidated return regulation. Because these formulae require one model as the standard for comparison, their use essentially assumes the conclusion.

A court may also need a comparative model to test whether a regulation is “inconsistent with the Code” or whether it “conforms” the Code to the “special myriad problems resulting from the filing of consolidated income tax returns.” If

Weak formulae notwithstanding, courts rarely invalidate consolidated return regulations, recognizing that Treasury needs significant flexibility to respond to the unique issues raised by consolidated returns.⁴¹ The courts generally rely on Treasury to describe “the nuts and bolts of computing income of consolidated corporations.”⁴² Further, they look with favor on longstanding interpretations⁴³ but accept that Treasury must sometimes alter its approach in light of its experience.⁴⁴ Finally, they acknowledge that the regulations must be of general application and that even a valid regulation may produce inequitable outcomes in some cases.⁴⁵

An examination of the few pre-*Rite Aid* cases that invalidate consolidated return regulations reveals that those regulations have the following flaws: they were not tax neutral and Treasury provided no justification for the regulations. The discussion reviews these and

the court does, these formulae suffer from the same flaw noted in the previous paragraph. In any event, neither formula helps answer when a regulation is inconsistent with the Code or otherwise unreasonable, likely the critical question.

41. See S. REP. NO. 70-760, at 15 (1928) (in the legislative history to the original grant of regulatory authority for the consolidated return regulations, providing in part that Congress “believe[d] it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations,” and therefore, authorized the consolidated return regulations); see also *Regal*, 53 T.C. at 267 (noting that Congress gave Treasury the authority to deal with unforeseen problems in the consolidated return regulations).

42. *Wolter Constr. Co. v. Comm’r*, 634 F.2d 1029, 1037 (6th Cir. 1980).

43. For example, one case involved a regulation that required a consolidated group to continue to file a consolidated return unless certain conditions were met. See *Regal*, 53 T.C. 261. The court concluded that the continued-filing requirement was a valid exercise of regulatory authority, in large part because it had been a requirement almost since consolidated returns were first authorized. *Id.* at 264-66, 269; see also *Salem Packing Co. v. Comm’r*, 56 T.C. 131, 141 (1971) (finding valid a consolidated return regulation that required group members to adopt the same accounting method “[f]or much the same reasons stated in *Regal, Inc.*”).

44. See *Nat’l Muffler Dealers Ass’n, Inc. v. United States*, 440 U.S. 472, 485 (1979). Of course, Treasury would also have to change the regulations to respond to legislative change.

45. See *Nichols v. United States*, 260 F.3d 637, 653-54 (6th Cir. 2001) (concluding that “equity and policy arguments are insufficient to invalidate a regulation that [was] otherwise properly enacted”); *Conn. Gen. Life Ins. Co. v. Comm’r*, 177 F.3d 136, 149 (3d Cir. 1999) (noting that the regulation was “not so unreasonable to be invalidated by the court on policy grounds”); *Garvey v. United States*, 726 F.2d 1569, 1571 (Fed. Cir. 1984) (concluding that a regulation was valid, but noting the “incongruity in [its] across-the-board application”); *Carboloy Co. v. Comm’r*, 18 T.C. 1028, 1031 (1952) (in concluding that a consolidated return regulation concerning inventory was valid, the court stated that the consolidated return regulations “are designed to be of general applicability”); *Wolter Constr.*, 634 F.2d at 1039 (refusing to overrule a regulation “based only on a generalized policy distilled from the regulations and symbiotic Code provisions”); see also *First Chi. Corp. v. Comm’r*, 96 T.C. 421 (1991) (concluding that without regulatory authority, a consolidated group could not aggregate its stock ownership of a foreign corporation to apply the ten percent requirement of I.R.C. § 902, even though that aggregation would better achieve a single-entity effect).

other significant cases that considered the validity of consolidated return regulations.⁴⁶

a. Unfettered discretion—Weidenhoff

In *Joseph Weidenhoff, Inc.*, a 1959 case, the Tax Court overturned a regulation that appeared to give Treasury absolute discretion to compute an aspect of a consolidated group's excess profits tax.⁴⁷ The regulation limited the excess profits tax credit for a consolidated group formed after March 14, 1941, unless the Commissioner concluded that removing the limitation would:

- (i) "better serve" the "general purpose" of the regulation,⁴⁸ or
- (ii) "not serve to distort the excess profits tax liability of the group or any of its members."⁴⁹

The Weidenhoff consolidated group, formed after March 14, 1941, computed its excess profits tax credit assuming that the regulatory limitation did not apply. However, the Commissioner applied the limitation, but he explained neither its purpose nor why it should be applied to the Weidenhoff group.⁵⁰

Not surprisingly, the court invalidated the limitation, since apparently at his whim, the Commissioner could increase or decrease the excess profits tax of a consolidated group like the Weidenhoff group.⁵¹ That discretion dampened the incentive for a group to acquire new members, hampering tax neutrality, and the court cautioned that:

Congress did not intend that the Commissioner could arbitrarily interpret or apply his regulations contrary to the provisions of the Internal Revenue Code. This is particularly true in a case like the

46. In two cases not discussed in the text, courts have invalidated a consolidated return regulation, but neither case appears relevant in analyzing *Rite Aid*. See *Colson Co. v. Comm'r*, 37 B.T.A. 1031 (1938) (invalidating a regulation that required a group filing a consolidated income tax return to also file a consolidated excess profits tax return, because no statute expressly authorized the filing of a consolidated excess profits tax return); *Cnty. Water Serv. Co. v. Comm'r*, 32 B.T.A. 164 (1935) (invalidating a portion of Art. 16(b) of Reg. 75, which provided that the common parent was the sole agent for a consolidated group in litigation before the Board of Tax Appeals, because it conflicted with the Board's rules of practice and procedure).

47. *Joseph Weidenhoff, Inc. v. Comm'r*, 32 T.C. 1222 (1959). See generally § 24.31(b)(24) of Reg. 29, 26 Fed. Reg. 6301-02 (1951).

48. See *id.* at 24.31(b)(24)(ii)(e) (effectively allowing the limitation to be lifted to serve the "general purpose" of the regulation; the limitation was lifted by postponing the effective date of the provision).

49. See *id.* at 24.31(b)(24)(ii)(d) (allowing the limitation to be lifted if the Commissioner found no distortion).

50. *Joseph Weidenhoff*, 32 T.C. at 1240.

51. Thus, similarly situated groups could be treated differently, raising significant issues of horizontal equity.

present one where the regulations would permit the Commissioner to determine in his own discretion what may or may not serve to distort the excess profits tax liability⁵²

Although the court also noted that the consolidated return regulations could not impose a tax on income not otherwise subject to tax,⁵³ *Weidenhoff's* hallmark is the following principle: the consolidated return regulations cannot give the Commissioner complete discretion to increase a group's tax. Because few regulations offer the Commissioner similar discretion, the *Weidenhoff* principle is rarely implicated.

b. Carryforward of losses

Of broader application are *General Machinery*⁵⁴ and *S. Slater & Sons*.⁵⁵ Each case involved a regulation limiting the loss that could be carried forward to a group's consolidated return year. One regulation defined what constituted a taxable year to which a loss was carried, and it was invalidated; the second measured the extent to which a loss carryover was absorbed in a taxable year, and it was approved.

In *General Machinery*, the Board of Tax Appeals and Sixth Circuit each invalidated a consolidated return regulation that limited the carryover period of a pre-affiliation loss when a subsidiary joined a consolidated group. The subsidiary, a calendar-year taxpayer, was acquired by a calendar-year consolidated group on March 27, 1929.⁵⁶ Although the subsidiary could carry its pre-affiliation, 1927 loss

52. *Id.* at 1241; see also *Covil Insulation Co., Inc. v. Comm'r*, 65 T.C. 364, 376 (1975) (noting that a regulation does not give the Commissioner too much discretion merely because it requires him or her to make a factual finding about worthlessness, noting that findings of that sort are required by many Code provisions). The Commissioner's discretion also made the regulation's application highly uncertain, a quality fundamentally inconsistent with the grant of authority under which the regulation was issued. S. REP. NO. 70-760, at 15 (1928) (stating that "[i]t is obviously of utmost importance that . . . questions be answered with certainty and a definite rule be prescribed [in the regulations]").

53. *Joseph Weidenhoff*, 32 T.C. at 1242 (providing that a consolidated return regulation cannot "impose a tax on income that would not otherwise be taxed . . . simply because the taxpayers exercise the privilege of filing consolidated returns, unless it is to prevent tax avoidance") (emphasis added); cf. *Garvey v. United States*, 1 Cl. Ct. 108, 116 (1983) (stating that in making this statement *Weidenhoff* was merely expressing its "frustration over its inability to understand the purpose of a regulation . . . and the failure of both the regulations and Commissioner to explain such purpose").

54. See *Comm'r v. Gen. Mach. Corp.*, 95 F.2d 759 (6th Cir. 1938); *Gen. Mach. Corp. v. Comm'r*, 33 B.T.A. 1215 (1936).

55. *S. Slater & Sons, Inc. v. White*, 119 F.2d 839 (1st Cir. 1941).

56. *Gen. Mach. Corp.*, 95 F.2d at 760.

forward two taxable years,⁵⁷ the Commissioner asserted that the carryforward period for the loss expired on March 26, 1929.⁵⁸ He relied on a consolidated return regulation that for this purpose treated the subsidiary as having two taxable years during the 1929 calendar year, one for its pre-affiliation period and one for its post-affiliation period.⁵⁹ If the regulation was valid, the Commissioner was correct because the subsidiary's second taxable year after 1927 would end on March 26, 1929.

In invalidating the regulation, both courts relied on a rationale enunciated in *Morgan's Inc.*, a 1934 Supreme Court case.⁶⁰ Considering a similar issue under pre-1928 law, the Court concluded that when Congress provided that a net operating loss is carried forward two taxable years, it intended that the loss be carried forward two full twelve-month periods.⁶¹ Although *Morgan's Inc.* considered earlier law, Congress had not thereafter changed the loss carryover rule or the Code's definition of "taxable year." Thus, the Board of Tax Appeals and Sixth Circuit in *General Machinery* each concluded that the consolidated return regulation generally was invalid when it limited the loss carryover to less than two twelve-month periods, because it violated Congressional intent.⁶²

57. See Revenue Act of 1926, Pub. L. No. 69-20, § 206(b), 44 Stat. 17.

58. *Gen. Mach. Corp.*, 95 F.2d at 760.

59. Art. 41(d) of Reg. 75, reprinted in 138 Internal Revenue Acts of the United States 1909-1950 Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr. ed., 1979) [hereinafter Reg. 75].

60. *Helvering v. Morgan's Inc.*, 293 U.S. 121 (1934).

61. *Id.* at 126-27.

62. *Gen. Mach. Corp.*, 95 F.2d at 761 (concluding that the purpose of the loss carryover provision was to "stabilize income over three year periods"); *Gen. Mach. Corp.*, 33 B.T.A. at 1219-21; cf. *Valley Paperback Mfrs., Inc. v. Comm'r*, 34 T.C.M. (CCH) 1359 (1975) (concluding that when a consolidated group acquired a subsidiary during the middle of a year, the subsidiary's pre- and post-acquisition periods during the year were separate taxable years for purposes of the relevant loss-carryover provision; the Tax Court noted a 1942 Code change that defined a taxable year to mean a period of less than twelve months if a tax return was required for that period); *Palomas Land & Cattle Co. v. Comm'r*, 91 F.2d 100 (9th Cir. 1937) (concluding that when the common parent of a consolidated group sold its only subsidiary in the middle of a year, the parent's post-acquisition net loss for the year could offset the group's pre-acquisition net income, because the assessment of tax was based on an annual twelve-month period); *Comm'r v. Hughes Tool Co.*, 118 F.2d 474 (5th Cir. 1941) (following *Palomas*); *Corner Broadway-Maiden Lane, Inc. v. Comm'r*, 76 F.2d 106 (2d Cir. 1935) (invalidating a regulation that defined affiliation inconsistent with the Code's definition of affiliation).

Despite *Morgan's Inc.* and contrary to *General Machinery*, the D.C. Circuit concluded that a period of less than twelve months could be a taxable year for purposes of the loss carryover provision. See *Wishnick-Tumpeer, Inc. v. Helvering*, 77 F.2d 774 (D.C. Cir. 1935). In *Wishnick-Tumpeer*, an affiliated group began filing consolidated returns on January 1, 1929 and each group member also changed its accounting period to a June 30 fiscal year, including a subsidiary that had previously used an October 31 fiscal year. The subsidiary, which had a loss carryover from its 1927 year, filed a

The regulation in *General Machinery* suffers from the two flaws of invalid consolidated return regulations noted above. It was not tax neutral, because it made it likely that a consolidated group's midyear purchase of a loss subsidiary would limit the period over which the subsidiary's loss carryforward could be used, thereby curbing those purchases. Further, Treasury never appeared to explain the purpose of the regulation.⁶³

General Machinery plays as an uncertain counterpoint to *S. Slater & Sons*.⁶⁴ In the latter case, the First Circuit considered how a group should carry forward and absorb its pre-1929 losses. The court endorsed the relevant provision in Reg. 75, even though the provision changed the law and, in effect, retroactively reduced a loss carryforward.⁶⁵

Under Art. 41 of Reg. 75, a consolidated group's net loss was carried forward and absorbed as if the group were a single taxpayer. For any consolidated return year, a group offset its members' income and expense items for the year before using any available loss carryforward.⁶⁶ If, overall, the group had positive taxable income for

separate tax return for the period between November 1 and December 31, 1928 and joined in the group's consolidated return for the period from January 1 through June 30, 1929. *Id.* The Fifth Circuit concluded that the subsidiary could carry its 1927 loss to its 1928 fiscal-year return and its 1928 short-period return, but not to the group's 1929 short-period return, even though the latter two returns covered a total of only eight months. To reach that ultimate conclusion, the court concluded that the short 1928 period was a "taxable year," relying on Art. 41(d) of Reg. 75, the provision invalidated by *General Machinery*. *Id.* at 775-77 (also concluding that Art. 41(d) did not violate congressional intent).

Both *General Machinery* courts distinguished *Wishnick-Tumpeer*, because group members in *Wishnick-Tumpeer* changed their accounting periods. *Gen. Mach. Corp.*, 95 F.2d at 761; *Gen. Mach. Corp.*, 33 B.T.A. at 1220. Their distinction seems flawed because the subsidiary's short-period separate return and the group's immediately succeeding consolidated return covered, in the aggregate, less than twelve months. If *Wishnick-Tumpeer* were consistent with *General Machinery*, it should have permitted the loss carryover to the short-period consolidated return, to more closely achieve the congressional intent, articulated in *Morgan's Inc.*, of permitting loss carryovers to two full twelve-month periods.

63. Treasury apparently asserted that the regulation was intended to prevent tax avoidance, but the court rejected that assertion (at least if no member changed its accounting period). See *Gen. Mach. Corp.*, 95 F.2d at 761 (stating that "it is difficult to see" how the regulation aids that purpose, adding that "[t]he stabilizing of corporate income over a three year period is not served by stabilizing income over a shorter [period] for if such is the purpose of the affiliation[,] the corporations need only to affiliate at the beginning of the calendar or fiscal year"); see also *Wolter Constr. Co. v. Comm'r*, 634 F.2d 1029, 1036 (6th Cir. 1980) (stating that the *General Machinery* court "found the Commissioner's proffered explanation illusory").

64. Both cases involved the same two-year loss carryforward provision. See Revenue Act of 1926, Pub. L. No. 69-20, § 206(b), 44 Stat. 17.

65. See generally *S. Slater & Sons, Inc. v. White*, 119 F.2d 839, 843-45 (1st Cir. 1941).

66. See Reg. 75, *supra* note 59.

the year, the loss carryforward could offset that income, even if the income and loss were attributable to different members.⁶⁷

Although Art. 41 changed the law, the fact of the change was not established until after the regulation was issued.⁶⁸ The prior law, as fully developed, used the following two-step approach to carry forward a consolidated group's loss:

(i) A member's net loss for a consolidated return year offset the net income of other members for the year. For this purpose, a member's net income for the year was computed by first taking loss carryforwards to the year into account.

(ii) If a member had a net loss remaining after the first step, the group could carry that remaining loss forward, but the loss could offset only the member's separate income in future years.⁶⁹

EXAMPLE 1—COMPARING ART. 41 AND PRIOR LAW

P and its subsidiary S filed consolidated returns for 1926 through 1929. During those years, they had the following separate income and losses:⁷⁰

Corporation	1926	1927	1928	1929
P	(\$600,000)	\$400,000	\$200,000	\$0
S	\$0	(\$400,000)	(\$200,000)	\$600,000 ⁷¹

Under pre-Reg. 75 law, the P group would not pay federal income tax or have net positive taxable income for any year between 1926 and 1929. Its \$600,000 net loss from 1926, attributable to P, would fully offset P's income in 1927 and 1928.⁷² As a consequence, the P group would have a \$400,000 net loss in 1927 and a \$200,000 net loss in 1928. These net losses, attributable to S, would be carried forward to 1929, fully offsetting S's \$600,000 income in that year.⁷³

67. *Id.*

68. See *S. Slater & Sons*, 119 F.2d at 841 (citing to a series of post-1929 cases concluding that a group carried over and absorbed its loss carryover using a separate-corporation approach); Gen. Couns. Mem. 15,595, XIV-2 C.B. 237, 238 (1935) (stating the conclusion of those post-1929 courts was contrary to the "well-established practice" of the IRS, in effect when the regulation was issued, to treat the group as a single entity for this purpose); cf. L.O. 1113, III-2 C.B. 36, 39-40 (1924) (concluding that a consolidated group applied the single-entity approach described in the preceding paragraph to carry over and absorb a consolidated net operating loss).

69. *S. Slater & Sons*, 119 F.2d at 841 (describing this approach).

70. Those amounts are determined before taking any carryforwards into account. Losses are in parentheses.

71. In *S. Slater & Sons, Inc.*, the common parent was a stand-alone corporation in 1926 but filed consolidated returns with two subsidiaries in 1927 through 1929. Although the common parent was not a member of a consolidated group in 1926, the results described in the example are consistent with the case. See *id.* at 841.

72. A 1926 net loss could be carried forward only two years. See *supra* note 57 (citing to the relevant provision).

73. See Revenue Act of 1928, Pub. L. No. 70-562, § 117(b), 45 Stat. (pt. 1) 791, 825 (providing for a two-year loss carryforward for 1928 losses).

Under Art. 41 of Reg. 75, however, the P group had net income and incurred federal income tax in 1929. In 1927 and 1928, S's loss offset P's income before the group could use its 1926 loss carryover, so the loss carryover expired unused. Because the group did not generate a net loss in 1927 or 1928, it had \$600,000 of net income in 1929. Thus, Art. 41 of Reg. 75 retroactively eliminated the benefit of a \$600,000 loss carryforward.⁷⁴

S. Slater & Sons concluded that Art. 41 of Reg. 75 "constitute[d] a proper exercise of the Commissioner's delegated power,"⁷⁵ but the court's conclusion should not be read as *carte blanche* for Treasury to eliminate an otherwise available loss through the consolidated return regulations. Although Art. 41 could retroactively eliminate the benefit of a loss carryforward, it followed the apparent state of the law when the regulation was issued, a fact that probably influenced the court and may distinguish *S. Slater & Sons* from, for example, *Rite Aid*.⁷⁶

Still, *S. Slater & Sons* is not irrelevant to a *Rite Aid* analysis, since the First Circuit's conclusion did not rest on the apparent state of the law when Art. 41 was issued. Instead, the court labeled Art. 41 as a "marked departure" from prior law and concluded that the regulation was valid because a consolidated group "cannot in logic object to a result which follows from a consistent application of the

74. Art. 41 of Reg. 75 could also retroactively reduce income subject to tax. Consider the following income and loss profile for P and S:

Corporation	1926	1927	1928	1929
P	(\$600,000)	\$0	\$0	\$600,000
S	\$0	\$600,000	(\$600,000)	\$0

Under the single-entity approach of Reg. 75, the P group's \$600,000 net losses in 1926 and 1928 would offset its \$600,000 net income in the succeeding years. Consequently, the P group would not pay federal income tax or have net income for any year between 1926 and 1929.

Under pre-Reg. 75 law, however, the group would have \$600,000 of net income in each of 1927 and 1929. Its \$600,000 1926 net loss, attributable to P, would expire unused, because P has no net income in 1927 or 1928. Further, its 1928 loss, attributable to S, could not be used in 1929, because S has no net income in that year.

75. See *S. Slater & Sons*, 119 F.2d at 845 (stating that Reg. 75 did not involve a retroactive redetermination of loss "in any invidious sense" and that the redetermination was "a matter of extreme simplicity, involving merely a reshuffling of figures"); see also *id.* at 843 (stating that "[t]he single-taxpayer theory has the merit of simplicity, and it also conforms to business reality"). Note that prospectively, Art. 41 promoted tax neutrality, because its single-entity approach made it more likely that a group's use of its loss carryovers would be unaffected by the formation or liquidation of a member.

76. See *supra* note 68 (describing the state of the law at that time). The court could readily determine that Congress authorized Treasury to prescribe Art. 41, because that article continued what appeared to be applicable law.

single-entity theory.”⁷⁷ By allowing Treasury to depart from prior law, the Fifth Circuit revealed the broad discretion Treasury may have to craft the consolidated return regulations, discretion that may permit the elimination of loss in an appropriate case.

Of course, the question is when a loss may appropriately be eliminated, and *Wolter Construction* provides more hints,⁷⁸ amplifying *S. Slater & Sons* and distinguishing *General Machinery*. In *Wolter Construction*, the Sixth Circuit considered the validity of the “SRLY” rule,⁷⁹ which applied when a subsidiary of a consolidated group had a loss carryforward from a pre-affiliation year.⁸⁰ The rule limited the portion of the loss carryforward that the group could absorb in the carryforward year to the subsidiary’s separate income for that year.⁸¹ Because it made it less likely that the group’s acquisition of a loss corporation could increase the pace at which the corporation’s losses were used, the SRLY rule promoted tax neutrality.⁸²

Despite that sound purpose, the Wolter group argued that the SRLY rule was invalid as it applied to the group, because the common parent and loss subsidiary were commonly controlled (though not affiliated) in the loss year.⁸³ Because of that common control, the group asserted, its acquisition of the loss subsidiary did not raise a loss trafficking concern.⁸⁴

By its terms, however, the SRLY rule applied to corporations that were commonly controlled but not affiliated during the loss year.⁸⁵ Calling the distinction between affiliation and common control “formalistic,” the group urged that, under *General Machinery*, the SRLY rule was invalid.⁸⁶ The Sixth Circuit disagreed, stating that:

Conspicuously absent in the consolidated return area is some guidance from Congress as to the nuts and bolts for computing the

77. *S. Slater & Sons*, 119 F.2d at 845.

78. *Wolter Constr. Co. v. Comm’r*, 634 F.2d 1029 (6th Cir. 1980).

79. See Treas. Reg. § 1.1502-21(c)(1) (containing the current version of that rule, and in relevant part, it is the same as the version considered in *Wolter Construction*).

80. More precisely, the rule limited the subsidiary’s loss carryforward from a separate return limitation year or “SRLY.” Treas. Reg. § 1.1502-21(c)(1). A SRLY includes a taxable year of the subsidiary for which it filed a separate return, unless it was a group member (*i.e.*, affiliated with the group) on every day of that year. Treas. Reg. § 1.1502-1(e) (defining separate return year) and (f)(1) and (2)(ii) (defining SRLY).

81. See Treas. Reg. § 1.1502-21(c)(1) (as amended in 1999).

82. See *Wolter Constr. Co.*, 634 F.2d at 1034 (acknowledging this point by stating that the SRLY rule “prevents the affiliated group from obtaining any advantage from the carryover losses”); see also *id.* at 1037 (also noting that the regulations are “designed to prevent ‘trafficking’ in loss corporations”).

83. *Id.* at 1034.

84. *Id.* at 1034-36.

85. See *id.* at 1036 (describing the application of the SRLY rule).

86. *Id.*

income of consolidated corporations. Unlike [the relevant Code provision]⁸⁷ which the *General Machinery* court used as a measuring rod, Wolter cites no consolidated return Code provision with which the instant regulations conflict.⁸⁸

Without an expressly conflicting Code provision, the court refused to overturn the SRLY rule based on general equitable considerations or a possibly inconsistent policy gleaned from the Code and consolidated return regulations.⁸⁹ It also gave Treasury latitude to attack loss trafficking without being confined by the Code's loss trafficking rules.⁹⁰ Because the SRLY rule reasonably attacked loss trafficking, the court concluded that it was a valid rule, even though it may not have been the best one.⁹¹

Thus, the Sixth Circuit in *Wolter Construction* gave Treasury broad discretion to craft consolidated return regulations to compute a group's income. It let Treasury choose among reasonable alternatives, affirming that a choice may be reasonable (and therefore valid) even if it may not reach equitable results in a particular case.

c. Investment adjustments and ELAs

The same themes also resonated in cases that considered the validity of the "investment adjustment" and "excess loss account" rules under the consolidated return regulations. Those cases share

87. See *supra* note 61 and accompanying text (for a description of that Code provision).

88. *Wolter Constr. Co.*, 634 F.2d at 1037; see also *id.* at 1038 (in which the court cautioned that "consolidated return computations are not, however, based on a consolidated accounting" of the group's tax items and that "the filing of a consolidated return is not the functional equivalent of a merger" of all members into a single corporation).

89. See *id.* at 1037, 1039-40 (noting, among other things, that a deduction does not depend on equitable considerations but is a matter of "legislative grace"); see also *Conn. Gen. Life Ins. Co. v. Comm'r*, 177 F.3d 136 (3d Cir. 1999) (refusing to follow an implication that when a regulation reserved a section for rules specifically relating to acquired groups, the regulation's general provisions did not apply to acquired groups).

90. *Wolter Constr. Co.*, 634 F.2d at 1041 (stating that "the consolidated return regulations may be applied to disallow a deduction even though that deduction is not disallowed under Section 269"); see also *Regal, Inc. v. Comm'r*, 53 T.C. 261, 267 (1969) (stating that "we think it hardly likely that Congress, in its concern about avoidance and the clear reflection of income, intended to limit the Commissioner in his choice of remedies merely because there might be a possible overlap"), *aff'd per curiam*, 435 F.2d 922 (2d Cir. 1970).

91. See *Wolter Constr. Co.*, 634 F.2d at 1044 (in which the court concluded that the SRLY rule was reasonable, even though it acknowledged that applying the rule to commonly controlled corporations was "somewhat incongruous when compared with related Code provisions").

an affinity with *Rite Aid*, because they contemplated how a consolidated group treats its disposition of subsidiary stock.

Excess loss accounts are a byproduct of the investment adjustment rules. Under those rules, a consolidated group increases or decreases its basis in subsidiary stock to account for the subsidiary's profits, losses, and distributions.⁹² Investment adjustments are intended to prevent the group from taking the subsidiary's profits or losses into account a second time when it disposes of its subsidiary stock.⁹³

When a subsidiary's losses and distributions exceed the group's basis in subsidiary stock, the consolidated return regulations may require the group to reduce the basis in its subsidiary stock below zero, and the regulations call that negative basis amount an "excess loss account."⁹⁴ A group treats an excess loss account (or "ELA") on subsidiary stock as income when the group disposes of its subsidiary stock.⁹⁵

The investment adjustment and ELA rules arguably violate the basic tax precept that an asset may not have a negative basis, and that issue was aired in *Covil Insulation*.⁹⁶ The Tax Court dismissed the argument with dispatch, noting that the rules prevented a group's tax loss from exceeding its economic loss.⁹⁷ The dynamic making the ELA rule necessary was the keynote of tax consolidation—that one member's loss may offset another member's income.⁹⁸ Because of loss sharing, a subsidiary could generate a net tax loss for the group

92. Treas. Reg. § 1.1502-32(b) (as amended in 2002).

93. See Treas. Reg. § 1.1502-32(a)(1) (describing the purpose of the investment adjustment rules); see also *Garvey v. United States*, 726 F.2d 1569, 1570 n.8 (Fed. Cir. 1984) (stating that the purpose of the investment adjustments is to prevent tax avoidance); *Covil Insulation Co. v. Comm'r*, 65 T.C. 364, 370 (1975) (noting that there may otherwise be a distortion if the group's tax losses exceed its economic losses). By preventing duplicate gain or loss, these rules promote tax neutrality, making it less likely that a group will form or acquire a member for tax reasons.

94. Treas. Reg. § 1.1502-32(a)(2)(ii) (as amended in 2002). The consolidated return regulations first provided for this negative basis amount in 1966. See 31 Fed. Reg. 16694, 16694, 16699 (Dec. 30, 1966) (introducing this negative-basis concept in Treas. Reg. §§ 1.1502-14(a)(2) and 1.1502-32(e)(1) (in force as of Dec. 15, 1967)).

95. See generally Treas. Reg. § 1.1502-19 (as amended in 1997).

96. *Covil Insulation Co.*, 65 T.C. at 375 (noting that the taxpayer argued that the ELA provision was "inconsistent with other Code provisions and the 'common law' of taxation which denies that property can have a negative basis"). Note that between 1986 and 1995, I.R.C. § 1059 provided, in effect, for a negative-basis result. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 614(a), 100 Stat. 2085, 2252 (providing that result by using a suspended-gain account).

97. See *Covil Insulation Co.*, 65 T.C. at 370 (calling the circumstance where a group's tax losses exceeded its economic losses a "distortion"). The Tax Court measured those economic losses with reference to the group's investment in its subsidiary stock, a measurement of at least some relevance in any *Rite Aid* analysis.

98. *Id.*; see also *id.* at 374 (stating that "[t]he burden of the excess loss account provisions must be accepted with the benefit of unlimited access to the subsidiary's losses").

exceeding the group's investment in the subsidiary.⁹⁹ That fact distinguished a consolidated group from other taxpayers and justified the investment adjustment and ELA rules to resolve "a problem created by the filing of consolidated returns."¹⁰⁰ Thus, the Tax Court endorsed the single-entity approach of the investment adjustment and ELA rules, inextricably tying a group's basis in subsidiary stock to the subsidiary's profits and losses.¹⁰¹

Those rules were also challenged in *Garvey*, where a subsidiary member distributed pre-affiliation profits to another member.¹⁰² The *Garvey* group argued that the investment adjustment rules were inconsistent with I.R.C. § 243 (which authorized a dividends received deduction), impermissibly increasing the group's tax contrary to *Weidenhoff*.¹⁰³ The *Garvey* court distinguished *Weidenhoff*, finding that the investment adjustment and ELA rules had the "obvious purpose" to prevent tax avoidance.¹⁰⁴ It also noted how difficult it may be to

99. That excess loss may be borne, for example, by the subsidiary's creditors. *Id.* at 376.

100. *Id.* at 373, 375-76 (distinguishing consolidated groups from partners and shareholders in S corporations, because the passthrough of a partnership's or S corporation's losses to an owner was limited to the owner's adjusted basis in the entity).

101. Limiting a group's tax loss to its economic loss also promoted tax neutrality, because it make it less likely that a group would form or acquire a subsidiary for tax reasons.

102. See *Garvey v. United States*, 726 F.2d 1569 (Fed. Cir. 1984); *Garvey v. United States*, 1 Cl. Ct. 108 (1983).

103. The argument presumed that the group would sell the distributing member's stock. If it did, the consolidated return regulations would increase the group's overall income by eighty-five percent of the distribution, an increase that could be indirectly tied to the regulations' not applying the eighty-five percent dividends-received deduction then permitted under I.R.C. § 243. Thus, on an overall basis, the group's tax could increase because it filed consolidated returns; see *Garvey*, 726 F.2d at 1572 n.12 (concluding that it could consider this argument as it applied to the particular facts of the case, but not as a general attack on the validity of the investment adjustment rules); *Garvey*, 1 Cl. Ct. at 116-18; *supra* notes 47-53 and accompanying text (for a discussion of *Weidenhoff*). Note, however, that on a *present-value* basis, a consolidated group's tax could be lower or higher, because the consolidated return regulations would also defer income and tax.

The *Garvey* group made two other arguments. First, it attacked the rules as they applied to subsidiary stock acquired in a carryover-basis transaction. The group complained that it should not reduce its basis in such subsidiary stock by the full amount of a distribution out of pre-affiliation profits, as the regulations required, because its stock basis did not fully reflect those profits. Both courts dismissed the argument, principally because any "phantom gain" the group recognized resulted from the carryover-basis rule, not the consolidated return regulations. *Garvey*, 726 F.2d at 1571; *Garvey*, 1 Cl. Ct. at 113-15.

Second, the group suggested that it should be entitled to rely on a proposed regulation that would have accounted for the "phantom gain" noted above but that was contrary to the existing regulation and never adopted. Each court readily rejected that suggestion. *Garvey*, 726 F.2d at 1571-72; *Garvey*, 1 Cl. Ct. at 118-19.

104. *Garvey*, 1 Cl. Ct. at 116; *Garvey*, 726 F.2d at 1572 n.12 (endorsing the lower court's analysis).

harmonize I.R.C. § 243 with the consolidated return rules, applauding the "wisdom of allowing such an issue to be addressed first by [Treasury] rather than the court."¹⁰⁵

Like *Wolter Construction*, the investment adjustment and ELA cases show the great deference courts traditionally give to the consolidated return regulations. They also show how reluctant courts have been to invalidate a consolidated return regulation because it strays from a Code rule or general tax principle.¹⁰⁶

d. Western Hemisphere Trade Corporations

In one set of pre-*Rite Aid* cases, which involved Western Hemisphere Trade Corporations ("WHTCs"), courts invalidated a consolidated return regulation because it directly conflicted with the Code and Congressional intent.¹⁰⁷ The regulation suffered the twin vices of the other invalid consolidated return regulations: it was not tax neutral and Treasury did not explain its purpose.

In the years at issue, the Code offered a WHTC a special deduction equal to a fraction of its taxable income (computed without regard to the deduction).¹⁰⁸ The deduction was intended to alleviate the "competitive disadvantage" that Congress believed U.S. corporations faced trading in foreign countries within the Western Hemisphere.¹⁰⁹

105. *Garvey*, 1 Cl. Ct. at 117-18; *Garvey*, 726 F.2d at 1572 n. 12 (endorsing the lower court's analysis); see also Axelrod, *supra* note 4, at 811 (supporting the conclusion in *Garvey*).

106. See also *Georgia-Pac. Corp. v. Comm'r*, 63 T.C. 790, 803 (1975) (considering the investment adjustment rule and concluding that Treasury has discretion to choose among reasonable alternatives).

107. See *Am. Standard, Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979); *Allied Corp. v. United States*, 685 F.2d 396 (Ct. Cl. 1982) (following *American Standard*); see also *Union Carbide Corp. v. United States*, 612 F.2d 558 (Ct. Cl. 1979) (following *American Standard* in a slightly different context).

108. I.R.C. §§ 921 and 922 (1968); see also Tax Reform Act of 1976, Pub. L. No. 94-455, § 1052(b), 90 Stat. 1647 (repealing the special deduction for taxable years beginning on or after January 1, 1980).

The fraction equaled fourteen percent divided by the sum of the normal and surtax tax rates in I.R.C. § 11. I.R.C. § 922(2) (1968); see also Treas. Reg. § 1.922-1(a) (in force as of December 15, 1967) (providing that the fraction in I.R.C. § 922(2) is the same "whether the corporation's taxable income is sufficient to subject it to the combined normal tax and surtax, or only to the normal tax"). A WHTC was a domestic corporation that:

- (i) Did all of its business (except for incidental purchases) in the Western Hemisphere;
- (ii) Derived at least 95 percent of its gross income from sources outside the United States during the three-year period preceding the close of the taxable year; and
- (iii) Derived at least 90 percent of its gross income from the active conduct of a trade or business during that same period.

I.R.C. § 921 (1968).

109. S. REP. NO. 77-1631, at 32 (1942).

Because WHTCs could join with other non-WHTCs in a consolidated group, Treasury somehow had to shoehorn the WHTC deduction into a consolidated world.

Treasury faced the same difficult task in accommodating a special deduction for dividends paid by public utilities on "qualified" preferred stock.¹¹⁰ Similar to the WHTC deduction, this special dividends paid deduction was tied to a fraction of the public utility's taxable income (computed without regard to the deduction).¹¹¹ Each special deduction effectively reduced the tax rate for the favored corporation by up to fourteen percentage points.¹¹²

In *American Standard*, the Federal Circuit considered whether Treasury's regulatory method to "consolidate" the WHTC deduction passed muster.¹¹³ The method reflected three policy choices and, although the court approved the first two choices, it rejected the third. Consequently, the court invalidated the method, finding that it defeated Congressional intent and inexplicably departed from not only past practice but also the consolidated scheme for the public utility deduction.¹¹⁴

As its first policy choice, Treasury had to decide how a consolidated group computed the taxable-income component of the WHTC deduction.¹¹⁵ It concluded that the group followed the methodology it used to compute a member's contribution to CTI, and the Federal Circuit approved.¹¹⁶

110. See I.R.C. § 247(a) (2003) (providing for this "public utilities" deduction); *id.* § 247(b)(1) (defining a public utility); *id.* § 247(b)(2) (generally defining "qualified" preferred stock as stock issued before October 1, 1942, the dividends on which for the taxable year were cumulative, limited, and preferred).

111. In the years in question, the fraction equaled fourteen percent divided by the sum of the normal and surtax tax rates in I.R.C. § 11. I.R.C. § 247(a)(2)(B) (1968); *cf. id.* § 247(a)(2)(B) (currently providing that the denominator of the fraction is the "percentage which equals the highest rate of tax specified in I.R.C. § 11(b)"). The deduction equaled that fraction multiplied by the smaller of:

- (i) The amount of dividends that the public utility paid during the taxable year on "qualified" preferred stock; or
- (ii) The public utility's taxable income for the year (computed without regard to the § 247 deduction).

Id. § 247(a)(1) (1968); see also *id.* § 247(a)(1) (currently the same rule).

112. See *Am. Standard*, 602 F.2d at 262 (noting that the special deductions had "the effect of a tax rate reduction").

113. *Id.*

114. *Id.* at 264-65. In testing the regulation, the court referred to each of the verbal formulae noted above, although none was central to its analysis. See *supra* notes 36-39 and accompanying text (describing these formulae).

115. See I.R.C. § 922(2) (1968) (providing that the WHTC deduction was a fraction of the WHTC's taxable income (determined without regard to the deduction)).

116. See *Am. Standard*, 602 F.2d at 262 (finding that this first policy choice by Treasury was "clearly a reasonable answer" because, except for their special deduction, a WHTC computed its taxable income like a typical corporation).

CTI was (and is) computed by combining each member's "separate taxable income" and certain consolidated items (*e.g.*, capital gains and losses).¹¹⁷ The group computes the tax items that comprise each member's "separate taxable income" generally using a separate-corporation approach,¹¹⁸ while computing certain "consolidated" items using a single-entity approach.¹¹⁹ This methodology promotes tax neutrality, because it makes the location of assets within the group less relevant.¹²⁰

EXAMPLE 2—COMPUTING CTI

P and S are members of a consolidated group. In a taxable year, P sells Asset A, recognizing a \$200 capital loss, and S sells Asset B, recognizing a \$200 capital gain. Although a corporation can use a capital loss only to the extent of its capital gain,¹²¹ the regulations apply this limitation by treating the group as a single entity.¹²² Thus, in computing the P group's CTI, its capital loss offsets its capital gain, a result unaffected by the location of the gain or loss within the group.

Location would matter if the regulations applied this limitation using a pure separate-corporation approach. Then, P's capital loss could not offset S's capital gain, because the capital-loss limitation would apply separately to each member and P had no capital gain. The loss could have offset the gain, however, if P had transferred Asset A to S in a § 351 exchange before the group sold Asset A.¹²³

117. Treas. Reg. § 1.1502-11(a); Treas. Reg. § 1.1502-11(a) (in force as of December 15, 1967). Although the group computed "separate taxable income" for each member under Treas. Reg. § 1.1502-12, that amount "could not alone be used as a base for the [WHTC] deduction because it [was] only a component of the corporation's taxable income." *Am. Standard*, 602 F.2d at 263.

118. See Treas. Reg. § 1.1502-12 (as amended in 1999) (providing that "[t]he separate taxable income of a member . . . is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations" with modification for consolidated items); see also Treas. Reg. § 1.1502-12 (in force as of December 15, 1967) (to the same effect).

119. See sources cited *supra* notes 15-18.

120. See *Am. Standard*, 602 F.2d at 262-63 (obliquely acknowledging that the method promoted tax neutrality, stating that "[t]hough such treatment can change the character and/or amount of income and deductions because of consolidation of certain items, this is the treatment all corporations are subject to when they elect the privilege of filing consolidated returns.").

121. I.R.C. § 1211(a) (2003).

122. See Treas. Reg. § 1.1502-22(a) (as amended in 1999) (providing that the capital gain and loss for the group is "determined for the group as a whole"); see also Treas. Reg. § 1.1502-22(b)(1)(i) (in force as of December 15, 1967) (also providing that the group combines the members' capital gains and losses).

123. Then, the group would have shifted the \$200 loss to S, so that under the separate-corporation approach, the group could offset the gain and loss. See I.R.C. § 362(a)(1) (2003) (providing that the controlled corporation (like S) takes a transferred basis in an asset received in a § 351 exchange).

Treasury followed the CTI methodology to determine the character and amount of a WHTC member's tax items in the group's computation of its WHTC deduction. The two methodologies complemented one another and together promoted tax neutrality.

EXAMPLE 3—THE WHTC DEDUCTION

In 1968 (a year at issue in *American Standard*), P, S, and T were members of a consolidated group, and P and S were WHTCs. During that year, each member had \$1,000 of ordinary income, P sold Asset A, recognizing a \$200 capital loss, and S sold Asset B, recognizing a \$200 capital gain. As in **EXAMPLE 2**, the P group computed its CTI by offsetting S's capital gain with P's capital loss. Thus, its CTI was \$3,000 minus its WHTC deduction.¹²⁴

Under the regulations, the group's WHTC deduction equaled 14/48 of its CTI attributable to its WHTC members,¹²⁵ and that CTI component equaled \$2,000 because the capital loss was treated as a deductible item.¹²⁶ Thus, its WHTC deduction equaled 14/48 of \$2,000 or \$583.33. That result would be unaffected by whether or not P shifted its capital loss to S through an asset transfer.

Under a separate-corporation approach, however, the WHTC deduction would depend on whether P or S recognized the capital

124. The \$3,000 amount equals the aggregate ordinary income of P, S, and T.

125. See Treas. Reg. § 1.1502-25(a) (in force as of December 15, 1967) (providing that the group's WHTC deduction equaled its taxable income attributable to WHTC members multiplied by the fraction specified in § 922(2)); see also I.R.C. § 922(2) (providing that the fraction equals fourteen divided by the normal and surtax rate for the year under § 11); *id.* § 11(a), (b)(2), (c)(3) (1968) (providing for a combined normal and surtax rate of forty-eight percent).

126. The attributable CTI was computed in three steps. First, the group computed the taxable income of each member, and in this computation, the capital loss of a member was deductible to the extent it was absorbed by the group. See Treas. Reg. § 1.1502-25(c)(2)(iii) (in force as of December 15, 1967) (providing that the taxable income of a member is adjusted for the member's net capital loss that is absorbed by the group). Thus, P had taxable income of \$800 (\$1,000 ordinary income minus \$200 capital loss), S had taxable income of \$1,200 (\$1,000 ordinary income plus \$200 capital gain), and T had taxable income of \$1,000 (\$1,000 of ordinary income).

Second, the group identified each member that had positive taxable income (without regard to the WHTC or public utilities deductions) and totaled those amounts for all WHTC members ("WHTC PTI") and for all group members ("Group PTI"). *Id.* § 1.1502-25(c)(1). Thus, the P group's WHTC PTI was \$2,000 (\$800 for P plus \$1,200 for S), and its Group PTI was \$3,000 (\$800 for P plus \$1,200 for S plus \$1,000 for T).

Finally, the group computed the CTI attributable to WHTC members under the following formula:

(WHTC PTI/Group PTI) X CTI (determined without regard to the WHTC deduction).

Id. Because the group took exactly the same items into account in computing the CTI amount and the Group PTI, those two amounts were identical, and the group's CTI attributable to WHTCs equaled its WHTC PTI or \$2,000.

loss. If P did, the deduction would be \$601.56,¹²⁷ while if S did, the deduction would be \$583.33.¹²⁸ Thus, under this approach, the group's WHTC deduction could depend on the location of its assets within the WHTC subgroup, impeding tax neutrality.

By making location less relevant, the methodologies to compute CTI and the WHTC deduction made more neutral the group's choice to form a new member or transfer assets between members.

Treasury's second policy choice also furthered tax neutrality. It had to decide whether (i) separate WHTC deductions were computed for each WHTC member and then combined or (ii) a single deduction was computed on the combined income of all WHTC members. It chose the latter approach, a choice the Federal Circuit endorsed without much discussion.¹²⁹ The choice made a difference if at least one WHTC member had a net loss.

EXAMPLE 4—THE SECOND POLICY CHOICE

In 1968, WHTCs P and S were members of a consolidated group. P had \$2,000 of ordinary income, while S had a \$200 ordinary loss. Under the regulations, P and S combined their tax items before the group computed its WHTC deduction,¹³⁰ and the P group's WHTC deduction equaled \$525.¹³¹ That result would be unaffected by which WHTC took the income or loss into account.

If, instead, the WHTC deduction were computed separately for each WHTC member and then combined, the P group would have a \$583.33 deduction, equal P's separate deduction.¹³² However, if P

127. In computing the CTI attributable to the WHTC members, the taxable income amounts would be \$1,000 for P (because the capital loss would not be deductible), \$1,200 for S, and \$1,000 for T. Thus, the attributable CTI would be \$2,062.50 (\$3,000 (CTI) X \$2,200/\$3,200), and the WHTC deduction would be 14/48 of that amount or \$601.56.

128. Because the group's relevant CTI amount and its Group PTI would be identical (*i.e.*, each \$3,000), the CTI attributable to the WHTC members would equal the WHTC PTI or \$2,000 (\$1,000 for P plus \$1,000 for S (\$1,000 of ordinary income plus \$200 capital gain minus \$200 capital loss)). Thus, the WHTC deduction would be 14/48 of that amount or \$583.33.

129. The court described the former choice as the "aggregate method without losses" but never discussed the merits of that approach. *See Am. Standard*, 602 F.2d at 259 n.1.

130. *See* Treas. Reg. § 1.1502-25(a) and (c) (in force as of December 15, 1967) (providing that the group's WHTC deduction equaled a fraction of the CTI attributable to the group's WHTCs, and CTI took all tax items of the WHTC members into account).

131. The group's WHTC deduction equaled 14/48 of its CTI attributable to WHTCs members. *See* Treas. Reg. § 1.1502-25(a) (in force as of December 15, 1967). Because P and S were the only members of the P group, the portion of the CTI attributable to P and S had to be the entire CTI or \$1,800 (*i.e.*, P's \$2,000 income minus S's \$200 loss). Thus, the P group's WHTC deduction equaled 14/48 of \$1,800, or \$525.

132. P's separate deduction would equal 14/48 of \$2,000 or \$583.33. Because S

had contributed sufficient assets to S to shift \$200 of its income to S, the group's WHTC deduction would have been reduced to \$525.¹³³

Thus, when Treasury based a group's WHTC deduction on the combined income of all WHTC members, it made the location of assets within the group less relevant for tax purposes, promoting tax neutrality.

In contrast, Treasury's third policy choice impeded tax neutrality and was rejected by the Federal Circuit. Treasury chose to compute the combined income of all WHTC members using a consolidated method rather than a subgroup method.¹³⁴ Under its consolidated method, non-WHTC losses could offset WHTC income (or WHTC losses could offset non-WHTC income), results that the Federal Circuit found unreasonable.¹³⁵

EXAMPLE 5—THE THIRD POLICY CHOICE

In 1968, P, S, W_G, and W_L were members of a consolidated group, and W_G and W_L were WHTCs. During that year, P, S, W_G, and W_L had \$1,000 of ordinary income, \$400 of ordinary loss, \$2,000 of ordinary income, and \$200 of ordinary loss, respectively. Thus, the P group's CTI equaled \$2,400 minus its WHTC deduction.

If the P group computed its WHTC deduction by looking only to the tax items of the WHTC subgroup, its WHTC deduction would equal \$525, an amount that would be unaffected by the location of

would have a net loss, it would not have a separate WHTC deduction.

133. P's income would have been reduced to \$1,800, and its separate deduction to \$525 (14/48 of \$1,800). Because S would have no net income or loss, it would not have a separate WHTC deduction.

134. The *American Standard* court described two subgroup methods, the "aggregate method with losses" and the "fractional method with losses," and one consolidated method, the "fractional method without losses." *Am. Standard*, 602 F.2d at 259-60 n.1.

Broadly speaking under either subgroup method, the CTI attributable to WHTC members would equal their aggregate combined income, and the group's WHTC deduction would equal 14/48 of that combined amount. The fractional method would produce a lower deduction, however, if the group also enjoyed the public utilities deduction. See Treas. Reg. § 1.1502-25(c) (in force as of December 15, 1967) (producing this result because the public utilities deduction was taken into account in computing CTI under (c)(1) but not in computing the taxable income amounts under (c)(2)); see also *Am. Standard*, 602 F.2d at 266 n.18; *Allied Corp. v. United States*, 685 F.2d 396, 400 n. 4 (Ct. Cl. 1982) (both noting that the subgroup methods produced the same results, unless the consolidated group also enjoyed the public utilities deduction). In effect, the public utilities deduction offset a portion of the WHTC members' taxable income, arguably contrary to rationale articulated in *American Standard*. See *Am. Standard*, 602 F.2d at 265.

135. See *Am. Standard*, 602 F.2d at 265 (concluding that having non-WHTC losses offset WHTC profits "clearly defeat[ed]" the purpose of the WHTC deduction); see also *supra* note 126 (providing the mechanics of the consolidated approach).

tax items (or assets) within either the WHTC or non-WHTC subgroup.¹³⁶

The location of a subgroup's tax items would be highly relevant, however, with the regulatory method. Under the facts, the group's WHTC deduction was \$466.67,¹³⁷ but it would have been:

- (i) \$538.46 if the group had combined P and S at the beginning of the year;¹³⁸
- (ii) \$450 if it had combined W_c and W_L at the beginning of the year;¹³⁹ or
- (iii) \$525 if it had done both combinations.¹⁴⁰

Because the location of assets within a consolidated group mattered, the regulatory approach was not tax neutral and, consequently, raised some disquieting concerns. First, the approach could frustrate a consolidated group's non-tax economic choices.

136. Regardless of the taxable income amounts of non-WHTC members, the P group's CTI attributable to its WHTC members would equal \$1,800 (*i.e.*, W_c 's income minus W_L 's loss), and its WHTC deduction would equal 14/48 of that amount or \$525. Further, the deduction would not change if the group had transferred assets between its WHTC members during the year, since the same tax items would be taken into account in computing the relevant CTI amount.

Note, however, that the WHTC deduction could be affected if assets were transferred between the subgroups (rather than just within a subgroup). See *infra* note 148 (illustrating this concept).

137. Under the regulations, the group's WHTC deduction equaled 14/48 of the CTI attributable to the WHTC members, and that attributable CTI amount equaled the following:

(WHTC PTI/Group PTI) X CTI, where —

WHTC PTI =The combined taxable income of all WHTC members with positive taxable income, and

Group PTI =The combined taxable income of all members with positive taxable income.

CTI was determined without regard to the WHTC deduction, and WHTC PTI and Group PTI were determined without regard to both the WHTC and public utilities deductions. See Treas. Reg. § 1.1502-25(c) (in force as of December 15, 1967). Thus, the P group's WHTC PTI was \$2,000 (equal to W_c 's \$2,000 income) and its Group PTI was \$3,000 (equal to \$1,000 (for P's income) plus \$2,000 (for W_c 's income)). Consequently, its WHTC deduction was \$466.67, or 14/48 of \$2,000/\$3,000 times \$2,400.

138. The P group's WHTC PTI would still be \$2,000 (equal to W_c 's \$2,000 income) but its Group PTI would be only \$2,600 (equal to \$600 (for P/S's income) plus \$2,000 (for W_c 's income)). Thus, its WHTC deduction would be \$538.46, or 14/48 of \$2,000/\$2,600 times \$2,400.

139. The P group's WHTC PTI would be only \$1,800 (equal to W_c/W_L 's \$1,800 income) and its Group PTI would be only \$2,800 (equal to \$1,000 (for P's income) plus \$1,800 (for W_c/W_L 's income)). Thus, its WHTC deduction would be \$450, or 14/48 of \$1,800/\$2,800 times \$2,400.

140. The P group's WHTC PTI would be only \$1,800 (equal to W_c/W_L 's \$1,800 income) and its Group PTI would be only \$2,400 (equal to \$600 (for P/S's income) plus \$1,800 (for W_c/W_L 's income)). Thus, its WHTC deduction would be \$525, or 14/48 of \$1,800/\$2,400 times \$2,400. As this factual variation illustrates, when a group has no member with negative taxable income, the consolidated and subgroup methods reach the same result.

Despite sound non-tax business reasons, a group may be disinclined to form a new member or transfer assets between subgroup members, fearing it could reduce its WHTC deduction. Further, a group may be encouraged to transfer assets between subgroup members to increase the deduction, even when those transfers would otherwise be ill-advised.

Further, the regulatory approach seemed to unfairly distinguish among similarly situated groups. Otherwise identical groups could be treated differently, based solely on the placement of assets within their WHTC or non-WHTC subgroups, something that may be entirely fortuitous. Although the disadvantaged group might increase its WHTC deduction through appropriate asset transfers, the group would likely incur added expense to make the transfers, a cost avoided by the advantaged group. More troubling, the group might be unable to make an appropriate asset transfer, to identify which assets to transfer, or even to tell whether it was disadvantaged by the regulatory approach (at least not until it was too late).¹⁴¹

In rejecting Treasury's third policy choice, the Federal Circuit in *American Standard* vaguely referenced those concerns. It noted that the regulatory method "change[d] the conceptual basis upon which Congress permitted the deduction under section 922" and "penalize[d]" consolidated groups with WHTC members, apparently because it "varie[d] dramatically" from the more tax-neutral subgroup method.¹⁴² Thus, the Federal Circuit's response to each Treasury policy choice was consistent with, and can be supported as promoting, tax neutrality.¹⁴³

141. The approach could also spark more tax disputes because the location of a group's tax items would be more relevant. For example, if a consolidated group was about to sell an asset, it may transfer the asset from one member to another, trying to shift location of the sales gain or loss and increase its WHTC deduction. The IRS might assert, however, that the gain or loss must be allocated to the transferor member. See *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (applying the substance-over-form doctrine, the Supreme Court required a liquidating corporation to recognize gain and loss on assets transferred to and in form sold by shareholders); see also I.R.C. § 482 (2000) (providing for an allocation of tax items among related taxpayers clearly to reflect their income).

142. See *Am. Standard, Inc. v. United States*, 602 F.2d 256, 265 (Ct. Cl. 1979) (also noting that the regulatory method could favor consolidated groups). In noting the change in conceptual basis and the penalty, the Federal Circuit necessarily assumed a standard of reference, which apparently was the subgroup method.

143. The past cases invalidating consolidated return regulations also could be read to promote tax neutrality. See *supra* notes 52, 63 and accompanying text. Note that the subgroup method was not entirely tax-neutral because a group may have different tax results if it transferred assets between (rather than just within) subgroups. Those transfers probably were less likely to occur than intra-subgroup transfers because they were more likely to disqualify a member as a WHTC. Thus, the subgroup method probably promoted tax neutrality more than the consolidated

Still, the Federal Circuit did not expressly endorse tax neutrality. It rejected Treasury's third policy choice, in part because it inexplicably departed from past practice and Treasury's consolidated scheme for the public utility deduction.¹⁴⁴ This rationale was less than satisfying, as it relied on that practice and scheme without critically examining them.¹⁴⁵ Whatever its merit, the rationale highlighted some possible red flags for future regulations.

First, a court may be more likely to invalidate a consolidated return regulation that significantly shifts how a tax item is treated, particularly if the regulations treat a similar item inconsistently. The Federal Circuit found that, until 1966, the consolidated return regulations had accounted for the WHTC and public utility deductions using a subgroup method.¹⁴⁶ The 1966 regulations retained the subgroup method for the public utility deduction but switched to the consolidated method for the WHTC deduction. The court saw no reason for the switch.¹⁴⁷

Problematically, Treasury failed to explain the switch, either in publishing the 1966 regulations or during the litigation process.

method.

144. *Am. Standard*, 602 F.2d at 264-65.

145. Note, however, that either could be amply justified as furthering tax neutrality.

146. *Am. Standard*, 602 F.2d at 264-65. Although this finding likely is accurate, it is not free from doubt. The pre-1966 regulations provide little help, failing to describe whether the WHTC or public utilities deduction was computed using a subgroup or consolidated approach. See Treas. Reg. § 1.1502-31(a)(14)-(15) (in force as of January 1, 1965) (stating, in relevant part, that each deduction was a fraction of the CTI "attributable" to the WHTCs or public utilities but not specifying how the attributable amount was computed). Further, administrative guidance is mixed. A 1958 revenue ruling seemed to follow the subgroup approach, while a 1968 ruling interpreting the pre-1966 regulations required the consolidated approach. Compare Rev. Rul. 58-618, 1958-2 C.B. 430, with Rev. Rul. 68-395, 1968-2 C.B. 395. Cf. *Int'l Tel. & Tel. Corp. v. United States*, 608 F.2d 462, 473 (Ct. Cl. 1979) (concluding that the 1958 revenue ruling's analysis of another point was "erroneous").

Nevertheless, the manner in which Treasury adopted the 1966 consolidated rules strongly suggests that the 1958 ruling accurately portrayed pre-1966 law. Treasury originally proposed using the subgroup method for both the WHTC and public utilities deductions. See 30 Fed. Reg. 12564, 12581 (Oct. 1, 1965) (proposing, among other sections, Treas. Reg. §§ 1.1502-25 and 1.1502-27). In finalizing those regulations, Treasury adopted the subgroup method for the public utility deduction but reserved on the WHTC deduction. See 31 Fed. Reg. 11794, 11810 (Sept. 8, 1966). In a companion package, Treasury for the first time proposed using the consolidated method for the WHTC deduction, the method it finally adopted. See 31 Fed. Reg. 11845, 11848 (Sept. 8, 1966) (the proposed rule); 31 Fed. Reg. 16694, 16697 (Dec. 31, 1966) (providing the final rule). The sequence of events implies that the consolidated method represented a change in law and, therefore, that the pre-1966 regulations contemplated using the subgroup method for the WHTC deduction.

147. See also *Am. Standard*, 602 F.2d at 266 (noting that the subgroup approach was also consistent with *Sinclair Oil Corp. v. United States*, 392 F.2d 249 (Ct. Cl. 1968), in which the court concluded, in a different context, that a group's WHTC losses could not offset its public utility income).

That failure limited the deference the court gave the consolidated method.¹⁴⁸ It also bound *American Standard* with the past court decisions that invalidated consolidated return regulations; in each case, Treasury provided no rationale for the invalid regulatory approach.¹⁴⁹ Thus, if Treasury does not justify a regulatory change, a court is less likely to accord the change much deference or to accept it.

The Federal Circuit also supported its conclusion by pointing to the purpose of the WHTC deduction, which was to help WHTCs compete with foreign corporations in the Western Hemisphere.¹⁵⁰ The Code tied the deduction to WHTC earnings, but under the consolidated method, the deduction could be reduced because of non-WHTC losses. Thus, the court reasoned, the consolidated method "direct[ly] conflict[ed] with sections 922 and 1502,"¹⁵¹ even though the Code and legislative history were silent about how to consolidate the WHTC deduction. Treasury did nothing to refine the court's reasoning, offering nary a whisper of support for its regulatory method. Its reticence, no doubt, weighed heavily in the court's decision.

As a footnote, the Federal Circuit briefly discussed the authority Congress delegated to Treasury to craft consolidated return regulations. I.R.C. § 1502 authorizes Treasury to prescribe regulations, as necessary, to "clearly reflect" the income tax liability of the group and each member and "to prevent" the avoidance of that liability. The court suggested that, more broadly stated, this

148. *Id.* at 261. Perhaps, Treasury rejected the subgroup method for the following reason: Under that method, if a group expected a WHTC member to generate a loss, it might reduce its tax by disqualifying the member as a WHTC. (for example, the group might have the member engage in disqualifying activities or stuff the member with sufficient assets so that it failed one of the WHTC income tests. See *supra* note 108 (describing WHTC qualification.) The consolidated method avoided that concern by taking the losses of the former WHTC into account. Moreover, because a group seemed less free to disqualify a member as a public utility, given the utility's heavy regulation, the public utility deduction seemed less likely to raise the same concern, arguably allowing Treasury to use different methods to compute the public utility and WHTC deductions.

If Treasury had the concern noted in the previous paragraph, however, it never said so. Further, the consolidated method was overbroad in addressing the concern, because it would take into account losses of not only former WHTCs but also any other non-WHTC loss members.

149. See *supra* notes 50, 63 and accompanying text; see also *Am. Standard*, 602 F.2d at 268-69 (concluding that a lack of notice also justified invalidating the regulation under the Administrative Procedure Act, because when Treasury first proposed the consolidated method, the regulatory text contained an ambiguity that Treasury did not explain away).

150. *Am. Standard*, 602 F.2d at 265.

151. *Id.*

delegation gave Treasury regulatory authority "to conform the applicable income tax law of the Code to the special myriad problems resulting from the filing of consolidated income tax returns."¹⁵² The consolidated group in *Rite Aid* read this deceptively vague refrain to limit Treasury's authority, adopting the refrain as its battle cry in litigation.¹⁵³

II. THE CHALLENGED REGULATION

A. *The Facts of Rite Aid*

In *Rite Aid v. United States*,¹⁵⁴ the Federal Circuit invalidated all or part of the loss disallowance rule found in Treas. Reg. § 1.1502-20 ("LDR"), concluding that Treasury exceeded its regulatory authority in prescribing that rule. The relevant facts were as follows:¹⁵⁵

Rite Aid Corporation ("Rite Aid"), the common parent of a consolidated group, purchased the stock of Penn Encore Inc. ("Encore"), a discount book seller, acquiring eighty percent of the stock in 1984 and the remaining twenty percent in 1988.¹⁵⁶ Although Encore enjoyed some initial success, it proved unprofitable over the longer haul, piling up huge losses despite large cash infusions by Rite Aid. In 1994, when Rite Aid sold the Encore stock to an unrelated purchaser, Lauriat's, Inc. ("Lauriat"),

152. *Id.* at 261; *First Chi. Corp. v. Comm'r*, 96 T.C. 421, 440 (1991) (citing to *American Standard* and quoting the same language); *cf. Regal, Inc. v. Comm'r*, 53 T.C. 261, 267 (1969), *aff'd per curiam*, 435 F.2d 922 (2d Cir. 1970) (noting that Congress gave Treasury discretion to deal with unforeseen problems).

153. Ironically, the Federal Circuit in *American Standard* acknowledged that the invalid regulation dealt with a "consolidated" problem. *Am. Standard*, 602 F.2d at 263 (stating that "[t]he problem, which is the source of dispute in this case, is to find a reasonable method to 'break out' taxable income properly attributable to the [WHTC] subgroup to form the base for the [WHTC] deduction."); *see also id.* at 265.

154. 255 F.2d 1357 (Fed. Cir. 2001).

155. Except as otherwise stated, these facts are culled from the opinions of the Federal Circuit and United States Court of Federal Claims in *Rite Aid*. *Id.* at 1358; *Rite Aid Corp. v. United States*, 46 Fed. Cl. 500, 501-02 (2000).

156. Rite Aid made a § 338 election for the 1984 stock purchase. Under I.R.C. § 338, a qualified stock purchase may be treated for federal income tax purposes in many ways like an asset purchase. If a § 338 election is made, the acquired corporation (the "target") is deemed to sell its assets on one day and acquire them the next day as a newly formed subsidiary of the purchaser. I.R.C. § 338(a) and (g). Immediately following the deemed asset sale, the target's aggregate basis in its assets is tied to the price paid for the target stock plus the amount of target liabilities. I.R.C. § 338(b).

Because of Rite Aid's § 338 election, Encore was deemed to sell and then purchase its assets in a deemed asset sale in 1984. Further, its asset bases reflected the 1984 stock purchase price plus Encore's liabilities immediately after the deemed sale. Assuming that Rite Aid paid a fair market value price for the Encore stock in 1984, Encore's asset bases should have equaled (or at least approached) fair market value immediately after the deemed sale.

it recognized a \$22,136,739 stock loss, which the IRS disallowed under Treas. Reg. § 1.1502-20 because Encore preserved a greater aggregate built-in loss in its assets.¹⁵⁷

In soliciting bids for Encore, Rite Aid had asked potential buyers to offer two prices for the Encore stock, one price if a § 338(h)(10) election was made and one if that election was not made.¹⁵⁸ Lauriat, the only bidder for Encore, refused to join in making the election.¹⁵⁹ Because Lauriat did not make the election, Encore retained its historic tax attributes, including an aggregate built-in asset loss of \$28,535,858.¹⁶⁰

Note that if Lauriat had joined with Rite Aid to make a § 338(h)(10) election, Encore would have recognized the \$28.5 million built-in loss and the Rite Aid group would have absorbed or succeeded to that loss.¹⁶¹ Further, without regard to LDR, Rite Aid could not have recognized its \$22.1 million stock loss.¹⁶²

157. Encore's assets had an aggregate built-in loss to the extent their aggregate basis exceeded their value.

158. Brief for Appellee, *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001) (No. 00-5098), 2001 TNT 155-24 (¶ 6). If a "§ 338(h)(10) election" is made, a sale of subsidiary stock is treated for federal income tax purposes in many ways like a sale of subsidiary assets followed by a liquidation of the subsidiary. See I.R.C. § 338(h)(10) (2003).

159. Brief for Appellant, *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001) (No. 00-5098), 2001 TNT 145-60 (¶ 8). It is unclear from the facts whether Lauriat refused to submit a price for a § 338(h)(10) purchase or it submitted such a price but Rite Aid rejected it.

160. See *Rite Aid Corp.*, 46 Fed. Cl. at 502 (stating that Encore calculated its "duplicated loss" as about \$28.5 million, equal to the aggregated adjusted basis of Encore's assets over the value of Encore's stock plus its liabilities; note that this computation presumes that Encore had no loss carryovers).

161. Because of the § 338(h)(10) election, Encore would have been deemed to sell its assets, recognizing the built-in loss, and the Rite Aid consolidated group could have taken that loss into account. See Treas. Reg. § 1.338(h)(10)-1(e)(1) (in force as of January 1, 1994) (providing that the target is treated as recognizing deemed sale gain or loss as a member of the selling consolidated group); see also *supra* note 156 (providing a brief description of the deemed asset sale). Further, Encore would have been deemed to liquidate. Treas. Reg. § 1.338(h)(10)-1(e)(2)(ii) (in force as of January 1, 1994) (providing that the target is deemed to distribute all of its assets in deemed liquidation while a member of the selling consolidated group). Because the liquidation would have been described in I.R.C. § 332, the Rite Aid group would have succeeded to any net loss, loss carryovers or deferred deductions attributable to Encore. I.R.C. § 381(a)(1), (c) (2000) (providing that in a § 332 liquidation, the controlling corporate shareholder succeeds to tax attributes of the liquidating corporation, including loss carryovers). See *id.* § 332(b) (2000) (describing the requirements for a § 332 liquidation).

Immediately following the deemed sale, Encore would have been treated as a new corporation for federal income tax purposes, taking bases in its assets equal to (or approaching) their fair market values. See *supra* note 156 (citing the applicable law).

162. Because of Encore's deemed liquidation, Rite Aid would not have recognized its stock loss. See I.R.C. § 332(a) (providing that gain or loss is not recognized by the controlling corporate shareholder in a § 332 liquidation).

B. Applying LDR to Rite Aid

The IRS disallowed Rite Aid's stock loss under LDR (*i.e.*, the loss disallowance rule of Treas. Reg. § 1.1502-20). Generally under this section, a consolidated group was not allowed a loss deduction on its sale of subsidiary stock.¹⁶³ This general loss disallowance was mitigated or limited in several ways.

It was mitigated under a "retribution" rule. If a group recognized a loss on its sale of subsidiary stock and the loss was otherwise disallowed under LDR, the group's common parent could retribute to itself a portion of any net operating or capital loss carryovers attributable to the subsidiary (or a lower-tier subsidiary).¹⁶⁴ Apparently, Encore had no attributable loss amounts, and Rite Aid could not benefit from this retribution rule.

The general loss disallowance was also limited in two ways. First, under a netting provision, the loss was allowed to the extent the group took gain into account "as a consequence of the same plan or arrangement [and] with respect to stock of the same subsidiary having the same material terms."¹⁶⁵ Rite Aid apparently could not use this netting provision.

Second, the stock loss was allowed to the extent it exceeded the sum of three factors: the subsidiary's extraordinary gain, positive investment adjustments, and duplicated loss.¹⁶⁶ Because Rite Aid's \$22.1 million stock loss did not exceed Encore's "duplicated" loss

163. Treas. Reg. § 1.1502-20(a)(1) (as amended in 2002).

164. *Id.* § 1.1502-20(g)(1) (also providing that "[t]he common parent succeed[ed] to the retributed losses as if the losses were succeeded to in a transaction described in section 381(a)."). The retributed amount could not exceed the group's loss otherwise disallowed under LDR. *Id.*; see also *id.* § 1.1502-20(g)(2) (providing for a further limitation on retribution if the subsidiary whose losses were retributed or a higher-tier subsidiary was insolvent). Further, to the extent of the retributed loss, the group reduced its basis in the subsidiary stock, eliminating the otherwise disallowed loss. See *id.* § 1.1502-20(g)(3) (treating retributed losses as absorbed for purposes of Treas. Reg. § 1.1502-32); *id.* § 1.1502-32(b)(2)(ii) (in force as of January 1, 1994) (providing a negative adjustment for absorbed loss carryovers attributable to a subsidiary).

165. See Treas. Reg. § 1.1502-20(a)(4) (in force as of January 1, 1994).

166. See *id.* § 1.1502-20(c) (applying this "three-factor test" on a share-by-share basis, determining this sum separately for each share of stock sold). "Duplicated loss" for a subsidiary was determined immediately after the stock disposition and, broadly stated, equaled the excess, if any, of:

- (i) The sum of (A) the subsidiary's aggregate asset basis, plus (B) its loss carryovers to its first taxable year following the disposition, plus (C) any of its deferred deductions (*e.g.*, under I.R.C. § 469), over
- (ii) The sum of (A) the total stock value of the subsidiary, plus (B) its liabilities, plus (C) any other relevant items.

Id. § 1.1502-20(c)(2)(vi).

(i.e., its \$28.5 million built-in asset loss), this second limitation also offered Rite Aid no relief.¹⁶⁷

Thus, the IRS disallowed Rite Aid's entire stock loss under the duplicated loss rule of LDR. The disallowance was proper if LDR was valid.

C. Treasury's Justification for LDR

LDR emerged from the ashes of the *General Utilities* doctrine.¹⁶⁸ Congress repealed the doctrine in the Tax Reform Act of 1986, providing that a corporation generally must recognize gain on a liquidating or non-liquidating distribution of appreciated property to its shareholders.¹⁶⁹ At the same time, Congress authorized Treasury to "issue regulations to ensure that [the purposes of the repeal] may not be circumvented through the use of any provision of the law or regulations . . . including the consolidated return regulations."¹⁷⁰ Treasury responded, in part, with LDR.

As a prelude to LDR, Treasury issued Notice 87-14,¹⁷¹ which anticipated regulations that, among other things, would target the "son of mirrors" transaction. In that transaction, a consolidated group acquired a target corporation with built-in gain assets,¹⁷² and the target distributed built-in gain assets to group members,

167. When a group cannot deduct its subsidiary stock loss because it does not exceed than the duplicated loss factor, the stock loss is said to be disallowed under the "duplicated loss" rule of LDR.

168. See Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935). Under this doctrine, a corporation recognized no gain or loss when it made a liquidating or non-liquidating distribution of property to a shareholder.

169. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269-75; see also I.R.C. §§ 311(b), 336(a) (2003); H.R. CONF. REP. NO. 99-841, at II-204 (1986) (providing that "[t]he repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context.").

Even though sixteen years have elapsed since the repeal, Treasury has never defined its scope. Cf. Eric M. Zolt, *The General Utilities Doctrine: Examining the Scope of the Repeal*, 65 TAXES 819, 822 (1987) (describing two possible forms of the repeal—the weak and strong forms). Absent an express statutory exclusion, the repeal should require at a minimum that a corporation recognizes gain when it disposes of an appreciated asset and the asset takes a stepped-up basis. See 1990-1 C.B. 68 (in the preamble to the first version of LDR, stating that the "principal reason for the repeal of the *General Utilities* doctrine was that it tended to undermine the corporate income tax" and that the principal purpose of the repeal "was to require the payment of a corporate-level tax in a transaction that results in a stepped-up basis to the new owner").

170. I.R.C. § 337(d) (2003); see also H.R. CONF. REP. NO. 99-841, II-204 (1986) (providing that Congress "expected the [the IRS] to issue those regulations").

171. 1987-1 C.B. 445.

172. A built-in gain asset is an asset with a value exceeding its adjusted basis at the time of the acquisition.

recognizing gain. The group took stepped-up bases in the distributed assets, increased its basis in the target stock under Treas. Reg. § 1.1502-32 to reflect the gain, and sold the target stock at a loss. Because the stock loss corresponded to the recognized built-in gain, the group could eliminate (or at least substantially reduce) the effective tax on the gain, inconsistent with the repeal of the *General Utilities* doctrine.¹⁷³

Notice 87-14 announced that under new or amended regulations a group's stock basis adjustments would "not reflect built-in gains that are recognized by a target on sales of, or by reason of distributions of, its assets."¹⁷⁴ The notice's approach revealed three apparent policy choices. First, the approach disallowed investment basis adjustments only for built-in gain recognized on asset dispositions.¹⁷⁵ Thus, it seemed to permit basis adjustments for operating income that reflected the built-in gain. Second, the approach could not only reduce a group's loss on a target stock disposition but also increase its gain. Finally and perhaps most significantly, the approach appeared to require tracing: a group had to value all target assets when the target joined the group and then determine to what extent, if any, the target recognized any pre-acquisition built-in gain (or loss) as it disposed of any of those assets.

Treasury reversed each of these policy choices in promulgating LDR, justifying and defending the rule in several extensive preambles.¹⁷⁶ Most significantly, it rejected tracing, concluding "that it would impose tremendous administrative burdens on both taxpayers and the [IRS]."¹⁷⁷ Further, in part to avoid the

173. See 1990-1 C.B. 66, 67-68 (noting that LDR implements rules to prevent the circumvention of the repeal of the *General Utilities* doctrine). The character of the stock loss and asset gain might not match, but if the group could otherwise absorb the stock loss and tax rates remained constant, it would incur no net federal income tax cost because of the transaction. Note, however, that the group would incur a time-value cost if the stock loss arose in a year that followed some or all of the asset sales.

174. 1987-1 C.B. 445 (also providing that the regulations would "be effective with respect to stock in a target that was acquired after January 6, 1987").

175. See I.R.C. § 1001(c) (2003) (providing for the recognition of gain or loss on the sale or exchange of property); *id.* § 61(a)(3) (gains derived from dealings in property).

176. LDR was developed over a short span in three regulatory packages. See *supra* note 4 (for cites to the preambles).

177. 1990-1 C.B. 66, 69. Treasury identified the following problems with tracing, among others:

- (i) It would require a consolidated group to separately value a subsidiary's assets whenever the group acquired subsidiary stock, often presenting difficult problems because of the number and nature of the subsidiary's assets.
- (ii) If a subsidiary had a lower-tier subsidiary, the assets of the lower-tier

administrative burden of tracing and in part to limit gain duplication within consolidated groups, LDR generally did not increase the gain a consolidated group otherwise recognized on its disposition of subsidiary stock.¹⁷⁸ It did, however, reduce a consolidated group's loss on subsidiary stock, targeting built-in gain reflected not only in asset dispositions but also in operating income.¹⁷⁹

Although Treasury implemented LDR in large part as a response to the repeal of the *General Utilities* doctrine, it tied LDR's loss duplication rule to the repeal only because it simplified LDR generally.¹⁸⁰ It asserted that it was "not possible to differentiate between loss attributable to built-in gain [in applying LDR generally] and duplicated loss without resort to tracing."¹⁸¹ In other words,

subsidiary would also then have to be valued. As a further complication, the group would have to compute the extent to which any built-in gain in an asset of a lower-tier subsidiary was reflected not only in the subsidiary stock but also in the stock of any intermediate lower-tier subsidiary and the stock of the lower-tier subsidiary itself.

- (iii) The IRS might not audit those valuations for years, if not decades. It would have great trouble determining whether a particular asset's value was incorrect, a challenge that could be faced a multitude of times for a typical subsidiary.

Id.; 1990-2 C.B. 696, 698; 1991-2 C.B. 43, 45; see also Michael L. Schler, *Consolidated Return Loss Disallowance: Conceptual Issues*, 95 TAX NOTES 899, 903-05 (May 6, 2002) (agreeing with many of these concerns with tracing).

Treasury also discussed why it rejected other alternatives to LDR. See 1990-1 C.B. 66, 69-70 (rejecting built-in gain presumptions, tracing/presumption combinations, and loss disallowance combined with tracing); 1990-2 C.B. 696, 698-700 (explaining why it adopted the three-factor test but rejected rules based on rates of return or caps on disallowed loss); 1991-2 C.B. 43, 46-47 (rejecting certain modifications to the three-factor test).

178. See 1990-2 C.B. 696, 697-98 (justifying LDR as consistent with the single-entity principles reflected in the investment adjustment rules, which limit gain and loss duplication); see also *id.* at 700 (noting that the consolidated return regulations limit gain and loss duplication and if gain duplication is inconsistent with the principles of consolidated returns, loss duplication is equally inconsistent). Thus, a basis adjustment for a subsidiary's built-in gain could offset an increase in value in the subsidiary stock attributable to the unrecognized, post-acquisition appreciation in its assets. Cf. Treas. Reg. § 1.1502-20(e)(3), Ex. 5 (in force as of January 1, 1994) (providing for a reduction of subsidiary stock basis under an anti-avoidance rule; the reduction could cause a group to increase its gain on its sale of the subsidiary stock). But see Irving Salem, *It's Time to Creatively Deconstruct LDR*, 93 TAX NOTES 1111, 1112 (2001) [hereinafter Salem III] (labeling Treasury's choice to allow built-in gain to offset an increase in subsidiary stock value a "Faustian deal").

179. 1990-2 C.B. 699 (justifying the rule's application to operating income because the rule would otherwise treat taxpayers in similar economic circumstances differently).

180. *Id.* at 700; see 1990-1 C.B. 66, 67 (stating that the loss duplication rule addresses a problem different from the repeal); see also *id.* at 68; 1991-2 C.B. 43, 46 (suggesting that LDR balances several tax policy considerations, including preventing avoidance of the repeal of the *General Utilities* doctrine, permitting the deduction of certain economic losses under rules that are administrable for both taxpayers and the IRS, and furthering single-entity principles by limiting loss duplication).

181. 1990-2 C.B. 696, 700. For example, if a group acquired a target with built-in

Treasury justified the duplicated loss rule in part to avoid the administrative burden of tracing.

Mainly, though, it justified the rule to address the following concern: absent the rule, a consolidated group would recognize duplicated loss on subsidiary stock, but it would avoid duplicated gain through elective self-help measures (*e.g.*, selling a subsidiary's assets or selling its stock but making a § 338(h)(10) election for the sale).¹⁸² That loss selectivity, it argued, was inconsistent with the core single-entity principle of the investment adjustment rules, which was to limit gain and loss duplication on subsidiary stock.¹⁸³ The investment adjustment rules prevented duplication for tax items that the subsidiary had already taken into account. The loss duplication rule extended the core principle to built-in amounts.¹⁸⁴

Treasury also responded to arguments made against the rule. Some had argued that because non-consolidated groups may enjoy loss duplication, it should be eliminated only by Congress.¹⁸⁵ Treasury rejected the argument because it ignored the consolidated return regulations' "comprehensive approach to gain and loss duplication," which the loss duplication rule complemented.¹⁸⁶

gain and loss assets, it would have to trace to determine the extent to which any later loss on target stock was attributable to recognized, pre-acquisition built-in gain or a decline in asset value.

182. 1990-1 C.B. 66, 69; 1990-2 C.B. 696, 700. For example, disregarding loss carryovers, if a group sold its entire stock interest in a wholly owned subsidiary:

- (i) Its stock loss was a duplicated loss to the extent the subsidiary had an aggregate built-in loss in its assets; and
- (ii) Its stock gain was a duplicated gain to the extent the subsidiary had an aggregate built-in gain in its assets.

Stated more broadly, a group had duplicated gain or loss on its sale of subsidiary stock to the extent that a corresponding gain or loss was preserved in the subsidiary's asset bases.

183. 1990-2 C.B. 696, 700; 1991-2 C.B. 43, 46; *see also* 1990-2 C.B. 696, 698 (asserting that "as the group and subsidiary operate in consolidated form, it becomes more appropriate to view the group's investment in a subsidiary as an investment in its assets and operations rather than in its stock."); 1991-2 C.B. 43, 46 (making the same point); Treas. Reg. § 1.1502-32(a)(1) (2003) (providing that the purpose of the investment adjustment rules is "to treat [the group] as a single entity" and to prevent a subsidiary's income, gain, loss, and deductions "from being taken into account a second time on [the group's] disposition of [the subsidiary's] stock").

184. A subsidiary's duplicated loss included not only its aggregate built-in asset loss but also its loss carryovers to its first taxable year following the disposition. Treas. Reg. § 1.1502-20(c)(2)(vi) (in force as of January 1, 1994). Under the "retribution" rule, however, those loss carryovers could be reattributed to the common parent to the extent of the group's otherwise disallowed loss under LDR. *See supra* note 164 and accompanying text. Because the group reduced its subsidiary stock basis under the investment adjustment rules by any reattributed loss, the "retribution" rule bridged the investment adjustment and loss duplication rules.

185. 1990-2 C.B. 696, 700.

186. 1990-1 C.B. 66, 70.

Commentators had also argued that the rule was unnecessary because it overlapped with other Code and regulatory loss limitations, such as I.R.C. § 382 and the SRLY rules.¹⁸⁷ Treasury found this argument unconvincing because the other loss limitation rules focused on loss trafficking, not loss duplication at the corporate level, and even if they “appl[ied] in a duplicated loss case, they [might] not significantly limit duplicated loss.”¹⁸⁸

III. AN ANALYSIS OF *RITE AID*

A. *The Decisions*

1. *The Court of Federal Claims decision*

The Court of Federal Claims embraced Treasury’s justifications for the loss duplication rule and graced Treasury with a clear but short-lived victory.¹⁸⁹ In concluding that the rule was valid, the court stated that:

The duplicated loss rule in [Treas. Reg. § 1.1502-20(c)] prohibits the opportunity that would exist—without the Regulation—for the affiliated group to recognize a loss on a sale of stock of the subsidiary and for the purchaser to recognize the *same* loss. By prohibiting the use of the *same* loss in the hands of the seller and purchaser, the Regulation assists in achieving the purpose of all regulations issued under I.R.C. § 1502 “clearly to reflect the income-tax liability” of both members and former members of the affiliated group and to “prevent avoidance of such tax liability.”¹⁹⁰

Because the court treated Rite Aid’s loss on the subsidiary stock and the subsidiary’s built-in loss on its assets as essentially the same loss, it concluded that LDR did not deny the Rite Aid group its economic loss.¹⁹¹ It noted that the group could have recognized the built-in loss on the Encore assets, either by selling the assets directly or by joining with the buyer to make a § 338(h)(10) election for the sale of the subsidiary stock.¹⁹² It also noted that by not making the

187. 1990-2 C.B. 696, 700.

188. *Id.* at 701.

189. *Rite Aid Corp. v. United States*, 46 Fed. Cl. 500 (2000).

190. *Id.* at 505 (emphasis added); *cf.* *Woods Inv. Co. v. Comm’r*, 85 T.C. 274, 282 (1985), *acq. in result*, 1986-2 C.B. 1 (refusing to adopt a single-entity approach when regulations expressly required a different result).

191. *But cf.* I.R.C. §§ 269, 382 (2003) (possibly limiting the benefit of built-in losses in target assets following a disposition of target stock).

192. *Rite Aid*, 46 Fed. Cl. at 505 (also pointing out that a deemed or actual asset sale could avoid duplicated gain but that without LDR a “regular” stock sale could preserve duplicated loss).

election, Rite Aid benefited from Encore's aggregate built-in asset loss, since Lauriat paid more for the Encore stock because of that built-in loss.¹⁹³

By giving substantial weight to Treasury's justifications for the loss duplication rule, the court followed a long line of precedent affording the consolidated return regulations substantial deference.¹⁹⁴ However, it failed to adequately confront the legitimate concerns raised by LDR's denying a stock loss that was historically allowed under the Code and regulations.

2. *The Federal Circuit decision*

Apparently finding those concerns paramount, the Federal Circuit invalidated the loss duplication rule.¹⁹⁵ Duplicated loss, the court asserted, was not "a problem resulting from the filing of consolidated [] returns," because such a loss could also arise in a non-consolidated setting.¹⁹⁶ It added that I.R.C. § 382 already dealt with the problem by limiting a subsidiary's future deductions, rather than by limiting the group's stock loss.¹⁹⁷ Thus, the court found, by treating consolidated and non-consolidated groups differently, the loss duplication rule

193. See *id.* (noting that Rite Aid acknowledged in oral argument that Lauriat paid more for the stock to account for the built-in loss but that it could not quantify how much more Lauriat paid). Because of this additional payment, if the Rite Aid group could take the stock loss into account, it would receive two economic benefits for the one economic loss that the group suffered. It would not, however, receive two tax benefits, although the additional payment would reflect the anticipated tax benefit of Encore's built-in loss.

The court mistakenly appeared to justify not applying I.R.C. § 165 to the group's stock loss when it concluded that the additional payment "compensated" Rite Aid for its stock loss. Cf. I.R.C. § 165(a) (2003) (permitting a deduction for a sustained loss that is "not compensated for by insurance or otherwise"). However, the additional payment only decreased Rite Aid's stock loss, it did eliminate the loss. See Axelrod, *supra* note 4, at 814 (making this point); Silverman & Zarlenga, *supra* note 4, at 461 n.57 (also making this point).

194. As noted in the case review in Part I.B.2 above, no court had ever invalidated a consolidated return regulation for which Treasury provided substantial justification.

195. See generally *Rite Aid*, 255 F.3d at 1360.

196. *Id.* The court stated that:

The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. § 1001, and deduct the loss under I.R.C. § 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns.

Id.

197. *Id.* But see *infra* note 324 (for why § 382 should not limit Treasury's authority to attack a consolidated group's duplicated stock loss).

“distort[ed] rather than reflect[ed]” a consolidated group’s tax liability and “contravene[d] Congress’ otherwise uniform treatment of limiting deductions for the subsidiary’s losses.”¹⁹⁸ The court therefore concluded that the rule was invalid.

The Federal Circuit likely did not invalidate LDR in total, although a casual reader might believe it did when it stated that “the regulation [*i.e.*, LDR] is not within the authority delegated by Congress.”¹⁹⁹ Despite its imprecise language, the court likely invalidated only the loss duplication rule. It analyzed only that rule and neither reviewed LDR generally nor questioned LDR’s strong tie to the repeal of the *General Utilities* doctrine.²⁰⁰

3. *Gaps in the decisions*

Both *Rite Aid* courts deserve criticism. The Federal Circuit offered only a cursory analysis, gave short shrift to Treasury’s justifications for the loss duplication rule and LDR,²⁰¹ and never distinguished the lower court’s opinion, gaps that seem remarkable with the tax dollars at stake.²⁰² The Court of Federal Claims failed to adequately support why consolidated and non-consolidated groups should be treated differently. More globally, each court’s analysis suffered because it conflated the following three distinct issues:

- (i) Whether Treasury had the authority to issue a consolidated return regulation that disallowed a group’s subsidiary stock loss;
- (ii) Whether it had the authority to limit duplicated loss for consolidated groups; and

198. *Rite Aid*, 255 F.3d at 1360 (adding that the rule was “manifestly contrary to the statute”).

199. *Id.* at 1358; *see also id.* at 1360 (adding that “[b]ecause the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute”).

200. *See Silverman & Zarlenga, supra* note 4, at 444 and 474-76 (concluding that the Federal Circuit invalidated only the loss duplication rule); *see Schler, supra* note 177, at 901 n.8 (May 6, 2002) (stating that the suggestion that *Rite Aid* invalidated all of LDR was merely “wishful thinking”). Note that, since *Rite Aid*, the IRS has conceded issues under LDR that did not implicate the duplicated loss rule, perhaps because of concerns about the potential breadth of the Federal Circuit’s opinion. *See id.* at 901 n.10 (also reporting this concession).

201. *Rite Aid*, 46 Fed. Cl. at 1360 (noting Treasury’s argument that the loss duplication rule complemented Treas. Reg. § 1.1502-32 but not noting the fundamental points that the rule addressed loss selectivity and was necessary to prevent tracing).

The court also stated that a consolidated group had to take the “bitter with the sweet” in filing a consolidated return but not the “invalid.” *Id.* The statement, although colorful, provides no help in determining whether a particular regulation is valid.

202. *See supra* note 5 (for the potential dollars at stake if LDR was invalidated).

(iii) Assuming that it had the authority to do both, whether the loss duplication rule was reasonable.

The discussion that follows analyzes each of these issues.

B. Authority to Disallow Subsidiary Stock Loss

Critics have asserted that Treasury lacks authority to disallow a group's recognized loss on its subsidiary stock, because the loss is otherwise allowed under I.R.C. § 165 and Treasury cannot override that section.²⁰³ The better answer, however, is that Treasury has that authority, an answer supported by applicable legislative history, case law, and past practice.

1. "Consolidated" problems

I.R.C. § 1502 gives Treasury the authority to prescribe consolidated return regulations "clearly to reflect" the income tax liability of the group and each member and to "prevent avoidance" of that tax liability. Treasury has operated under substantially the same grant of regulatory authority since 1928.²⁰⁴

The applicable 1928 legislative history justified this broad grant of authority to deal with the "difficult and complicated problems" related to filing consolidated income tax returns.²⁰⁵ In *Rite Aid*, the Federal Circuit molded this justification into a standard to define and limit the grant; it maintained that "in the absence of a problem created from the filing of consolidated returns," Treasury could not change how a Code provision applied to a consolidated group.²⁰⁶

Despite any superficial appeal, this standard does little to define Treasury's authority, except in one exceptional circumstance.²⁰⁷ Treasury should have no authority to change how a Code provision

203. See, e.g., Christian M. McBurney, *The Consolidated Return Regs.' Loss Disallowance Rule—When is it Vulnerable?*, 20 J. TAX'N 20, 25 (1999); Salem I, *supra* note 4, at 211 (concluding that "[c]ertainly, the Congress issued no license to eliminate economic losses"). The critics presume that the stock loss must be measured using a separate-corporation approach.

204. Revenue Act of 1928, Pub. L. No. 70-562, § 141(b), 45 Stat. (pt. 1) 791, 831; cf. I.R.C. § 1502 (2003) (substantially the same grant of authority). But see *infra* note 236 (discussing stylistic differences between the two grants).

205. S. REP. NO. 70-960, at 15 (1928) (stating that "[m]any difficult and complicated problems have arisen in the administration of the provisions permitting the filing of consolidated returns"); see also H.R. REP. NO. 70-2, at 20 (1928) (proposing to eliminate consolidated returns, stating that consolidated filing "has given rise to a great many important and difficult problems").

206. *Rite Aid*, 46 Fed. Cl. at 1359.

207. But see Salem II, *supra* note 4, at 427 (arguing that when the Federal Circuit stated that the IRS was delegated power to write rules which can only fix consolidated problems, it stated a "concept... that has never before been articulated so precisely").

applies if the change cannot be justified under any single-entity, separate-corporation, or hybrid approach.²⁰⁸ For example, Treasury cannot impose a higher tax rate on consolidated groups.²⁰⁹ The imposition would find no support under any rationale single-entity, separate-corporation, or hybrid approach.²¹⁰

Typically, however, those approaches accommodate more than one way to apply the Code, as they would for a consolidated group's loss on subsidiary stock. Under a "pure" separate-corporation approach, the loss would be allowed in full. Under a "pure" single-entity approach, none of the loss would be allowed (but instead the subsidiary would be treated as selling its assets). Under a hybrid approach, some or all of the stock or asset loss could be allowed. LDR (and Treas. Reg. § 1.1502-32) reflect a hybrid approach.

When the various approaches abide more than one way to apply the Code, the Federal Circuit's standard offers little help. Because the standard presumes a comparative model or baseline, a court must choose one approach as its model, essentially assuming its conclusion.²¹¹ Typically, therefore, the standard has little utility and may cause more harm than good, luring a court into circular reasoning and diverting it from what is likely the critical inquiry—whether the regulatory approach is reasonable.

2. *Applicable legislative history*

In any event, in the same legislative history that inspired the Federal Circuit's standard, Congress stated that a subsidiary stock loss was a "consolidated" problem. It listed five concerns that Treasury

208. In other words, this exceptional circumstance would not involve a "consolidated" problem. Cf. *id.* at 431 (suggesting that Treasury should be authorized to adopt an approach that was consistent with what would happen if the entities had merged); Silverman & Zarlenga, *supra* note 4, at 473 (following *American Standard* and suggesting that a "consolidated" problem was something that "(i) require[d] a mechanical or technical adjustment of individual returns to the consolidated return format or (ii) present[ed] a question unique to consolidated returns").

209. However, it can treat the group as a single entity to determine what statutory tax rate to apply.

210. As another example, none of those approaches would justify a regulation overriding I.R.C. § 351 on a group member's transfer of property to a non-member. In contrast, a single-entity theory should justify a regulation that measured control for purposes of I.R.C. § 351 by looking to the group as a whole. See Treas. Reg. § 1.1502-34 (2003) (applying that standard for control).

211. In fact, the Federal Circuit in *Rite Aid* used the separate-corporation approach as the comparative model and, not surprisingly, invalidated the loss duplication rule, which followed a hybrid approach. See *Rite Aid*, 255 F.3d at 160; cf. *Comm'r v. Gen. Mach. Corp.*, 95 F.2d 759, 759-60 (6th Cir. 1938) (applying a separate-corporation approach to define taxable years, relying on *Helvering v. Morgan's, Inc.*, 293 U.S. 121 (1934)).

should address in consolidated return regulations, and heading the list was "[t]he extent to which gain or loss shall be recognized upon the sale by a member of the [consolidated] group of stock issued by another member."²¹² Pre-1928 law reveals the reason for this concern.

Before 1928, the IRS and consolidated groups intensely debated whether (and to what extent) a consolidated group should recognize gain or loss on its sale of subsidiary stock to a non-member. Commentators often argued for a pure single-entity or separate-corporation approach,²¹³ and at first, Treasury opted for full recognition, asserting that members should be considered separate corporations.²¹⁴

However, *H.S. Crocker Co.*, an influential 1926 case, articulated a single-entity approach and concluded that the group recognized no gain or loss.²¹⁵ Later courts followed this approach.²¹⁶

212. H.R. CONF. REP. NO. 1882, 70th Cong., 1st Sess. 16-17 (1928); S. REP. NO. 960, 70th Cong., 1st Sess. 15 (1928); *see also* Revenue Act of 1928, Pub. L. No. 70-562, § 23(f), 45 Stat. (pt. 1) 791, 800 (the same provision as current I.R.C. § 165(a) (2003)). Congress noted the following additional concerns that the regulations should address:

- (i) the extent to which (and the manner in which) gain or loss on intercompany transactions should be recognized when a member disaffiliates;
- (ii) the basis of property acquired in an intercompany transaction; (iii) the carryover of losses between separate return and consolidated return years; and (iv) the identification of one agent for the group to receive statutory notices of deficiency, refunds, and so on "as though the agent were the taxpayer."

See S. REP. NO. 70-960, at 15 (1928).

213. For example, one commentator argued for the separate-corporation approach by asking: "How then can invested capital and incomes be consolidated, joined, united, or combined on a single return unless they are first found by separate computation in the manner approved by the statute?" Lyle T. Alverson, *Consolidated Returns and Invested Capital*, 2 NAT'L INC. TAX MAG. 165, 167 (1924); *see also* Joseph D. Peeler, *Apportionment of Nat'l Inc. Tax Mag. Under Consolidated Returns*, 6 NAT'L INC. TAX MAG. 127, 128 (1928) (stating that the group is not treated as a single taxpayer in assessing tax or "as a group for any other purpose"). Other commentators argued for a single-entity approach. *See* James S. Y. Ivins, *Affiliated Corporations*, 4 NAT'L INC. TAX MAG. 131 (1926) ("In the case of affiliated corporations, the corporate entity was required by law to be disregarded, and the taxes on several corporations were computable as if they were one"); *see also* Ludlow S. Smyth, *Consolidation of Accounts and Consolidated Tax Returns*, 5 NAT'L INC. TAX MAG. 449, 449-50 (1927); J.S. Seidman, *Consolidated Invested Capital of Affiliated Corporations*, 5 NAT'L INC. TAX MAG. 129, 129-32 (1927) (each asserting that courts had adopted a single-entity approach). *But see* J. Weldon Jones, *The Consolidated Return*, 55 J. ACCT. 255, 258-60 (1933) (describing how the regulations apply both the single-entity and separate-corporation approaches).

214. A.R.R. 8159, II-2 C.B. 256 (1924) (concluding that members retain their separate legal status).

215. Appeal of *H.S. Crocker Co.*, 5 B.T.A. 537 (1926) (concluding that a group recognized no gain on its sale of subsidiary stock).

216. *See Baker-Vawter Co. v. Comm'r*, 7 B.T.A. 594, 598 (1927) (stating that the

Despite the prevalent view that the *Crocker* court adopted a single-entity approach, it justified non-recognition primarily using a hybrid approach. The court reasoned that if a group were taxed as an economic unit, its tax consequences should be no different than if the subsidiary were an unincorporated branch of the parent.²¹⁷ To achieve this effect, the group would reduce its stock gain (or loss) to the extent of the subsidiary's net undistributed profits (or net loss) during consolidation.²¹⁸ Under this hybrid approach, a group would recognize gain or loss on its sale of subsidiary stock (a separate-corporation approach), but it would adjust the gain or loss to account for the subsidiary's net income or loss during consolidation (consistent with a single-entity approach).²¹⁹

Thus, pre-1928 law was unclear about whether a group determined its gain or loss on subsidiary stock under a single-entity, separate-corporation, or hybrid approach. That lack of clarity, illustrative of a more general confusion about consolidation, prompted Congress to grant Treasury regulatory authority broad enough to accommodate a single-entity, separate-corporation, or hybrid approach.²²⁰ Consequently, Treasury had (and has) broad authority to determine the extent of a group's gain or loss on its sale of subsidiary stock.²²¹ In

court "relied solely upon the authority of the statute in adhering to the so-called single economic unit theory"); Appeal of Farmers Deposit National Bank, 5 B.T.A. 520, 528 (1926) (stating that the subsidiary stock sale was "nothing more than the sale by the . . . group of its own capital stock").

217. *H.S. Crocker Co.*, 5 B.T.A. at 540-41.

218. *Id.* at 540-41 (in effect suggesting basis adjustments so that a group did not "account twice for the same profit or . . . be allowed a double deduction of the same loss").

219. This hybrid approach anticipated the current regime. See Treas. Reg. § 1.1502-32 (2003). Note, however, that post-1928 courts interpreting pre-1928 law generally adopted a pure separate-corporation approach. See *Remington Rand, Inc. v. Comm'r*, 33 F.2d 77, 78-79 (2d Cir. 1929); *Obenchain-Boyer Co. v. Comm'r*, 18 B.T.A. 293, 296-97 (1929). But cf. *Riggs Nat'l Bank v. Comm'r*, 17 B.T.A. 615 (1929), *aff'd*, *Burnet v. Riggs Nat'l Bank*, 57 F.2d 980 (4th Cir. 1932) (concluding that the parent could recognize a loss on a subsidiary's liquidation but that the loss was reduced to take into account the subsidiary net loss included in the consolidated tax computation).

220. See S. REP. NO. 70-960, at 15 (1928) (stating that "[i]t is, obviously, of utmost importance that these questions [in filing consolidated returns] be answered with certainty and a definite rule be prescribed. Frequently, the particular policy is comparatively immaterial, so long as the rule to be applied is known").

221. One commentator has argued, however, that when Congress directed Treasury to answer how much gain or loss a consolidated group recognized on its sale of subsidiary stock, it authorized Treasury to defer or recognize gain or loss, but not to eliminate it. See Thomas J. Sykes, *Powerful New Arguments Against the Duplicated-Loss Provisions of the LDR*, 91 TAX NOTES 471-75 (2001), 2001 TNT 73-106. His argument is flawed for two reasons. First, it disregards pre-1928 law, which provides the context for the 1928 legislative history. Second, it disregards that a sale of stock is a transfer for cash, and in a typical cash transaction, gain or loss is recognized or eliminated, not deferred. Although in rare cases, *gain* from a cash transaction has

particular, it may disallow a "separate" subsidiary stock loss under a reasonable single-entity or hybrid approach.

3. *The regulatory response to the 1928 legislation*

In fact, in Reg. 75, the regulatory response to the 1928 legislation, Treasury implemented a hybrid approach for sales of subsidiary stock and a single-entity approach for intra-group liquidations.²²² In either case, a group could be denied a stock loss that it otherwise would have recognized under a separate-corporation approach. Courts approved, and Congress implicitly did as well.

Under Reg. 75, when a member sold subsidiary stock outside the group, the member recognized gain or loss,²²³ but, in computing the gain or loss, it first reduced its stock basis to prevent the group's benefiting twice from any subsidiary loss.²²⁴ This regulatory approach was universally endorsed by courts, despite distinguishing between consolidated and non-consolidated groups.²²⁵ Although Reg. 75 did not directly disallow a group's loss on its sale of subsidiary stock, its required basis reduction could have the same effect.²²⁶

For intra-group liquidations, however, Reg. 75 directly disallowed a consolidated group's loss on subsidiary stock. It provided that a shareholder member recognized no gain or loss on the liquidation and took a transferred basis in any distributed assets.²²⁷ In sharp contrast, absent consolidation, a shareholder corporation recognized any gain or loss on a liquidation and took a cost basis in any distributed assets.²²⁸

been deferred, Congress gave no indication that a group's sale of member stock merited this special treatment. Cf. I.R.C. §§ 362(c), 1033(a)(2) (each providing for gain deferral by tracing the use of cash); see also Revenue Act of 1928, Pub. L. No. 70-562, §§ 112(f) and 113(a)(10), 45 Stat. (pt. 1) 791, 817, 820 (1928) (for the predecessor to I.R.C. § 1033).

222. See Reg. 75, *supra* note 59, at Art. 33, 34, and 41.

223. *Id.* at Art. 33 (providing that gain or loss is recognized as if the members had never been consolidated).

224. *Id.* at Art. 34 (also providing that the basis reduction did not occur if the disposition did not break the subsidiary's affiliation with the group).

225. See *supra* notes 92-106 and accompanying text (describing cases approving the hybrid approach (and Treasury's later decision to provide for ELAs)). Note that a non-consolidated group did not reduce its basis in subsidiary stock to compute its stock loss.

226. Its effect was even broader, since the basis reduction could not only reduce loss but also increase gain.

227. See Reg. 75, *supra* note 59, at Art. 37(a) (providing that a shareholder member recognized no gain or loss on liquidation of another member; also providing that any distribution was an intercompany transaction); *id.* at Art. 38(b) (providing that the basis of an asset acquired in an intercompany transaction "was not affected by reason of the transfer").

228. See Revenue Act of 1928, Pub. L. No. 70-562, § 115(c), 45 Stat. 791, 822 (1928) (treating a distribution in liquidation as in full payment in exchange for

EXAMPLE 6—INTRA-GROUP LIQUIDATION

In 1924, P bought all S stock for \$1,000, and S's only asset was land with a \$100 basis and \$1,000 value. By 1930, the land had declined in value to \$400, and P liquidated S.²²⁹

P's tax consequences depended on whether P and S joined in filing a consolidated return in 1930.²³⁰ If they did, P's \$600 "economic" stock loss was disallowed and P acquired the land with a \$100 basis. If they did not, P recognized its \$600 loss and took a \$400 basis in the land.

Courts uniformly approved this liquidation rule, even though it could deny a group its "economic" loss in subsidiary stock, a loss otherwise allowed under the predecessor to I.R.C. § 165.²³¹ Treasury

stock); *id.* at § 112(a), 45 Stat. 816 (requiring all gain or loss from the liquidating distribution to be recognized); *id.* at 113(a), 45 Stat. 818 (providing for a cost basis); *cf. id.* at § 112(b)(3), 45 Stat. 816 (providing non-recognition for distributions as part of a reorganization).

It was not until 1935 that Congress introduced special rules for parent-subsidiary liquidations. *See* Revenue Act of 1935, Pub. L. No. 74-407, § 110(a), 49 Stat. 1014, 1020 (1935) (providing partial non-recognition; the parent recognized realized gain to the extent of any cash received in the liquidation); H.R. REP. NO. 74-1885, at 8-10 (1935) (applying the basis rules of § 113(a)(6) of the Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680, 706-07 (1934); under those rules, the parent took bases in subsidiary assets determined by reference to its basis in the subsidiary stock). In 1936, Congress provided that the parent recognized no gain or loss on a subsidiary liquidation and took transferred bases in any distributed subsidiary assets. *See* Revenue Act of 1936, Pub. L. No. 74-740, §§ 112(b)(6), 113(a)(15), 49 Stat. 1648, 1679, 1684-85 (1936). The current Code contains substantially the same rules. *See* I.R.C. §§ 332(a), 334(b)(1) (2003).

229. Assume that the stock purchase and liquidation were separate steps for tax purposes.

230. Whether P and S joined in filing a consolidated return, S did not recognize its built-in gain on the liquidation. *See* Art. 71 of Reg. 74, reprinted in 138 *Internal Revenue Acts of the United States 1909-1950 Legislative Histories, Laws, and Administrative Documents* (Bernard D. Reams, Jr. ed., 1979) (providing that a corporation recognized no gain or loss on a liquidating distribution, except for distributions of installment obligations); *see also* Reg. 75, *supra* note 59, at Art. 3 (the predecessor to Treas. Reg. § 1.1502-80, providing that general tax rules applied to the extent a provision in Reg. 75 did not apply).

231. *Great N. Ry. Co. v. Comm'r*, 30 B.T.A. 691, 717 (1934) (applying Art. 37(a) of Reg. 75 to disallow a shareholder member's stock loss on another member's liquidation, concluding that Art. 37(a) was valid even though the group suffered an economic loss; the court relied on the Supreme Court's decision in *Ilfeld* to support its conclusion that the regulation was valid); *Niagara Share Corp. v. Comm'r*, 30 B.T.A. 668, 669 (1934) (disallowing a shareholder member's stock loss on another member's liquidation under Art. 37(a)); *First Nat'l Corp. of Portland v. Comm'r*, 2 T.C. 549, 558-59 (1943) (to the same effect); *cf. Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 65 (1934) (disallowing a shareholder member's stock loss on another member's liquidation under Art. 37(a), but noting that "[n]o question as to validity [of Art. 37(a)] is raised"); Revenue Act of 1928, Pub. L. No. 70-562, § 23(f), 45 Stat. (pt. 1) 791, 800 (1928) (the same provision as current I.R.C. § 165(a)). *But cf. Burnet v. Aluminum Goods Mfg. Co.*, 287 U.S. 544 (1933) (permitting a loss on a 1917 liquidation when the applicable regulations did not expressly disallow the loss). *See Ronald Press Co. v. Shea*, 27 F. Supp. 857 (1939) (concluding that a group's stock loss on a member's 1928 liquidation would be disallowed to the extent that it

justified the approach for substantive and administrative reasons that offer striking parallels to LDR.²³²

Congress implicitly approved (and perhaps even endorsed) Reg. 75 when it reconsidered the consolidated return rules in 1932.²³³ In its reconsideration, Congress not only failed to disturb Reg. 75's policy choices or question its scope, but stated that consolidated groups were subject to Reg. 75 until Treasury chose to amend it.²³⁴

Taken together, this congressional action, the applicable legislative history, and case law compel the following conclusion: In 1928, Congress granted Treasury regulatory authority to deny a consolidated group its "economic" loss on subsidiary stock, despite the predecessor to I.R.C. § 165.²³⁵ Because the 1928 grant and its contemporary counterpart (I.R.C. § 1502) are substantially the same,²³⁶ the two grants should be interpreted consistently.

duplicated loss the group already took into account, despite there being no regulatory or statutory provision providing that result); *see also* N. Jersey Quarry Co. v. Comm'r, 13 T.C. 194 (1949) (as part of a dispute regarding the excess profits tax for a later year, concluding that, under Art. 37(a), a shareholder member did not recognize its stock gain on another member's 1930 liquidation).

232. Andrew W. Mellon, *Consolidated Returns Regulations—Summary of Provisions*, 7 NAT'L INC. TAX MAG. 105, 106 (1929). Mellon was the Secretary of Treasury when Reg. 75 was issued, and his article briefly summarized and justified Reg. 75. He appeared to justify Art. 37(a), in part, because it achieved a single-entity effect. *Id.* Although he suggested that in certain cases a member probably should recognize gain or loss, he rationalized the absolute disallowance rule to promote "sound administration" and certainty, urging that "as a practical matter" it was too hard to distinguish among liquidations. *Id.* As further justification, he noted that a group could employ self-help measures to recognize loss. *Id.* Cf. *Kanawha Gas & Util. Co. v. Comm'r*, 214 F.2d 685, 690-92 (5th Cir. 1954) (applying the *Kimbell-Diamond* doctrine to a subsidiary liquidation in a way that arguably was inconsistent with Mellon's rationale).

233. *See* Revenue Act of 1932, Pub. L. No. 72-154, § 141(c), (e), 47 Stat. 213-14 (1932) (providing that fire insurance and life insurance companies could not join together in filing consolidated returns and adding a 0.75% additional tax for consolidated groups).

234. *See id.* § 141(a), 47 Stat. 213 (providing that groups would be subject to Reg. 75 (to the extent not inconsistent with the 1932 Act) if Treasury did not amend the regulations before returns had to be filed); *see also* S. REP. NO. 70-665, at 9 (1932) (stating that "[t]he provisions for consolidated returns under present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole").

235. This conclusion gains added support because Reg. 75 was issued shortly after the 1928 legislative grant. A regulation is given added weight if it is a "substantially contemporaneous" interpretation of a statute. *See* Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979) (giving greater weight to such interpretations). Thus, because of when Reg. 75 was issued, it is more likely to be considered within the grant's intended scope.

236. The two grants differ in style, but not substance. *See* Georgia-Pac. Corp. v. Comm'r, 63 T.C. 790, 803-04 (1975) (noting the difference between the two standards but not suggesting that one standard is substantively different than the other). The 1928 grant authorized regulations to clearly reflect the "income" of the group and each member. Revenue Act of 1928, Pub. L. No. 70-562, § 141(b), 45 Stat. (pt. 1) 791 (1928). The current grant authorizes regulations to clearly reflect the

Consequently, I.R.C. § 1502 also authorizes Treasury to deny a group its subsidiary stock loss, despite I.R.C. § 165.²³⁷

C. *Authority to Limit Duplicated Loss*

In addition to questioning Treasury's authority to deny subsidiary stock loss, critics challenged its authority to limit loss duplicated in a subsidiary's stock and assets. That duplicated loss raised two distinct concerns: "classic" loss duplication and loss selectivity. Both concerns were targeted by LDR's loss duplication rule, and Treasury has regulatory authority to deal with each concern.

1. *"Classic" loss duplication*

"Classic" loss duplication occurs when a consolidated group deducts the same economic loss more than once.

EXAMPLE 7—"CLASSIC" LOSS DUPLICATION

P and S form T, with P transferring \$100 cash for T's common stock and S transferring land with a \$50 basis and \$10 value for T's preferred stock.²³⁸ P and S take \$100 and \$50 exchanged bases in the T stock, and T takes a \$50 transferred basis in the land.²³⁹ P, S, and T join in filing consolidated returns.

"income tax liability and the various factors necessary for the determination of such liability" for the group and each member "both during and after the period of affiliation." I.R.C. § 1502. The current grant reflects language first introduced in 1942. See Revenue Act of 1942, Pub. L. No. 77-753, § 159(a), 56 Stat. 859 (1942).

The 1942 change was one of style, however, and it certainly did nothing to narrow Treasury's authority to prescribe consolidated return regulations. Cf. Salem I, *supra* note 4, at 176 (arguing that the revision *broadened* Treasury's regulatory authority). The change merely formalized the previous directives in legislative history to consider relevant factors in crafting the consolidated return regulations. See *supra* note 212 and accompanying text (for those factors). Further, the change was never even mentioned in the relevant legislative history, a telling silence that denotes a stylistic change. See S. REP. NO. 1631, 77th Cong., 2d Sess. 132-35 (1942); H.R. REP. NO. 77-2333, at 101-03 (1942). Finally, it appeared that Congress made the change to more succinctly combine the grants for the consolidated income-tax and excess-profits-tax regulations. Its economy of words should not portend a substantive change.

237. Cf. Sykes, *supra* note 221, at 469-71 (arguing that the loss duplication rule is unconstitutional in denying an "economic" stock loss; the argument presumes, however, that the loss duplication rule "squarely conflicts" with I.R.C. § 165); Salem III, *supra* note 178, at 1112 (arguing that the loss duplication rule "probably fails the constitutional test of taxing income," citing *Doyle v. Mitchell Bros.*, 247 U.S. 179 (1920), a case that considered how "net income" should be interpreted under the Corporation Excise Tax Act of 1909; the author cited no case considering whether a tax provision was constitutional under the Sixteenth Amendment); see also Salem I, *supra* note 4, at 209 (arguing that LDR is invalid because it violates a group's fundamental right to claim a loss).

238. Assume that T's preferred stock is described in I.R.C. § 1504(a)(4) and not in § 351(g).

239. See I.R.C. § 351(a) (providing that persons recognize no gain or loss if they transfer property to a corporation solely in exchange for its stock and control the

In an unrelated transaction, S sells its T preferred stock for \$10, recognizing a \$40 loss.²⁴⁰ Subsequently, T sells the land for \$10, also recognizing a \$40 loss. Absent any limitation, the P group takes both losses into account and therefore could deduct the same economic loss twice.²⁴¹

For at least two reasons, Treasury has regulatory authority to address "classic" loss duplication. First, it has attacked this concern through its investment adjustment rules since 1928, and courts have uniformly upheld those rules.²⁴² Second, longstanding and influential Supreme Court precedent, *Charles Iffeld Co. v. Hernandez*,²⁴³ gives Treasury ample authority to address the concern.

In *Ilfeld*, the Supreme Court concluded that a consolidated group could not deduct the same economic loss twice. Two subsidiary members of a consolidated group incurred losses that the group absorbed.²⁴⁴ In a subsequent year, each subsidiary sold its assets for cash, paid off all creditors except the common parent, and dissolved, distributing its remaining cash to the common parent, its sole shareholder and creditor. Although the group argued that it recognized loss on each dissolution,²⁴⁵ the Court denied each loss, based in part on its interpretation of the existing consolidated return regulations.²⁴⁶ It also reasoned that if the losses were allowed:

corporation immediately after the exchange); *id.* § 358(a)(1) (providing that a person takes an exchanged basis in controlled corporation stock received in a § 351 exchange); *id.* § 362(a) (providing that the controlled corporation takes a transferred basis in an asset received in a § 351 exchange).

240. T remains a P group member, because the preferred stock is not counted in measuring affiliation. See I.R.C. § 1504(a)(4) (2003); see also *id.* § 1504(a)(1), (2) (for the general definition of an affiliated group).

241. Although P will take a reduced basis in its T stock to account for T's loss (Treas. Reg. § 1.1502-32(b)(2)(i)), the reduction will not affect the P group if it retains its T stock or liquidates T. See I.R.C. § 332(a) (providing broadly that a parent recognizes no gain or loss on the liquidation of an affiliated subsidiary).

242. See *supra* notes 223-26 and accompanying text (for a discussion of the investment adjustment rule in Reg. 75).

243. 292 U.S. 62 (1934).

244. Overall, each subsidiary's losses exceeded its gains while it was a group member.

245. *Id.* at 64. The group argued that the loss for each subsidiary equaled the excess of (i) the common parent's basis in the subsidiary's stock and debt over (ii) the distributed cash. *Id.*

246. *Id.* at 66-67; see Reg. 75, *supra* note 59, at Art. 37(a) (providing that no gain or loss was recognized on a "distribution during a consolidated return period by a member of [a consolidated] group to another member of the group, in cancellation or redemption of all or any portion of its stock"); *id.* at Art. 40(a) (providing that a group could not take a bad debt deduction during a consolidated return period on "obligations which are the result of intercompany transactions"); see also *Charles Iffeld Co.*, 292 U.S. at 67-68 (concluding that under Art. 37(a), a group recognized no gain or loss when a member sold its assets and dissolved, overturning *Hernandez v. Charles Iffeld Co.*, 67 F.2d 236 (10th Cir. 1933) on this point).

The group had apparently argued that each dissolution broke (and should have

[It] would permit [the group] twice to use the subsidiaries' losses for the reduction of its taxable income. By means of the consolidated returns in earlier years it was enabled to deduct them. And now it claims . . . deductions for the diminution of assets resulting from those same losses. If allowed, this would be the practical equivalent of [a] double deduction.²⁴⁷

A double deduction would be problematic, because it would distort the income (and tax liability) of the group. Since I.R.C. § 1502 authorizes Treasury to issue consolidated return regulations clearly to reflect a group's income (and tax liability), Treasury has regulatory authority to prevent that distortion. Stated equivalently, it may address "classic" loss duplication in a consolidated return regulation.

2. *Loss selectivity*

a. *The concern*

LDR's loss duplication rule addressed not only "classic" loss duplication but also the following phenomenon: Absent a limitation, a consolidated group will likely recognize any duplicated loss on its sale of a subsidiary but eliminate any duplicated gain.²⁴⁸ This loss selectivity arises, because a group typically can choose to either:

- (i) Eliminate stock gain or loss but recognize gain or loss on the subsidiary's assets (with the buyer taking cost bases in those assets), or
- (ii) Recognize stock gain or loss but not recognize gain or loss on the subsidiary's assets (with the subsidiary preserving its asset bases).

The group will eliminate duplicated gain by making the first choice but preserve duplicated loss by making the second.

EXAMPLE 8—STRUCTURING A SUBSIDIARY'S SALE

P and its wholly owned subsidiary S are members of a consolidated group, and P plans to sell S. The tax consequences of the sale will depend on its structure and any relevant tax elections.

Asset sale. S could sell its assets and liquidate, distributing the sales proceeds to P.²⁴⁹ On the asset sale, S would recognize any gain or

been treated as occurring after) consolidation, so that the group took its investment loss into account for each subsidiary. Cf. Reg. 75, *supra* note 59, at Art. 37(b) (providing that a liquidating or non-liquidating distribution on stock between members after a consolidated return period was treated as a sale); *id.* at Art. 34(c), 35 (providing for adjustments to the basis of subsidiary stock and debt to account for post-1928 subsidiary losses during consolidation).

247. *Charles Ilfeld Co.*, 292 U.S. at 68.

248. See *supra* note 182 (for a further description of duplicated gain and loss).

249. See Rev. Rul. 69-6, 1969-1 C.B. 104 (providing that in a merger, the target

loss, which the group would take into account.²⁵⁰ On the liquidation, neither P nor S would recognize gain or loss.²⁵¹ The buyer would take a cost basis in the S assets.²⁵²

Stock sale. If P sold the S stock and joined the buyer in making a § 338(h)(10) election, the results would be essentially the same as for the asset sale.²⁵³ If this election was not made, P would recognize any gain or loss on its S stock sale, while S would retain its tax attributes, including its asset bases.²⁵⁴

EXAMPLE 9—LOSS SELECTIVITY

P and its wholly owned subsidiaries, S_L and S_G, are members of a consolidated group, and P plans to sell S_L and S_G for \$100 each. S_L owns one asset with a \$140 basis and \$100 value, and P's basis in its S_L stock is \$140. S_G owns one asset with a \$60 basis and \$100 value, and P's basis in its S_G stock is \$60.

No matter how the group structured the S_L and S_G sales, it would recognize a \$40 loss for the S_L sale and a \$40 gain for the S_G sale. Without a consolidated loss-selectivity rule, the group typically would structure the sales to preserve the extra \$40 loss in S_L's asset but eliminate the extra \$40 gain in its S_G stock. It would sell the S_L stock but not make a § 338(h)(10) election, so that it would recognize a \$40 stock loss but S_L would preserve its \$40 built-in asset loss.²⁵⁵ Further, the group would sell the S_G stock but make a § 338(h)(10) election, or it would have S_G sell its assets and liquidate. In either case, the group would recognize S_G's \$40 asset gain but eliminate its \$40 built-in gain on the S_G stock.

corporation is treated as selling its assets and then liquidating).

250. See Treas. Reg. § 1.1502-11 (as amended in 1999) (providing that CTI for a consolidated return year includes a subsidiary's tax items for the year).

251. See I.R.C. § 332(a) (providing broadly that a parent recognizes no gain or loss on the liquidation of an affiliated subsidiary); *id.* § 337(a) (providing broadly that the affiliated subsidiary recognizes no gain or loss on any liquidating distribution to the parent).

252. See I.R.C. § 1012.

253. As a member of the P group, S would be deemed to sell its assets to a newly formed subsidiary of the buyer and then liquidate. See *supra* note 156 (for a general description of this deemed asset sale). The Code and regulations have provided for this deemed sale and liquidation since before LDR was introduced. See Treas. Reg. § 1.338(h)(10)-1T(c), (e)(1)-(3) (in force as of January 1, 1991) (as amended by T.D. 8940, 66 Fed. Reg. 9925, 9950 (Feb. 13, 2001)).

254. Note, however, that S's use of any loss carryovers or built-in loss could be restricted by I.R.C. § 382.

255. Thus, unlike with "classic" loss duplication, a group that selectively recognizes loss generally would not recognize the same economic loss twice. Instead, the group would recognize a stock loss but the subsidiary would preserve a corresponding asset loss. Cf. I.R.C. § 1502 (authorizing Treasury to prescribe rules to clearly reflect income and prevent tax avoidance for the group and its members "both during and after the period of affiliation").

Although critics did not deny that loss selectivity raised a concern, they argued that it was part of a broader problem that Congress must address, and without explicit congressional support, Treasury could not target consolidated groups.²⁵⁶ Central to their argument was the following point: Non-consolidated groups could also selectively recognize loss.²⁵⁷ Critics also pointed to Code rules affecting stock loss, essentially arguing that those rules pre-empted a special consolidated rule.²⁵⁸ Although these arguments are not without force, the better answer is that Treasury can address loss selectivity for consolidated groups, a conclusion flowing, directly or indirectly, from the repeal of the *General Utilities* doctrine.

b. Historical conformity for groups

In arguing that Treasury should conform the treatment of consolidated and non-consolidated groups, critics might point to vintage roots. For instance, the Supreme Court in *Ifeld* supported its attack on "classic" loss duplication, at least in part, to treat consolidated groups no more favorably than non-consolidated groups.²⁵⁹ In this regard, the Court followed Treasury's lead in Reg. 75.

Under this 1929 regulation, a consolidated group decreased its basis in subsidiary stock to account for subsidiary loss but did *not* increase its basis to account for subsidiary gain.²⁶⁰ Treasury reasoned that the basis decrease prevented a consolidated group from twice deducting the same loss, something, it noted, a non-consolidated group could not do.²⁶¹ It added that a basis increase for gain was not justified, because an increase was denied a non-consolidated group.²⁶² Thus, Treasury justified both aspects of its investment adjustment

256. See, e.g., 1990-2 C.B. 696, 700; McBurney, *supra* note 203, at 25.

257. In fact, since 1994, the results in EXAMPLE 9 would be similar if the P group were a non-consolidated group. In 1994, Treasury first authorized a non-consolidated group to join in making a § 338(h)(10) election on its sale of subsidiary stock. See T.D. 8515, 1994-1 C.B. 89, 115, 59 Fed. Reg. 2958, 2982 (Jan. 20, 1994) (providing for this election for the sale of a non-consolidated subsidiary).

258. McBurney, *supra* note 203.

259. *Charles Ifeld Co. v. Hernandez*, 292 U.S. 68, 69 (1934).

260. Art. 34 of Reg. 75 (providing that subsidiary stock basis was reduced by any subsidiary loss absorbed by the group that the subsidiary would not have used if it had filed separate returns; the article did not provide an increase to account for subsidiary gain).

261. Mellon, *supra* note 232, at 105 (1929) (noting that a basis increase would be unavailable to an affiliated, non-consolidated group).

262. See *id.* at 105-06 (1929) (noting that a basis increase would be unavailable to a non-consolidated group); see also Gen. Cons. Mem. 7765, IX-1 C.B. 223, 224-25 (1930) (concluding that a basis increase "would result in a clear discrimination in favor of" consolidated groups over non-consolidated groups).

rule to conform the treatment of consolidated and non-consolidated groups.²⁶³

By 1936, however, Treasury had moved the investment adjustment rule toward a single-entity approach,²⁶⁴ and by 1966, it had adopted the approach in full flower, amending the rule to provide a basis increase for subsidiary gain.²⁶⁵ Thus, by 1966, Treasury had fully abandoned its 1929 rationale for the investment adjustment rules and, if its 1966 change was valid, Treasury's 1929 explanation really adds nothing to the current debate about loss selectivity.

There should be no doubt that the 1966 change was valid. First, when Congress granted Treasury broad regulatory authority in 1928, it gave Treasury great flexibility to adopt a single-entity approach.²⁶⁶

263. Both aspects of the rule could also be supported for the following related reason: Consolidation affected a group's total tax only if at least one member had a net loss; if all members had net income, the group's total tax would be the same, whether or not it filed consolidated returns. Gen. Couns. Mem. 11,676, XII-1 C.B. 75, 76-77 (1933); see also *Charles Iffeld Co.*, 292 U.S. at 69 (appearing to clarify an argument stated in Gen. Couns. Mem. 11,676).

264. In 1936, Congress reduced the dividends received deduction for corporate shareholders from 100 to 85%. Section 26(b) of the Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1664 (1936) (providing for the reduction); *id.* § 1, 49 Stat. 1652 (providing that this amendment applied to taxable years beginning after December 31, 1935). Thus, a non-consolidated group included a net fifteen percent of an intercompany dividend in taxable income.

Despite that statutory change, the applicable consolidated return regulations continued to eliminate intercompany dividends from CTI and provided no basis adjustment for those dividends. See Art. 31(b) of Reg. 97, reprinted in 138 *Internal Revenue Acts of the United States 1909-1950 Legislative Histories, Laws, and Administrative Documents* (Bernard D. Reams, Jr. ed., 1979) (providing that intercompany dividends were eliminated); *id.* at Art. 37 (providing no basis adjustment for dividends). Treasury could have better conformed the treatment of consolidated and non-consolidated groups in one of two ways. It could have forced a consolidated group to either include fifteen percent of an intercompany dividend in CTI or reduce its subsidiary stock basis by fifteen percent of any intercompany dividend. By taking neither step, Treasury moved toward a single-entity model for the investment adjustment and related rules.

265. See 31 Fed. Reg. 16698 (Dec. 30, 1966) (introducing positive adjustments for subsidiary gain in Treas. Reg. § 1.1502-32(b)(1) and (c)(1)).

266. In authorizing the broad grant of regulatory authority, Congress gave the following rationale for consolidation:

The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. . . . The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. . . . [T]o require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies.

S. REP. NO. 70-960, at 14 (1928) (also stating that the members of a group "are really one corporation" and "no ultimate advantage under the tax laws really results" from filing consolidated returns).

Although the statement quoted above seems to invite a single-entity approach, Congress also directed the IRS to provide definite rules in the regulations, if

Congress surely contemplated that Treasury might use that approach for its investment adjustment rule, since the most influential pre-1928 case endorsed the approach and some contemporary commentators favored it.²⁶⁷ Second, Congress has never tied investment adjustments to the treatment of non-consolidated groups²⁶⁸ but instead has implicitly endorsed the 1966 change.²⁶⁹ Third, courts concluded that another aspect of the 1966 change was valid, even though it distinguished between consolidated and non-consolidated groups.²⁷⁰ Finally, with its single-entity approach, the 1966 change promoted tax neutrality, making it more likely that a group would not affect its tax by forming a new member or transferring assets between members.²⁷¹ For all of these reasons, Treasury properly abandoned its early rationale for the investment adjustment rule, and its dated use of the rationale should provide no support for critics of the loss duplication rule.

c. Repeal of the General Utilities doctrine

Despite abandoning the rationale, Treasury did not attack loss selectivity systemically for consolidated groups until it prescribed the loss duplication rule as part of LDR. Critics maintained that Treasury could not change its longstanding position on loss selectivity without Congressional direction. However, not only could Treasury change its position without Congressional direction, Congress gave Treasury that direction, at least implicitly, with the repeal of the *General Utilities* doctrine.

necessary emphasizing certainty over conceptual purity:

It is, obviously, of utmost importance that these questions [in filing consolidated returns] be answered with certainty and a definite rule be prescribed. Frequently, the particular policy is comparatively immaterial, so long as the rule to be applied is known.

Id. By emphasizing certainty, Congress fell short of a single-entity mandate, instead affording the IRS considerable leeway to develop consolidated policy through the consolidated return regulations.

267. See *supra* notes 215-19 and accompanying text (for a discussion of *Crocker*); see also *supra* note 213 (for cites to articles discussing the various approaches).

268. In fact, as the quotes in second preceding footnote show, to the extent that Congress had a preference, it seemed to lean toward a single-entity approach.

269. See § 10222(a)(1) of Pub. L. No. 100-203, Omnibus Budget Reconciliation Act of 1987, 101 Stat. 1330-410 (1987) (modifying the investment adjustment rule to better achieve a single-entity effect); see also H.R. REP. NO. 391, 100th Cong., 1st Sess. 1089 (1987) (stating that a stock-basis increase "should be permitted" for subsidiary income or gain accrued and recognized while the subsidiary is a member of the consolidated group).

270. See *supra* notes 92-106 and accompanying text (describing cases approving the ELAs).

271. As the case review in Part I.B.2 illustrates, a consolidated return regulation is unlikely to be invalidated if it is tax-neutral.

To begin with, it should be irrelevant that Treasury's former position on loss selectivity was of long standing.²⁷² As courts have long recognized, Treasury can amend even interpretive regulations in light of administrative experience.²⁷³ Further, it can amend a legislative regulation like a consolidated return regulation, as long as it adopts a reasonable approach.²⁷⁴ With that freedom and despite its longstanding position, Treasury could attack loss selectivity in the consolidated return regulations if it could reasonably distinguish consolidated and non-consolidated groups.²⁷⁵

Treasury made such a distinction in 1966 when it increased a group's subsidiary stock basis to account for subsidiary gain.²⁷⁶ The change was part of a massive revision of the regulations that signaled a fundamental shift in Treasury's consolidated approach.²⁷⁷ The shift

272. Cf. *Salem I*, *supra* note 4, at 212 (arguing that courts are suspicious of abrupt changes in the regulations, citing *American Standard*; however, Treasury could not justify its amendment in that case, a critical point that distinguishes LDR's loss duplication rule from the challenged rule in *American Standard*). Note that a court may be more likely to approve a longstanding position, sometimes by reasoning that Congress has approved the position under the legislative-reenactment doctrine. See *Regal, Inc. v. Comm'r*, 53 T.C. 261, 267-68 (1969), *aff'd per curiam*, 435 F.2d 922 (2d Cir. 1970) (essentially applying the legislative-reenactment doctrine in approving the continued-filing requirement). A court's approval of one position, however, does not imply its rejection of all other reasonable positions.

273. See, e.g., *Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 485 (1979) (considering interpretive regulations).

274. Except as limited by the applicable grant of regulatory authority, Treasury is free to amend a legislative regulation in the same way Congress can amend the Code. That freedom of choice marks the essence of a legislative regulation.

For a consolidated return regulation, Treasury's choice must "clearly reflect" the income tax liability of the group and each member, both during and after affiliation and "prevent avoidance" of that tax liability. I.R.C. § 1502 (2003). If Treasury's choice achieves those goals, it is "reasonable."

275. Treasury would also have to use a reasonable method in its attack, a topic discussed in the next section of the article.

276. See *supra* notes 266-71 and accompanying text (for why the change was a reasonable approach).

277. Among other things, the 1966 revision provided that:

- (i) A member recognized but deferred gain or loss on an intercompany transaction. See 31 Fed. Reg. 11801 (Sept. 8, 1966) (providing this rule in Treas. Reg. § 1.1502-13(c)). Cf. Treas. Reg. § 1.1502-31(b)(1)(i) (in force as of Jan. 1, 1966) (eliminating gain or loss on an intercompany transaction).
- (ii) A consolidated group increased its basis in subsidiary stock to account for subsidiary profits and could have a negative basis (or ELA) in subsidiary stock. See 31 Fed. Reg. 16695-96 and 16698-99 (providing these rules in Treas. Reg. § 1.1502-19 and Treas. Reg. § 1.1502-32(b)(1), (c)(1), and (e)). Cf. Treas. Reg. § 1.1502-34(b)(2) (in force as of Jan. 1, 1966) (not providing a basis increase for gain or negative basis).
- (iii) A group could carry back the portion of its consolidated net operating loss ("CNOL") attributable to a newly formed subsidiary without restriction. 31 Fed. Reg. 11807 (Sept. 8, 1966) (providing this rule in Treas. Reg. § 1.1502-21(b)). Cf. *Midland Mgmt. Co. v. Comm'r*, 38 T.C.

made the regulations more tax-neutral²⁷⁸ and was prompted by a loss-selectivity concern.²⁷⁹

That concern was unique to consolidated groups, arguably differentiating the 1966 revision from LDR's loss duplication rule. That argument assumes that consolidated and non-consolidated groups present the same loss-selectivity concern. They don't, in part because the investment adjustment rule treats a consolidated group more like a single entity. Those and other "single-entity" rules justify a targeted consolidated response to loss selectivity, a response also supported, directly or indirectly, by the repeal of the *General Utilities* doctrine.

The repeal caused a sea change in corporate taxation. Before the repeal, a corporation could sometimes distribute or sell an asset without recognizing gain or loss.²⁸⁰ The non-recognition provided a second-best alternative to corporate integration, and Congress accepted its blend of corporate tax and tax on shareholders' stock gain as an adequate surrogate for a broader-based corporate tax.²⁸¹

In implementing the repeal, Congress concluded that the non-recognition undermined the corporate tax, because a corporation could eliminate built-in gain on an asset through the asset's transfer.²⁸² Thus, it necessarily rejected the surrogate taxation of

211 (1962) (concluding that a group could not carry back the portion of its CNOL attributable to a newly formed subsidiary to any pre-formation consolidated return year).

278. See *supra* notes 12-26 and accompanying text (describing the regime and explaining why it is tax neutral). Note that the current regulations reflect the same basic approach as the 1966 regulations.

279. Among other things, the revision corrected a gap in the pre-1966 intercompany transaction rules that groups exploited to recognize loss but avoid gain on asset sales. See *Henry C. Beck Builders v. Comm'r*, 41 T.C. 616 (1964) (describing a series of steps exploiting the pre-1966 intercompany transaction rules under which a group could sell a built-in gain asset without gain). The revision addressed that loss selectivity.

280. See generally I.R.C. § 311 (1968) (for non-liquidating distributions) and I.R.C. §§ 336 and 337 (1968) (for liquidating distributions); see also Tax Reform Act of 1969, Pub. L. No. 91-172, § 905(a), 83 Stat. 713-14 (1969) (modifying I.R.C. § 311 to require a corporation to recognize gain on some non-liquidating distributions). The 1969 change began an erosion of the *General Utilities* doctrine that culminated in 1986 with its outright repeal. See *supra* note 169.

281. See STAFF OF THE SENATE FINANCE COMM., The Subchapter C Revision Act of 1985, S. Prt. 99-47, 99th Cong., 1st Sess. 42 (Comm. Print 1985) [hereinafter Green Book] (noting the linkage between the shareholder-level and corporate-level tax).

282. H.R. REP. NO. 426, 99th Cong, 1st Sess. 282 (1985). It also justified the repeal to promote tax neutrality, arguing that the doctrine "create[d] significant distortions in business behavior." *Id.* at 281-82 (also noting the bias, absent the repeal, for a corporation to sell built-in gain assets, since they were worth more to the buyer because of their stepped-up bases and the seller would recognize no gain in a properly structured sale); see also Green Book, *supra* note 281, at 42-44 (noting the doctrine's bias and also arguing that its repeal would eliminate the need for certain complex rules).

corporate income through a shareholder tax.²⁸³ Further, in delinking the shareholder and corporate tax, Congress narrowed the focus of the corporate tax regime, generally looking solely to a corporation's income to determine its proper level of tax.

Although the breadth of the repeal remains unclear, at a minimum it requires that a corporation recognize gain when it sells an appreciated asset and the asset takes a stepped-up basis.²⁸⁴ As a corollary, a corporation should not recognize a loss if it sells a built-in loss asset, the asset remains in corporate solution, but its basis is not stepped down (so that the basis preserves or duplicates the loss). Like gain elimination, this loss duplication undermines the corporate tax, even if later use of the built-in loss is somehow limited (*e.g.*, under I.R.C. § 382).

The corollary justifies a targeted consolidated response to loss selectivity. It could probably apply only to a consolidated group and only if the group sold its subsidiary stock at a loss but the loss was duplicated in the subsidiary's assets.²⁸⁵ Under a single-entity approach, the stock and asset losses could be viewed as the "same" loss. Then, a consolidated group would violate the corollary if it recognized a subsidiary stock loss that was duplicated (*i.e.*, preserved) in the subsidiary assets.

Treasury should be authorized to use a single-entity approach to apply the corollary to a consolidated group, since it used that

283. The legislative history does not explain why, but it may be because shareholders of publicly traded corporations increasingly were tax-exempt.

284. See *supra* note 169.

285. Arguably, a similar duplicated-loss concern may arise if a partner sells a partnership interest at a loss. Cf. I.R.C. § 311(b)(3) (giving Treasury regulatory authority to compute gain on a corporation's non-liquidating distribution of a partnership interest by disregarding any built-in loss in property that the corporation contributed to the partnership with the principal purpose of avoiding § 311 gain). If the loss is duplicated in the partnership assets and the partnership has not made an I.R.C. § 754 election, the buyer may subsequently be allocated a corresponding partnership loss. However, the buyer will reduce its outside partnership basis to account for the loss, increasing its gain (or reducing its loss) on a later disposition of its partnership interest or distributed partnership assets. See I.R.C. § 705(a)(2)(A) (2003) (for a determination of basis of a partner's interest); *id.* § 732 (describing how a partner determines its basis in distributed partnership assets). This tax detriment can be postponed but not readily avoided; cf. *id.* § 1014 (providing that property acquired from a decedent generally takes a date-of-death value).

In contrast, the corporate buyer of a "duplicated loss" subsidiary can readily avoid any tax detriment arising from the subsidiary's later recognition of a duplicated loss. Although a consolidated buyer of the subsidiary reduces its basis in subsidiary stock when the subsidiary takes the loss into account, the buyer can eliminate that detriment by liquidating the subsidiary or by selling the subsidiary stock and joining in a § 338(h)(10) election for the sale. See I.R.C. § 332(a) (providing that a parent recognizes no gain or loss on a subsidiary's liquidation); see also Treas. Reg. § 1.1502-32(b)(2)(i) and (3)(i) (2003) (for the subsidiary basis adjustment on taxable income or loss); *supra* note 253 (for the consequences of a § 338(h)(10) election).

approach for the investment adjustment rule. Both gauge the amount a group should recognize on its sale of subsidiary stock, and both attack loss duplication.²⁸⁶ Because the corollary complements the investment adjustment rule, it could likewise be applied using a single-entity approach. However, the corollary should be applied only to consolidated groups, since non-consolidated groups generally do not use a single-entity approach to determine basis in subsidiary stock.

Thus, the repeal of the *General Utilities* doctrine supports a targeted consolidated response to loss selectivity.²⁸⁷ Despite that support, Treasury did not treat loss selectivity as a concern directly implicated by the repeal.²⁸⁸

d. Code changes related to the repeal

Whether or not the repeal directly implicated loss selectivity, the two are intimately connected. In concert with its response to the repeal, Treasury had (and has) the authority to craft a consolidated loss-selectivity rule. The rule would complement both the Code changes related to the repeal and the investment adjustment and other "single-entity" rules of the consolidated return regulations.

Loss-selectivity concerns have always been entwined with the *General Utilities* doctrine and its repeal. Such a concern, in fact, provided the backdrop for the *General Utilities* case.²⁸⁹ The law at the time seemed to permit the following facile ploy: A corporation could avoid gain by declaring and making an in-kind distribution of gain property, while it could recognize loss by declaring a distribution of a stated dollar amount but satisfying the declaration with loss

286. The investment adjustment rule prevents duplication for a subsidiary's tax items that already have been taken into account, while the corollary applies to built-in loss amounts.

287. Some may counter, however, that the repeal should not support a consolidated attack on loss selectivity, because Congress rejected such an attack. I address that argument, as more broadly stated, below.

Others may accept the connection noted in the text between loss selectivity and the repeal, but argue that a consolidated attack on loss selectivity is valid only if consolidated gain duplication is also limited. As I also note below, consolidated groups, as a practical matter, can eliminate most gain duplication that the regulations do not already limit. Any vestige that remains should not require a regulatory response.

288. See T.D. 8294, 1990-1 C.B. 66, 67-68 (stating that the loss selectivity rule "addresses another problem"); 1991-2 C.B. 43, 46 (also differentiating loss selectivity as a concern separate from the repeal); see also 1990-2 C.B. 696, 700 (noting commentators' assertions that loss duplication was beyond the scope of the repeal); Lee A. Sheppard, *Federal Circuit Invalidates Loss Disallowance Rule*, 92 TAX NOTES 334, 340-41 (2001), 2001 TNT 136-3 (concluding that loss duplication was not a concern of the repeal).

289. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

property.²⁹⁰ Perhaps to counter the ploy, Treasury in *General Utilities* urged that a corporation recognized gain on its in-kind distribution of gain property. The Supreme Court, however, disagreed.²⁹¹

In 1954, Congress codified the Supreme Court's holding and also codified and expanded the regulatory non-recognition rule for liquidations.²⁹² Under the expanded rule, if a corporation liquidated within twelve months after adopting a plan of liquidation, it generally recognized no gain or loss on asset sales during that twelve-month (or shorter) period.²⁹³ Although the rule was intended to provide more certain tax results for liquidations and related asset sales,²⁹⁴ it also limited loss selectivity. Before the change, a corporation could sell its loss property and recognize loss, but distribute its gain property in

290. *Callanan Rd. Improvement Co. v. Comm'r*, 12 B.T.A. 1109 (1928), *acq.* VII-2 C.B. 7 (concluding that a corporation recognized loss when it declared a distribution of a stated dollar amount, which it satisfied with loss property); *see also* *Bacon-McMillan Veneer Co. v. Comm'r*, 20 B.T.A. 556 (1930) (concluding that a corporation recognized gain when it declared a distribution of a stated dollar amount, which it satisfied with appreciated property); *cf.* *First Utah Sav. Bank v. Comm'r*, 17 B.T.A. 804, 810-11 (1929), *aff'd*, *First Sav. Bank of Ogden v. Burnet*, 53 F.2d 919, 920-21 (D.C. Cir. 1931) (concluding that a corporation recognized no gain or loss when it made an in-kind distribution of property, because the in-kind distribution was not a sale or other disposition).

291. *Gen. Utilities*, 296 U.S. at 206 (noting that the distribution was not a sale or exchange).

292. Internal Revenue Code of 1954, Pub. L. No. 83-591, §§ 311(a), 337(a), 68A Stat. 95, 106 [hereinafter 1954 Code]. Applicable legislative history appeared to preserve the distinction between in-kind distributions and stated-dollar distributions satisfied with non-cash property. *See* S. REP. NO. 83-1622, at 247 (providing that a "distribution of property made to a shareholder in his capacity as a creditor of the distributing corporation is not within the [non-recognition] rule of" I.R.C. § 311(a)); H.R. REP. NO. 83-1337, at A90 (1954) (to the same effect); *see also* Jasper L. Cummings, *Discontinuities in Corporate Recognition of Loss*, 44 TAX LAW. 39, 48-49 (1990) (noting that the 1954 Code preserved the distinction but that in an appropriate case when a stated-dollar distribution was satisfied with non-cash property, it could be treated in substance as an in-kind distribution).

Beginning in 1919, Treasury provided by regulation that a corporation generally recognized no gain or loss on a liquidating distribution. *See* § 39.22(a)-20 of Reg. 118 (1953); § 29.22(a)-20 of Reg. 111 (1943); § 19.22(a)-21 of Reg. 103 (1940); Art. 22(a)-21 of Regs. 101 (1939), 94 (1936), and 86 (1935); Art. 71 of Regs. 77 (1933) and 74 (1929); Art. 548 of Regs. 69 (1926), 65 (1924), and 62 (1922); Art. 547 of Reg. 45 (1919). Although *General Utilities* dealt with in-kind, non-liquidating distributions, the doctrine bearing its name stood for the following broader proposition: A corporation recognized no gain or loss on liquidating and non-liquidating distributions.

293. *See* 1954 Code, *supra* note 292, at § 337, 68A Stat. 106-07 (providing that the special rule generally did not apply to § 332 or § 333 liquidations or to certain types of property).

294. *See* S. REP. NO. 83-1622, at 258 (providing the rule to eliminate the uncertain tax results under prior law); H.R. REP. NO. 83-1337, at A106 (1954) (also justifying the rule to eliminate a "trap for the unwary"). *Compare* *Comm'r v. Court Holding Co.*, 324 U.S. 451 (1945) (treating an asset sale in form made by a corporation's shareholders as made by the corporation), *with* *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 341 (1950) (under similar facts, respecting the form of the sale).

liquidation and avoid gain. With the change, the liquidating corporation recognized loss on an asset sale only if it sold the asset before it adopted the liquidation plan or liquidated more than twelve months after the plan's adoption.

Even this lingering selective-loss recognition troubled Treasury,²⁹⁵ illustrating that the *General Utilities* doctrine would likely raise loss-selectivity concerns no matter how it was refined.²⁹⁶ Not surprisingly, then, as Congress repealed the doctrine, it addressed loss selectivity.

In the repeal's first phase, which began in 1969, Congress required that a corporation recognize gain on some non-liquidating distributions of appreciated property.²⁹⁷ It reasoned that "a corporation should [not] be permitted to avoid tax on any appreciated property" through a non-liquidating distribution.²⁹⁸ Without explanation, Congress continued to disallow loss on a non-liquidating distribution of loss property, a disallowance it likely justified, at least in part, to curb loss selectivity.²⁹⁹

295. Treasury fought this loss selectivity but was rebuffed and eventually retreated. Compare *City Bank of Wash. v. Comm'r*, 38 T.C. 713, 721-22 (1962) (in which Treasury argued that a corporation recognized no loss on an asset sale because it occurred after an "informal" liquidation plan was adopted; in rejecting Treasury's argument, the court looked to the date of the formal plan, reasoning that I.R.C. § 337 was intended to add certainty), with Rev. Rul. 77-150, 1977-1 C.B. 88 (concluding that I.R.C. § 337 did not apply to limit a corporation's loss on a sale of assets after the corporation adopted a liquidation plan, because the corporation finally liquidated more than 12 months after the plan was adopted; the IRS reasoned that I.R.C. § 337 "was designed to operate in a mechanical fashion so that uncertainty would be eliminated in liquidations thereunder"); see also *Virginia Ice & Freezing Corp. v. Comm'r*, 30 T.C. 1251, 1256-58 (1958) (looking to the date that the formal plan of liquidation was adopted).

296. See, e.g., Green Book, *supra* note 281, at 44 (justifying the repeal in part because of a "mirror" transaction, which involved loss selectivity); *id.* at 42-44 (noting how the *General Utilities* doctrine spawned tax avoidance schemes that "required complex statutory and judicial responses").

297. Tax Reform Act of 1969, Pub. L. No. 91-172, § 905, 83 Stat. 713-14 (1969) (adding I.R.C. § 311(d)).

298. S. REP. NO. 91-552, at 279 (1969).

299. If Congress had not continued the disallowance, a corporation could selectively recognize loss by distributing loss property and retaining gain property. See George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 573, 623 (1987) (stating that non-recognition might be appropriate to curb loss selectivity).

Congress might also have worried that allowing loss would entice some corporations and shareholders to understate the value of distributed property. The understatement could benefit both corporations and shareholders, increasing (or producing) corporation-level loss while reducing shareholder-level income. Note, however, that the gain-recognition rule offers a similar lure, since an understatement would reduce income or gain at both levels.

Finally, loss non-recognition could offer a collateral administrative benefit—helping to value distributed property. Because a corporation could always sell loss property and recognize loss, it would give up that potential tax benefit by distributing such property. Thus, a corporation might hesitate to distribute loss property, giving the IRS evidence against a shareholder's claim that distributed property was worth

In 1986, Congress sounded the death knell for the *General Utilities* doctrine, requiring a corporation generally to recognize gain on its liquidating or non-liquidating distribution of appreciated property.³⁰⁰ Although a liquidating corporation could also generally recognize loss, Congress expanded loss disallowance from a mere refrain to a resounding chorus. It disallowed a corporation's loss not only for non-liquidating distributions but also for distributions that were part of a:

- (i) Parent-subsidiary liquidation;³⁰¹
- (ii) § 355 transaction;³⁰²
- (iii) Reorganization exchange;³⁰³ and
- (iv) § 351 exchange.³⁰⁴

Congress did not explain why it expanded loss disallowance, but each expansion likely arose in part to address loss-selectivity concerns.³⁰⁵

Thus, those concerns were closely allied with the repeal of the *General Utilities* doctrine, arguably justifying Treasury's attack on

less than the corporation's basis in the property.

300. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2269-75 (1987). Congress retained the general non-recognition rule for parent-subsidiary liquidations and for § 355 distributions; I.R.C. § 337(a) (providing that an affiliated subsidiary recognizes no gain or loss on any liquidating distribution to the parent); *id.* § 355(a) (providing that a corporation recognizes no gain or loss on a qualified distribution of subsidiary stock).

301. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2269-75 (1987) (providing that in a § 332 liquidation, the subsidiary recognized no gain or loss on distributions to its affiliated parent (I.R.C. § 337(a)) and that it recognized gain but not loss on distributions to other shareholders (§ 336(a) and (d)(3))); see also *id.* at 2271 (providing in I.R.C. § 337(b)(1) that a subsidiary recognized no gain or loss when it satisfied its debt to its affiliated parent as part of a § 332 liquidation; because the parent took transferred bases in the subsidiary assets, that gain or loss was preserved); *id.* at 2269-70 (adding I.R.C. § 336(d)(1) and (2), which sometimes disallowed a liquidating corporation's loss on distributions to related persons or on distributions of recently contributed property).

302. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1018(d)(5)(C), 102 Stat. 3580 (1988) (adding I.R.C. § 355(c) to provide that a corporation recognized gain but not loss on its distribution of non-qualified property as part of a § 355 distribution).

303. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(g)(1), 100 Stat. 2806 (adding I.R.C. § 361(c) to provide that a corporation recognized gain but not loss on its distribution of non-qualified property under a plan of reorganization); see also Technical and Miscellaneous Revenue Act, § 1018(d)(5)(A) (amending I.R.C. § 361(c)).

304. Technical and Miscellaneous Revenue Act, § 1018(d)(5)(G) (amending I.R.C. § 351(f) to provide that the controlled corporation recognized gain but not loss on its distribution of non-qualified property in a § 351 exchange).

305. See *supra* note 299 (for the loss selectivity and other concerns that may have motivated many of those changes). But see Yin, *supra* note 299, at 623-24 (arguing that gain and loss should be recognized on distributions to minority shareholders in a § 332 liquidation, because gain or loss generally is recognized for non-§ 332 liquidations).

consolidated loss selectivity. Critics countered that a targeted consolidated response was improper, because consolidated and non-consolidated groups shared the same concern: Either could recognize duplicated loss in subsidiary stock but avoid duplicated gain by selling subsidiary assets.³⁰⁶

However, consolidated groups raise a distinct concern that merits a targeted response, not only because a consolidated response helps avoid tracing under LDR, but also for at least two other reasons. First, the investment adjustment and other "single-entity" rules limit gain and loss duplication systematically for just consolidated groups. The investment adjustment rule prevents duplication for a subsidiary's tax items that the group takes into account.³⁰⁷ LDR limits duplication of subsidiary built-in gain.³⁰⁸ Both rules are complemented by a consolidated response to loss selectivity, because the response limits duplication of subsidiary built-in loss.

Second, without any restriction, a consolidated group seems more likely to recognize a duplicated stock loss. That loss could offset the entire group's capital gain,³⁰⁹ not just the selling's member's as it would for a non-consolidated group. Because a consolidated group would more likely believe that it could use a duplicated stock loss, it would more freely recognize the loss, warranting a targeted consolidated response.

A consolidated response should also promote tax neutrality, although a group's acquisition of a new member may not be tax-neutral with or without the response. The response might deter such acquisitions, since it could limit any later stock loss. That danger

306. See, e.g., 1990-2 C.B. 696, 700; *McBurney*, *supra* note 203. Either group could also sell subsidiary stock but be deemed to sell subsidiary assets by joining in a § 338(h)(10) election for the sale. See *supra* Part III.C.2.a (for **EXAMPLE 9**, which illustrates the loss-selectivity concern). Note that Treasury first allowed non-consolidated groups to make those elections in 1994, an allowance that made loss selectivity more likely for non-consolidated groups. See T.D. 8515, 1994-1 C.B. 89, 115, 59 Fed. Reg. 2958, 2982 (Jan. 20, 1994) (providing for this election for the sale of a non-consolidated subsidiary).

307. See *supra* note 19 and accompanying text. Because a non-consolidated group's basis in subsidiary stock is not adjusted to account for the subsidiary's tax items, such a group is more likely to duplicate gain and (particularly) loss in subsidiary stock. Cf. I.R.C. § 243(a)(3), (b) (providing a 100% dividends received deduction for distributions between members of an affiliated group if paid out of affiliated earnings and profits).

308. A consolidated group can offset that amount with a stock-basis increase for any pre-affiliation built-in gain that the subsidiary recognizes. See *supra* note 178 and accompanying text.

309. See Treas. Reg. § 1.1502-22(a) (2003) (providing that the group takes its capital gain and loss into account like a single entity). The text assumes, as is likely, that the stock loss will be capital. A corporation's capital loss can offset only capital gain. I.R.C. § 1211(a) (2003).

would be greater for a risky investment, where a later stock loss would be more likely, but even if such an investment turned sour, a group could still typically recognize loss by selling the subsidiary's assets.³¹⁰ On the other hand, without a consolidated response, a group could have a tax incentive to make the risky investment, since it could recognize any later stock loss but, as *Rite Aid* shows, also receive an economic benefit for any inside asset loss.³¹¹ Thus, with or without a consolidated response, the regulations might not be tax neutral for a group's acquisition of a new member.

However, a consolidated response should promote tax neutrality in a group's choice to form a subsidiary or transfer assets to a subsidiary. Without the response, a group might take either step to duplicate loss, even if the step did not otherwise make sound business sense.³¹² Because the response should neither deter nor encourage either step, tax neutrality, on balance, should favor the response.³¹³

Thus, the Code changes related to the repeal of the *General Utilities* doctrine support a targeted consolidated response to loss selectivity. The response would complement the investment adjustment and

310. See *infra* notes 350-51 and accompanying text (describing how the group may recognize asset loss). Note that the subsidiary's net asset loss could be less than the group's stock loss if, for example, the subsidiary had built-in gain when acquired. If the group's loss is limited to the subsidiary's asset loss, the group in effect must take the subsidiary's built-in gain into account, a result arguably supported by the repeal of the *General Utilities* doctrine.

311. See *supra* note 193; see also H.R. REP. NO. 100-391, at 1082 (1987) (stating that a principal purpose of the *General Utilities* doctrine was to eliminate tax biases favoring dispositions).

312. The IRS may argue that I.R.C. § 351 does not apply to any such asset transfer (so that the loss was not duplicated) if the transfer did not have a significant non-tax business purpose. See Notice 2001-17, 2001-9 I.R.B. 730; F.S.A. 1999-05-008 (Feb. 8, 1999) (both asserting that I.R.C. § 351 may not apply if an exchange lacks a non-tax business purpose). However, it is not altogether clear absent a legislative or regulatory change that I.R.C. § 351 has an independent business-purpose requirement. See, e.g., Treas. Reg. § 1.351-1(a)(1)(ii) (2003) (providing, among other things, that the "primary" purpose of an accommodation transfer must be to qualify others under I.R.C. § 351; that requirement might be unnecessary if I.R.C. § 351 had a business-purpose requirement). But cf. *Caruth v. United States*, 688 F. Supp. 1129, 1140 (N.D. Tex. 1987), *aff'd on another issue*, 865 F.2d 644 (5th Cir. 1989) (concluding that I.R.C. § 351 has a business-purpose requirement that parallels the requirement for § 368 reorganizations; it based that conclusion, in part, on the close historical relationship between the operative provisions; the court nonetheless concluded that I.R.C. § 351 applied because the exchange had a modest non-tax business purpose); see also *Stewart v. Comm'r*, 714 F.2d 977, 992 (9th Cir. 1983) (treating a corporation as the conduit for its shareholder when the shareholder contributed property to the corporation that the corporation quickly sold; there was no non-tax business purpose for the contribution); *Rollins v. Comm'r*, 66 T.C.M. (CCH) 1869 (1993) (applying the same theory); Rev. Rul. 55-36, 1955-1 C.B. 340 (recasting a transaction in part because it failed to meet a business purpose requirement).

313. As the case review in Part I.B.2 illustrates, a consolidated return regulation is unlikely to be invalidated if it is tax-neutral.

other "single-entity" rules of the consolidated return regulations and better promote tax neutrality.

e. Other Code changes

Instead of focusing on the repeal and related changes, however, some commentators point to other Code changes which, they argue, preclude any consolidated response to loss selectivity. Their arguments do not bear scrutiny.

They urge that Congress rejected a targeted consolidated response because of the Green Book,³¹⁴ which is an influential 1985 study by the Staff of the Senate Finance Committee that proposed radical surgery on Subchapter C of the Code.³¹⁵ Among other things, the Green Book recommended the following broad-based approach to loss duplication:

- (i) In a § 351 exchange, the transferring shareholder would take a fair market value basis in controlled corporation stock received in exchange for loss property;³¹⁶
- (ii) In a "qualified acquisition" of a target, a "controlling" corporate shareholder's basis in the target stock could not exceed the stock's fair market value;³¹⁷ and
- (iii) A "controlling" corporate shareholder would take a conforming stock basis in its controlled subsidiary.³¹⁸

The Green Book proposal, however, offers no help in a debate about Treasury's authority to address loss selectivity for consolidated groups. Because it differs so dramatically from the regime actually adopted, it implies next to nothing about what Congress intended when it implemented the actual regime. At most, by not adopting the proposal, Congress implicitly rejected a broad-based solution to loss duplication. Its rejection should have no bearing on any target

314. See Salem I, *supra* note 4, at 211; see also Salem III, *supra* note 178, at 1111-12 n.5 (referring to suggested legislative proposals by the Staff of the Senate Finance Committee found in the Green Book); Irving Salem & Richard Bress, *Agency Deference Under the Judicial Microscope of the Supreme Court*, 88 TAX NOTES 1257, 1258 n.3 (2000) (referring to the Green Book proposal).

315. Salem I, *supra* note 4, at 211; see also Green Book, *supra* note 281.

316. Green Book, *supra* note 281, at 103-04 (proposing this basis step-down in § 358(a)(2)) and § 220 (explaining the proposal).

317. *Id.* at 104 (proposing § 358(c)) and § 221 (explaining the proposal). Broadly, a "qualified acquisition" was an acquisition of an affiliated interest in target stock or substantially all target assets within a 12-month period. *Id.* at 50, 112-17 (proposing § 364). A "controlling" corporate shareholder was a corporation that owned an affiliated interest in the target. *Id.* at 130, 132 (proposing § 366(c) and (g)). Note that the Green Book proposed to make the corporate-level consequences of qualified acquisitions explicitly elective. *Id.* at 51.

318. *Id.* at 160 (proposing § 1020) & 237-39 (describing the proposed change).

consolidated response to loss selectivity, since consolidated groups raise a unique loss-selectivity concern.³¹⁹

Commentators also point to I.R.C. § 336(d)(1) and (2) and I.R.C. § 382(g)(4)(D), two provisions in which Congress addressed loss duplication generally.³²⁰ They argue that Congress intended those provisions to be the exclusive response to loss duplication, preventing further action by Treasury.³²¹ The argument necessarily assumes that consolidated groups raise no unique loss-selectivity concerns. Because the assumption is wrong, the argument is flawed and §§ 336(d) and 382(g)(4)(D) should not limit Treasury's regulatory authority to target consolidated loss selectivity.

Moreover, both provisions treat a shareholder's stock loss and a corporation's asset loss as the "same" economic loss.³²² In that way, the provisions apply a kind of single-entity approach, often in a classic separate-corporation setting. It seems fanciful to suggest that by extending the single-entity approach to those cases, Congress thereby limited Treasury's authority to treat duplicated losses as the same loss in a classic single-entity setting like consolidation.³²³ Accordingly, neither § 336(d) nor § 382(g)(4)(D) should limit Treasury's regulatory authority to target consolidated loss selectivity.³²⁴

In fact, the provisions probably expand Treasury's authority. With § 336(d) and other related provisions, Congress labeled at least some duplicated loss as inappropriate.³²⁵ However, it was concerned that it

319. See *supra* notes 307-09 and accompanying text (for why consolidated groups raise a unique concern); cf. Green Book, *supra* note 281, at 237 (introducing the proposed conforming-basis rule and noting that consolidated groups already had a conforming-basis rule (*i.e.*, the investment adjustment rule)).

320. See Salem I, *supra* note 4, at 210. Section 336(d)(1) and (2) sometimes disallow a loss that a liquidating corporation otherwise would recognize on a distribution to a majority shareholder or a distribution of recently contributed property. Section 382(g)(4)(D) limits a corporation's use of its loss attributes after a majority shareholder treats the corporation's stock as becoming worthless.

321. See Salem I, *supra* note 4, at 211.

322. See H.R. REP. NO. 100-391, at 1096 (1987) (justifying § 382(g)(4)(D) to limit the deduction of the "same" economic loss).

323. The suggestion finds no support in any Code language or legislative history.

324. That authority is also not limited by I.R.C. § 382 generally, because that section addresses loss trafficking, a different concern. In any case, courts have permitted the consolidated return regulations to supplement a loss limitation rule like I.R.C. § 269 or I.R.C. § 382. See *supra* note 90 (for applicable cites).

Further, despite commentators' assertions (*see, e.g.*, 1990-2 C.B. 696, 700), I.R.C. § 382, by itself, insufficiently responds to loss duplication. It does not apply to every loss-duplication case, and even when it applies, it may permit too ready a use of the duplicate asset loss. See *id.* at 701 (making these points); cf. I.R.C. § 382(h)(6)(B) (2003) (providing that a deduction may be treated as a built-in loss but Treasury has not issued regulations describing how this provision should operate).

325. The legislative history supporting I.R.C. § 336(d) stated that:

The conferees are concerned that taxpayers may utilize various means to avoid the repeal of the *General Utilities* doctrine, or otherwise take advantage

could not identify all schemes in which loss was inappropriately recognized, so it gave Treasury broad authority to attack those schemes.³²⁶ Therefore, with § 336(d) and related provisions, Congress arguably broadened Treasury's authority to attack loss duplication.

As a final point, a commentator argues that Congress implicitly preempted Treasury's authority to adopt a consolidated loss disallowance rule by enacting the following Code provisions: I.R.C. §§ 304(b)(4), 1059(e)(2)(B), and 1503(e)(1) and (4).³²⁷ Each provision was passed shortly after the 1986 repeal of the *General Utilities* doctrine, and each could affect a consolidated group's gain or loss on its disposition of subsidiary stock.³²⁸ The commentator insists that Congress would not

of the new provisions, to recognize losses in inappropriate situations or inflate the amount of losses actually sustained.

H.R. REP. NO. 99-841, at II-200 (1986).

326. See I.R.C. § 337(d); see also H.R. REP. NO. 99-841, at II-204 (1986) (explaining that § 337(d) gave Treasury broad authority to prevent circumvention of the repeal "through the use of any provision, including the consolidated return regulations").

327. See Salem I, *supra* note 4, at 211.

328. For the most part, these provisions attacked specific "artificial-gain" transactions (*i.e.*, transactions that eliminated gain (or created loss) at the corporate level). For example, § 304(b)(4) attacked a potential mirror transaction that involved § 304. See Lawrence M. Axelrod, *Section 304, Excess Loss Accounts, and Other Consolidated Return Gallimaufry*, 36 TAX NOTES 729, 729-30 (1987) (for a description of the transaction).

Section 1059(e)(2)(B) refined § 1059, a section that was introduced in 1984 and addressed transactions in which a corporate shareholder purchased target stock, received an anticipated dividend on the stock, and promptly sold the stock, recognizing a non-economic loss. See H.R. REP. NO. 432, 98th Cong., 2d Sess. 1185-86 (1983) (discussing a dividend-stripping transaction). Section 1059 reduced the chance that a dividend distribution would artificially eliminate gain (or create loss) in subsidiary stock.

Note that § 1059(e)(2)(B) provided that § 1059 could apply to certain qualifying dividends (defined in § 243(b)). Although § 1059(e)(2)(B) did not literally apply to dividends between consolidated group members, legislative history extended its principles to those dividends. See H.R. REP. NO. 100-795, at 42-44 (1988); S. REP. NO. 100-445, at 43-44 (1988); *cf.* Treas. Reg. § 1.1502-14(a)(1) (1988) (eliminating dividends between consolidated group members; thus, those dividends could not be qualifying dividends and § 1059(e)(2)(B) could not literally apply to them).

Section 1503(e)(1) addressed an artificial-gain transaction highlighted by *Woods Inv. Co. v. Comm'r*, 85 T.C. 274 (1985), *acq.* 1986-2 C.B. 1. In *Woods*, the Tax Court applied the applicable investment adjustment rule literally, concluding that a subsidiary's tax depreciation deduction could exceed the consolidated group's corresponding reduction in its subsidiary stock basis. *Id.* at 282. Consequently, the group could artificially eliminate gain (or create loss) in its subsidiary stock. See H.R. REP. NO. 100-495, at 960 (1987); H.R. REP. NO. 100-391, at 1088 (1987). Section 1503(e)(1) was intended to prevent that result by requiring the stock basis reduction to equal the depreciation deduction.

Addressing a different type of concern, § 1503(e)(4) prevented a consolidated group from reducing its basis in subsidiary debt to avoid including any portion of an ELA in subsidiary stock in gross income. Congress believed that "it [was] not appropriate to permit deferral of gain recognition by shifting the recapture liability [for the ELA] to a debt instrument." H.R. REP. NO. 101-247, at 1234 (1989).

have adopted the provisions if it believed that Treasury had the authority to prescribe a broad loss disallowance rule.³²⁹

This argument falls short, particularly as it relates to Treasury's authority to target consolidated loss selectivity, since none of the noted Code provisions dealt with a loss-selectivity concern, expressly or impliedly. Instead, they attacked transactions under which a corporation artificially eliminated (or deferred) gain.

Perhaps, the provisions implicitly restricted Treasury's authority to attack artificial-gain transactions, but even that conclusion seems doubtful. The provisions responded to specific transactions, and Congress never suggested that its patchwork response somehow limited Treasury's authority to attack similar transactions.³³⁰

Even reading the response broadly, it did not denote a seismic shift in how rules for consolidated groups should be crafted. Since 1928, Congress has looked to Treasury to develop the consolidated rules,³³¹ only occasionally adding its voice.³³² Consistent with that long-established practice, Treasury should have authority in consolidated return regulations to target loss selectivity and more generally loss duplication.

D. A Reasonable Rule

Although Treasury has regulatory authority both to disallow a consolidated group's loss on subsidiary stock and to address loss duplication, it must exercise that authority reasonably. Treasury should meet this requirement for any regulation that is consistent with the relevant Code provisions³³³ and applies those provisions rationally. LDR's loss duplication rule met both of those standards.

329. See Salem I, *supra* note 4, at 211 (stating "[d]oes it make sense for Congress to have labored so hard to handcraft these complicated provisions potentially affecting losses by members filing a consolidated return if it believed [that the] IRS could or would adopt a blanket (or near blanket) loss disallowance rule? Certainly not.").

330. If anything, the Code expands Treasury's authority to attack artificial-gain transactions (e.g., newly created mirror transactions). See § 337(d) (giving Treasury broad authority to implement the repeal of the *General Utilities* doctrine); see also H.R. REP. NO. 100-495, at 970 (1987) (stating that "[n]o inference is intended as to the Treasury Department's authority to amend the consolidated return regulations consistent with the purposes of [§ 304(b)(4)]"); H.R. REP. NO. 100-495, at 962 (1986) (in discussing § 1503(e)(1), stating that "[t]here is no intention, however, to preclude the Treasury Department from accomplishing this result directly, by requiring a member to increase its earnings and profits without regard to basis adjustments").

331. S. REP. NO. 70-760, at 15 (1928) (justifying the broad delegation of regulatory authority because it was "impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations").

332. See *supra* note 29 (for applicable Code provisions).

333. See *supra* note 33 and accompanying text.

1. *Consistency with the Code*

For reasons aired at length above, the loss duplication rule was consistent with relevant Code provisions and principles. In attacking "classic" loss duplication, the rule followed longstanding Supreme Court precedent,³³⁴ and in attacking consolidated loss selectivity, it was consistent with (if not mandated by) the repeal of the *General Utilities* doctrine.³³⁵ Moreover, the rule deserved added weight, because it promptly responded to the repeal.³³⁶ Thus, the rule met the first standard for a reasonable regulation.

2. *Rational application*

LDR's loss duplication rule also met the second standard (*i.e.*, it applied the relevant Code provisions rationally). A regulation may meet this standard even if it fails to adopt the best possible approach³³⁷ or produces inequitable outcomes in some circumstances.³³⁸ Thus, Treasury often has great flexibility to craft a "rational" regulation.

Despite that flexibility, Treasury arguably had to attack loss duplication by eliminating the subsidiary's duplicate built-in asset loss, rather than by disallowing the group's subsidiary stock loss. Eliminating the asset loss arguably would better promote single-entity treatment, as the loss duplication rule is intended to do.³³⁹ That approach would also follow how Congress and Treasury chose to curb loss trafficking.³⁴⁰ Finally, the approach might be fairer than

334. See *supra* Part III.C.1 (discussing "classic" loss duplication).

335. See *supra* Part III.C.2 (discussing loss selectivity and the repeal of the *General Utilities* doctrine).

336. Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979) (stating that a factor in testing a regulation's reasonableness was whether it was a substantially contemporaneous interpretation of the statute); *cf.* Salem I, *supra* note 4, at 212 (arguing that the response was not contemporaneous because it was unrelated to the repeal of the *General Utilities* doctrine).

337. See *supra* note 35 (for relevant cites that a regulation need not adopt the best possible approach); see also *Georgia-Pac. Corp. v. Comm'r*, 63 T.C. 790, 803 (1975) (considering the investment adjustment rule and concluding that Treasury has discretion to choose among reasonable alternatives).

338. See *supra* note 45 (for relevant cites).

339. 1990-2 C.B. 700 (noting the general policy shift in favor of single-entity treatment); see Salem I, *supra* note 4, at 212-13 (noting that a pure single-entity approach would require the asset loss to be recognized by the consolidated group).

340. See Silverman & Zarlenga, *supra* note 4, at 468-69 (noting that historically, Congress and Treasury has limited the use of a loss corporation's attributes, citing to I.R.C. §§ 269, 382, 383(b), and 384).

Note, however, that loss duplication arises in different contexts and raises different concerns than loss trafficking. The loss trafficking rules are aimed at making sales of loss corporations more tax-neutral. See H.R. REP. NO. 99-841, at II-188 (1986) (using this reason to justify why § 382 uses a rate lower than the long-term Federal rate). A loss-duplication rule might share that goal but should have a broader reach. It

disallowing stock loss. If stock loss were disallowed, it might mean that no portion of the duplicated loss could be deducted, since the corresponding asset loss could practically be disallowed by I.R.C. § 382.³⁴¹

a. Subsidiary remains in the group

These arguments have little appeal when a consolidated group sells subsidiary stock but the subsidiary remains in the group. Then, the group's sale is unlikely to implicate § 382 (or other loss-trafficking rules),³⁴² so that the group can likely still take any subsidiary asset loss into account, consistent with a single-entity approach. Further, if Treasury disallowed the asset loss rather than the stock loss, it would fail to address another significant concern—the group's acceleration of loss in the “classic” loss-duplication transaction.

EXAMPLE 10—LOSS ACCELERATION³⁴³

P and S form T, with P transferring \$100 cash for T's common stock and S transferring land with a \$50 basis and \$10 value for T stock described in I.R.C. § 1504(a)(4) (but not in I.R.C. § 351(g)). P and S take \$100 and \$50 exchanged bases in the T stock, and T takes

should also promote tax neutrality for the transfer of assets between subsidiaries, protect against an artificial acceleration of loss (*e.g.*, in the “classic” loss duplication transaction) and, arguably, further the repeal of the *General Utilities* doctrine. See *supra* notes 284-85 and accompanying text (for why the repeal should support an attack on loss duplication).

341. See, *e.g.*, Axelrod, *supra* note 4, at 814-15 (arguing that because of I.R.C. § 382, no one may take the loss into account, instead of the loss being taking into account twice).

The Federal Circuit apparently raised another concern in oral argument, posing the following hypothetical to government counsel:

Would all benefit from an economic loss be eliminated if (i) a consolidated group sold subsidiary stock at a loss, (ii) the loss was disallowed as a duplicated loss, (iii) the duplicated-loss assets appreciated in value, eliminating their built-in loss, and (iv) the buyer sold the subsidiary stock?

See Sheppard, *supra* note 288, at 336; see also Sykes, *supra* note 221, at 473 (posing a similar hypothetical). The answer is no, because the subsidiary would eventually benefit from the built-in asset loss by selling the assets at a reduced gain, a reduction in no way limited by § 382. See Sheppard, *supra* note 288, at 336 (making a similar point).

Apparently, the government botched the answer in oral argument and sent the court a letter explaining its answer. *Id.* at 336-37. That unusual step may have irked the court, perhaps contributing to the government's loss in *Rite Aid*.

342. Section 382 applies when a loss corporation undergoes an ownership change, which broadly occurs upon a disposition of fifty percent of the loss corporation's stock over a three-year period. See I.R.C. § 382(g)(1) (2003). In measuring this change, stock described in I.R.C. § 1504(a)(4) (*i.e.*, non-convertible, non-voting preferred stock) is disregarded. I.R.C. § 382(k)(6)(A) (2003). Note that in the “classic” loss duplication transaction, a consolidated group is likely to sell subsidiary stock described in § 1502(a)(4).

343. **EXAMPLE 10** is essentially the same as **EXAMPLE 7**. See *supra* Part III.C.2.a. For a justification of the tax consequences in this example, see **EXAMPLE 7**.

a \$50 transferred basis in the land. P, S, and T join in filing consolidated returns.

In an unrelated transaction but before the group sells the land, S sells its T preferred stock for \$10, recognizing a \$40 loss.³⁴⁴ Unless the stock loss is disallowed, the P group accelerates its \$40 loss through S's asset contribution and stock sale. Further, the P group can duplicate the loss when S later sells the land.

By disallowing stock loss, LDR's loss duplication rule rationally addresses concerns with both loss duplication and loss acceleration when the subsidiary remains in the group.

The loss duplication rule applies rationally, even though it may eliminate the benefit of a cost-basis purchase of subsidiary stock, a consolidated benefit that Treasury (and Congress) had taken care generally to preserve before LDR.³⁴⁵ Congress disregarded that benefit in an analogous situation when it enacted I.R.C. § 358(h).³⁴⁶ Like LDR's loss duplication rule, that provision was intended to prevent loss acceleration and duplication.³⁴⁷ Because Congress

344. T remains a P group member, because the preferred stock is not counted in measuring affiliation, and the sale does not implicate § 382, because the stock sold is § 1504(a)(4) stock.

345. In **EXAMPLE 10**, if T later sold the land and recognized a \$40 loss, P would take a reduced basis in its T stock to account for T's loss. Treas. Reg. § 1.1502-32(b)(2)(i). However, the reduction would not affect the P group if it retained its T stock or liquidated T. See I.R.C. § 332(a) (providing broadly that a parent recognizes no gain or loss on the liquidation of an affiliated subsidiary). Note that Treasury might have added a supplemental rule that would have limited the \$40 negative adjustment on P's T stock when T sold the land, but such a rule would have required administratively complex tracing.

346. See Community Renewal Tax Act of 2000, Pub. L. No. 106-554, § 309 (Appendix G), 114 Stat. 2763A-638 (2000) (requiring a basis reduction, in certain cases, to account for § 357(c)(3) liabilities assumed as part of a § 351 exchange). The next footnote describes a situation in which § 358(h) should apply.

347. The Senate used the following example to help justify § 358(h):

As one example of a transaction that concerns the Committee, a transferor corporation may transfer assets with a fair market value basis . . . in exchange for preferred stock of the transferee corporation, plus the transferee's assumption of a contingent liability that is deductible in the future, but capable of current valuation. The transferor claims a high basis for the stock of the transferee held with respect to this transfer, because the basis of the assets is taken into account, while the taxpayer contends that the assumed liability does not reduce stock basis under current law. [See I.R.C. § 357(d)(2).] However, the value of the transferee stock in the hands of the transferor is nominal, because of the liability that offsets virtually all the value of the assets. The transferor may then attempt to *accelerate* the deduction that would be attributable to the liability, by selling or exchanging the transferee stock at a loss. Furthermore, the transferee (which may still be a member of the consolidated group filing a tax return with the transferor) might take the position that it is entitled to deduct the payments on the liability, *effectively duplicating* the deduction attributable to the liability.

S. REP. NO. 106-120, at 214-15 (1999) (emphasis added); see also Notice 2001-17, 2001-9 I.R.B. 730 (in which the IRS discussed how it may attack this "contingent liability")

disregarded the benefit of a cost-basis purchase in enacting § 358(h),³⁴⁸ Treasury should be able to do so as well in crafting a loss duplication rule.

b. Subsidiary leaves the group

Such a rule also applies rationally when a consolidated group sells subsidiary stock but the subsidiary leaves the group. Although the rule could be challenged because it might preserve an unusable asset loss while disallowing the duplicate stock loss,³⁴⁹ the challenge should fall short for at least three reasons. First, it improperly discounts a group's likely option to recognize the asset loss as part of the subsidiary's sale. Second, it dismisses legitimate administrative concerns with eliminating the asset loss. Finally, it disregards Congress's telling silence on LDR's loss duplication rule.

Typically, when a consolidated group sells a subsidiary with duplicated loss, it can recognize the duplicate asset loss by:

- (i) Selling the subsidiary assets instead of the subsidiary stock;
- (ii) Selling the subsidiary stock and making a § 338(h)(10) election with the buyer;³⁵⁰ or

transaction).

348. Congress never suggested that the benefit should be protected when it enacted § 358(h), even though it might be easier to trace § 357(c)(3) liabilities than built-in asset losses.

349. See *supra* notes 339-41 and accompanying text (for this argument and related arguments).

350. See **EXAMPLE 8**, *supra* Part III.C.2.a (discussing the tax consequences of an asset sale or a stock sale with a § 338(h)(10) election). Although LDR's loss duplication rule may increase the utility of a § 338(h)(10) election, it does not eliminate the election's benefit, as some have suggested. See Axelrod, *supra* note 4, at 813-14 (making this suggestion but focusing on the different treatment of consolidated and non-consolidated groups because of LDR). By making the election, a group can still sell subsidiary stock but treat the transaction as if the subsidiary sold its assets and liquidated.

Making a tangentially related point, Rite Aid asserted that when a group sold the stock of a subsidiary with a duplicated loss, LDR's loss duplication rule could practically compel it to make a § 338(h)(10) election to recognize the asset loss. See Brief for Appellant, *Rite Aid Corp. v. United States*, 255 F.3d 1357, at ¶¶ 25 and 68 (Fed. Cir. 2001) (No. 00-5098). Rite Aid argued that the compulsion negated § 338(h)(10)'s elective feature, but its argument was misguided for several reasons. First, a group could recognize asset loss without making the election. See *infra* note 351 and accompanying text. Second, the loss duplication rule would not practically compel a § 338(h)(10) election for most qualified subsidiary stock sales, only for *some* in which the rule would otherwise limit the group's stock loss. Finally, Rite Aid misconstrued the essential nature of a tax election. It is almost always true that one elective choice is more favorable than another, but that characteristic does not negate the elective feature of either choice.

(iii) Selling the subsidiary stock without making a § 338(h)(10) election but also selling or distributing loss assets before the stock sale.³⁵¹

LDR's loss duplication rule invites groups to sell (or distribute) assets to avoid disallowed stock loss, much as the Code repeatedly invites corporations to sell rather than distribute loss assets.³⁵² Although there may be a few instances where a group has no real option to recognize the asset loss,³⁵³ a rule may apply rationally even if it produces inequitable results in scattered cases.

In any event, it seems better to disallow stock loss than to eliminate asset loss, since the latter approach could not only be unfair but would also raise greater administrative concerns.³⁵⁴ Under the latter

351. If the subsidiary distributes loss assets in connection with the sale, the loss will be recognized and deferred on the distribution but taken into account on the sale. *See* Treas. Reg. § 1.1502-13(f)(2)(iii) (2003) (providing that for intercompany distributions, the principles of I.R.C. § 311(b) apply to loss as well as gain); Treas. Reg. § 1.1502-13(d)(1)(i) (discussing the timing of intercompany items under the acceleration rule); § 1.267(f)-1(c)(1) (providing that losses between controlled group members are taken into account under the timing principles of the matching and acceleration rules of § 1.1502-13); Treas. Reg. § 1.1502-13(f)(7) (2003), *Ex. 1(d)* (illustrating an intercompany distribution of loss property where the group later sells the distributed property, triggering the loss); Don Leatherman, *Current Developments for Consolidated Groups*, 486 PLI/tax 406-09 (2000) (discussing F.S.A. 2000-12-046).

If the subsidiary in substance sells a loss asset to an unrelated person, it can recognize the loss. *See* Treas. Reg. § 1.338-8(d)(2)(iv) (added by T.D. 8858, 2001 C.B. 333, 344, 65 Fed. Reg. 1236, 1246 (Jan. 7, 2000)) (providing that the § 338 asset-consistency rule does not apply to the sale of a loss asset); Treas. Reg. § 1.338-4(d)(2)(iv) (introduced by T.D. 8515, 1994-1 C.B. 89, 106, 59 Fed. Reg. 2958, 2973 (Jan. 20, 1994)) (to the same effect); § 1.338-4T(f)(5), A(i) (in force as of Jan. 1, 1991) (to the same effect).

In either case, if the subsidiary recognizes a loss that the group absorbs, the group will correspondingly reduce its subsidiary stock basis, eliminating any duplicate stock loss. § 1.1502-32(b)(2)(i) (providing negative adjustments for losses); § 1.1502-32(b)(3)(i) (providing that a loss is taken into account (i) when absorbed if it is not carried back or (ii) when it arises if it is carried back and absorbed).

352. *See* I.R.C. §§ 311, 336(d)(3), 351(f), 355(c), 361(c) (2003) (each disallowing loss on a corporation's distribution to its shareholder); *see also supra* notes 300-06 and accompanying text (for a discussion of these sections, each introduced in connection with the repeal of the *General Utilities* doctrine).

353. For example, a subsidiary stock sale may not qualify for a § 338(h)(10) election (*e.g.*, because the buyer is an individual or the group sells less than an affiliated interest in the subsidiary). Further, even if the sale qualifies, the election may be unwise for other reasons. *See, e.g.*, Salem I, *supra* note 4, at 209 n.27 (stating that a § 338(h)(10) election may be practically unavailable for a stock sale because of potentially adverse state tax consequences).

Note that although Rite Aid did not make a § 338(h)(10) election for its sale of Encore stock, the election could have been made if the buyer had joined in the election. The buyer refused to join in the election, perhaps because Rite Aid did not agree to a lower sales price. *See supra* note 159 (noting that it is unclear why the buyer refused to join in the election).

354. It seems rational to use administrative considerations to choose among otherwise reasonable alternatives. *See also* Salem I, *supra* note 4, at 214 (arguing that other aspects of LDR still raised administrative concerns); *cf.* Thomas D. Sykes, *Chevron Deference Not Due for Overbroad Loss Disallowance Rules*, 92 TAX NOTES 1609,

approach, a selling group would recognize duplicate stock loss but correspondingly reduce the basis of built-in loss assets of the disposed subsidiary.³⁵⁵ Presumably, the group would choose which asset bases it reduced,³⁵⁶ but it might need costly asset valuations to make the choice and would no doubt try to eliminate the least useful basis.³⁵⁷ The process would inevitably spark disputes with the IRS, adding deadweight cost.³⁵⁸ Further, because of the subjective nature of valuations (and the audit process), similarly situated groups could be treated differently.³⁵⁹ To avoid those concerns, Treasury sensibly disallowed stock loss rather than eliminating asset loss.³⁶⁰

Finally, Congress's silence on LDR's loss duplication rule seems noteworthy, given the avalanche of criticism the rule generated.³⁶¹ Despite the criticism, Congress left the rule intact, and it implicitly

1610 (2001) (arguing that a regulation cannot be based solely on administrative convenience and incorrectly implying that LDR was such a rule).

355. Under this rule, it should not reduce the subsidiary's basis in stock of a lower-tier subsidiary but instead should reduce the basis of the lower-tier subsidiary's assets, appropriately "tiering-up" the write-down. Special "tiering-up" rules could be required under Treas. Reg. § 1.1502-32 for a lower-tier subsidiary not wholly owned by the disposed subsidiary.

356. The group could instead reduce the bases of all relevant built-in loss assets proportionately, but that alternative would require the group to value every asset of the disposed subsidiary (and its lower-tier subsidiaries). The alternative should be dismissed because its required valuations would likely have an unwarranted cost.

357. Eliminating the least useful basis would reduce the present-value cost of the basis reduction. 1991-2 C.B. 43, 49 (preamble to the final LDR, noting that "it would be necessary to identify the extent to which the stock loss is attributable to particular assets with a basis in excess of value rather than to built-in gain assets or assets whose basis is unlikely to be recovered in the near term"). Note that a group could achieve a similar effect if the subsidiary sold or distributed the relevant loss asset to another member (although that option may be unavailable for non-tax reasons).

358. In contrast, a rule that shifted net operating loss (or loss carryovers) would not raise these concerns, and LDR permitted that loss "retribution." See *supra* note 164 and accompanying text (describing the retribution rule).

359. It is also likely that groups with greater resources could better exploit the process, raising vertical-equity concerns.

360. LDR's loss duplication rule also offered striking parallels to Treasury's 1929 loss-disallowance rule for liquidations. See *supra* notes 227-32 and accompanying text (for a discussion of the 1929 rule). Treasury supported both rules, in part, for administrative reasons and also justified the loss disallowance in both cases because it could generally be avoided through self-help. See *supra* note 232 (for a discussion of the 1929 rule); 1990-1 C.B. 71 and 1991-2 C.B. 49 (for discussions of the loss duplication rule). Treasury's approach in the 1929 rule should merit deference as a nearly contemporaneous application of the 1928 regulatory grant. Cf. *Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 477 (1979) (describing factors considered in testing the reasonableness of a regulation). Because the 1928 grant of regulatory authority is substantially the same as the current grant, Treasury's approach in the loss duplication rule has a solid historical base. See *supra* note 236 (for why the grants are substantially the same).

361. See *supra* note 4 (for cites related to that criticism).

endorsed the rule's approach when it enacted a related provision using a consistent scheme.³⁶²

For all of these reasons, LDR's loss duplication rule applied the Code rationally. It represented a valid and elegant solution to a difficult "consolidated" problem.

IV. BROADER IMPLICATIONS OF *RITE AID*

With *Rite Aid's* dearth of reasoning, it is difficult to predict how a future court will use the case. It may affect the model a court uses to test a consolidated return regulation, the deference it gives such a regulation, and its conclusion about the regulation's validity.

A. A Separate-Corporation Model

Rite Aid could be read to mandate use of a separate-corporation model to test any consolidated return regulation.³⁶³ That reading should be rejected, because the regulations adopt a hybrid approach, so that a separate-corporation model could not adequately reflect each provision in the regulations.³⁶⁴ Instead, the appropriate model for any provision should depend on context, a standard supported by the Supreme Court's decision in *United Dominion Indus. Inc. v. Commissioner*.³⁶⁵

362. See *supra* notes 345-48 and accompanying text (discussing I.R.C. 358(h)).

363. See Sheppard, *supra* note 288, at 337-38 (suggesting that the Federal Circuit would test the validity of a consolidated return regulation by comparing the treatment of consolidated and non-consolidated groups); see also Salem, *supra* note 6, at 600 (arguing that *American Standard* did not rely on the difference between the consolidated return rule and the separate-return result in reaching its conclusion and that the Federal Circuit in *Rite Aid* weakened its flawed "reasoning" by overlooking that point).

364. See Silverman & Zarlenga, *supra* note 4, at 470-71 (discussing how the regulations use a hybrid approach); see also Axelrod, *supra* note 4, at 812 (arguing that the single-entity approach is a result, not a justification for a result).

365. See 532 U.S. 822 (2001). In fact, in *United Dominion*, the Supreme Court probably rejected a single-entity or separate-corporation default rule. First, it appeared to reject a separate-corporation default rule, because it adopted a single-entity approach even though the regulations did not expressly consider the relevant issue. Cf. *id.* at 841 (Stevens, J., dissenting) (citing to *H Enter. Int'l, Inc. v. Comm'r*, 105 T.C. 71, 85 (1995), and quoting in a parenthetical reference language from *H Enterprises* that supported a separate-corporation default rule). Further, it implicitly rejected a single-entity default rule when it failed to cite Treas. Reg. § 1.1502-80(a) to support its single-entity approach, a telling omission since the Sixth Circuit in *Internet* had concluded that Treas. Reg. § 1.1502-80(a) created a single-entity default rule. Cf. *Internet Corp. v. Comm'r*, 209 F.3d 901, 905-06 (6th Cir. 2000); see also Leatherman, *supra* note 8, at 690-93 (discussing why neither a separate-corporation nor single-entity default rule should be adopted and encouraging a balance of the two approaches that promoted tax neutrality).

B. Deference

Rite Aid could also be read to support giving little deference to Treasury's choices in crafting a consolidated return regulation.³⁶⁶ That approach should be rejected for the following compelling reasons.

First, the approach would make the application of the regulations less certain.³⁶⁷ The uncertainty would have two likely effects: It would aid the more aggressive groups, hurting the fisc and making the tax system less fair, and it would prompt Congress to pass more detailed tax legislation, further complicating the Code.

Second, the approach would encourage litigation, creating deadweight cost and likely frustrating courts by asking them to perform a task that Treasury with its tax expertise is better equipped to handle. Treasury was granted its broad authority for the consolidated return regulations, because Congress "believe[d] it to be impracticable to attempt by legislation to meet the many differing and complicated situations" facing consolidated groups.³⁶⁸ Courts would likely find the task even more daunting than Congress.³⁶⁹

Finally, the suggested approach is inconsistent with the separation of powers doctrine, essentially requiring courts to make the law, rather than merely to interpret it (*i.e.*, "saying what the law is"). Legislative power is vested in Congress or its delegate (*e.g.*, Treasury through legislative regulations), not in the courts.³⁷⁰

C. Threatened Consolidated Provisions

Rite Aid could also threaten the validity of several existing consolidated return regulations. The following is a non-inclusive list of regulations that may be vulnerable in *Rite Aid's* aftermath, because they may apply less favorably to consolidated groups than non-

366. Cf. *Salem I*, *supra* note 4, at 174 (suggesting that a court should engage in a *de novo* analysis and give little deference to Treasury's choice in crafting a consolidated return regulation).

367. See Coverdale, *supra* note 27, at 68 (applauding deference because it contributes to the "uniform application of the tax laws").

368. S. REP. NO. 70-960, at 15 (1928).

369. Cf. *United States v. Cleveland, Painseville & E. R.R. Co.*, 42 F.2d 413, 414 (6th Cir. 1930) (in discussing pre-1929 law in which courts were asked to develop many of the tax rules for consolidated groups, the court stated that "[f]ew provisions of the income tax statutes . . . have required a greater amount of litigation and judicial labor").

370. U.S. Const. art. I, § 1 ("All legislative Powers herein granted shall be vested in a Congress of the United States"); see *Salem I*, *supra* note 4, at 174 n.16 (acknowledging this argument as "another view").

consolidated groups, they arguably do not deal with consolidated "problems," or they are arguably inconsistent with the Code:³⁷¹

- (i) Treas. Reg. § 1.1502-13(f)(6)³⁷²
- (ii) Treas. Reg. § 1.1502-30;³⁷³
- (iii) Treas. Reg. § 1.1502-31;³⁷⁴
- (iv) Treas. Reg. § 1.1502-32, at least for certain basis reductions relating to subsidiary loss;³⁷⁵ and

371. Other commentators have identified these and other provisions as vulnerable in *Rite Aid's* aftermath. See, e.g., Silverman & Zarlenga, *supra* note 4, at 478; Schler, *supra* note 177, at 922; Sheppard, *supra* note 288, at 338-39; Salem II, *supra* note 4, at 438.

372. This provision denies a consolidated group any loss on its sale of common parent stock even though a similar non-consolidated group's loss would not be disallowed. Note, if a consolidated group recognizes loss on common parent stock, the loss could offset the common parent's income, an offset that seems inconsistent with I.R.C. § 1032.

373. This regulation deals with stock basis after triangular reorganizations and may result in a consolidated group having an ELA in target stock even though a similar non-consolidated group would take a \$0 basis in the stock. Compare Treas. Reg. § 1.1502-30(b)(3) (2003) (providing that the negative adjustments under Treas. Reg. § 1.1502-30 could create an ELA), with Treas. Reg. § 1.358-6(c)(1)(ii) (2003) (preventing a negative-basis result outside of consolidation).

374. This section may adjust a consolidated group's basis in subsidiary stock following a group structure change. There is no similar provision for a comparable non-consolidated transaction.

375. The IRS first provided for basis adjustments for subsidiary stock in 1928, but until 1966, it provided negative adjustments only for certain losses and provided no positive adjustments for gain. See, e.g., Art. 34(c)(2) and (e) of Reg. 75 (providing a stock basis reduction for subsidiary loss absorbed by the group that the subsidiary would not have used if it had filed separate returns). The IRS justified the limited adjustment for loss to conform the treatment of consolidated and non-consolidated groups. See *supra* note 261 and accompanying text (for a discussion of that rationale).

For the first time in 1967, the IRS required a basis reduction for all subsidiary loss absorbed by the group, even if the subsidiary could have used the loss if it had filed a separate return. See Treas. Reg. § 1.1502-32(b)(1)(ii) and (2)(i) and (ii) (1967), 1967-1 C.B. 248-49. As a result, consolidated groups could be treated worse than non-consolidated groups, as the following example shows:

A consolidated group acquires all T stock for \$100. After the acquisition, the group has a consolidated net operating loss (a "CNOL"), \$10 of which is attributable to T. T carries back that portion of the CNOL and offsets its income in a separate return year. The group reduces its basis in the T stock by \$10, from \$100 to \$90. See Treas. Reg. § 1.1502-32(b)(3)(i)(B); see also Treas. Reg. § 1.1502-32(b)(2)(i) (1967) (reaching the essentially same result). If the group had not filed a consolidated return, T still could have offset its \$10 of income with the \$10 loss carryback, but the group would have retained a \$100 basis in the T stock.

See 1990-2 C.B. 700 (preamble to Prop. Treas. Reg. § 1.1502-20, noting this case and also noting the negative adjustment under Treas. Reg. § 1.1502-32 for dividends paid out of pre-affiliation earnings and profits, another potentially problematic case). Under *Rite Aid*, Treas. Reg. § 1.1502-32 may be invalid to the extent it authorizes the basis reduction in the example, because the reduction arguably is not connected with any problem created by filing consolidated returns.

- v) Various subsections of Treas. Reg. § 1.1502-80, which provide that certain Code sections do not apply to transactions between members of a consolidated group.³⁷⁶

Probably nothing short of legislation will assure that each of those provisions is valid.

CONCLUSION

In *Rite Aid*, the Federal Circuit dealt a death blow to LDR's loss duplication rule. In its rush to invalidate the rule, the court bypassed relevant precedent and substantial arguments that supported the rule's validity. Its sparse reasoning added uncertainty to an already complex area of the tax law.

The court gave little or no deference to the rule, even though it was part of a legislative regulation, a type traditionally meriting great deference. In the past, courts had been reluctant to invalidate consolidated return regulations, and in the rare case when such a regulation was invalidated, it had the following two flaws: It was not tax-neutral and Treasury could not justify the regulatory approach. LDR's loss duplication rule suffered from neither flaw.

The rule attacked two consolidated concerns, "classic" loss duplication and loss selectivity. It disallowed a consolidated group's loss on subsidiary stock to the extent the loss was duplicated in the subsidiary's tax attributes (including its built-in asset loss). The Federal Circuit concluded that the rule was invalid, because it could disallow a group's economic loss.

In reaching this conclusion, the court conflated three distinct issues: (i) whether Treasury had authority to disallow stock loss, (ii) whether it had authority to target consolidated loss duplication, and (iii) assuming that it had the authority to do both, whether its approach was reasonable. A detailed analysis of these issues reveals that the loss duplication rule was valid. First, Treasury had authority to disallow stock loss, based on explicit legislative history, case law, and past practice. Second, it had authority to target consolidated loss duplication, following well-respected Supreme Court precedent and

376. See Treas. Reg. § 1.1502-80(b) (2003) (providing that I.R.C. § 304 does not apply to the acquisition of stock in an intercompany transaction), (d) (providing that I.R.C. § 357(c) does not apply to an intercompany transaction), (e) (providing that I.R.C. § 163(e)(5) does not apply to an intercompany obligation), and (f) (providing that I.R.C. § 1031 does not apply to an intercompany transaction). Each of those provisions would apply to a similar transaction between members of an affiliated, non-consolidated group. But see H.R. REP. NO. 100-495, at 970 (1987) (stating that "[n]o inference is intended as to the Treasury Department's authority to amend the consolidated return regulations consistent with the purpose of '[I.R.C. § 304(b)(4)]'").

in concert with (or as an aspect of) the repeal of the *General Utilities* doctrine. Finally, its approach (*i.e.*, to disallow stock loss) was reasonable, since it was consistent with the Code and raised fewer administrative concerns than the alternative (*i.e.*, to eliminate asset loss).

In practically every sense, the Federal Circuit's decision in *Rite Aid* was wrong. The decision deserves to become a forgotten (albeit expensive) footnote.