

Consolidated Return Unified Loss Rules

Danni Sternfeld Dunn

Ernst & Young LLP

Patricia W. Pellervo

PricewaterhouseCoopers LLP

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Selective History of ULR

- **Notice 87-14:** No § 1.1502-32 adjustment where a member acquires stock of a target with a “built-in gain” asset (i.e., an asset with FMV exceeding basis at the time the target stock is acquired) and the gain is recognized from the asset’s sale or distribution.
- **§1.337(d)-1:** Loss from stock of a “transitional subsidiary” is disallowed, except to the extent the taxpayer establishes that the loss is not attributable to the recognition of “built-in gain”.
- **§1.337(d)-2:** Loss from subsidiary stock is disallowed, except to the extent the taxpayer establishes that the loss is not attributable to the recognition of “built-in gain” .
- **§1.1502-20:** Loss from subsidiary stock is disallowed, except to the extent the taxpayer establishes that the loss exceeds the sum of the subsidiary’s:
 - Positive investment adjustment factor,
 - Extraordinary gain disposition factor, and
 - Loss duplication factor.
- ***Rite Aid*, 255 F.3d 1357 (Fed. Cir. 2001):** The loss duplication factor of §1.1502-20 was an invalid exercise of regulatory authority.

Selective History of ULR

- **§1.337(d)-2:** Loss from subsidiary stock disallowed, except to the extent the taxpayer establishes that the loss was not attributable to the recognition of “built-in gain” on the disposition of an asset (i.e., any excess of FMV over basis reflected, before the disposition of the asset, in the basis of the stock).
 - **Notice 2004-58:** Taxpayers could use tracing or the “basis disconformity” approach. Under the basis disconformity approach, stock loss disallowed under §1.337(d)-2 to the extent of the least of three factors:
 - Inside/outside basis disparity,
 - Cumulative, gross gains from asset dispositions, and
 - Net positive investment adjustments (disregarding distributions).
- **§1.1502-35:** Addresses duplication of loss within the selling group
 - Generally applicable to transfers not subject to §1.1502-36, i.e., transfers before 9/17/2008.
 - This includes closings on or after 9/17/2008 subject to binding contract exception of -36.
- **2004 Amendment to §1502 (AJCA)**

**§1.1502-36 (“Unified Loss Rule”):
Proposed 1/2007, Finalized 9/2008 in T.D. 9424**

- *Goal*: one integrated set of rules apply to all transactions in which noneconomic and/or duplicated stock loss is either recognized or preserved for later use.
- Basis redetermination rule of §1.1502-36(b) addresses losses arising from noneconomic allocations under §1.1502-32
- Basis reduction rule of §1.1502-36(c) addresses noneconomic “son of mirror” loss
- Attribute reduction rule of §1.1502-36(d) addresses duplicated loss.

Scope of New Rules

- The new Unified Loss Rules apply when a member of a consolidated group realizes a loss with respect to stock of another member.
- Here are several situations where the new rules do NOT apply . .

Scope of New Rules

Do not apply if:

- Buyer purchases some or all of the common parent's stock;
- Buyer purchases assets other than member stock;
- Seller and Buyer elect sec. 338(h)(10);
- Buyer purchases CFC stock;
- Member liquidates tax-free under Sec. 332, provided there is only one shareholder

Scope of New Rules

Do apply if:

- Buyer purchases member stock and seller recognizes a loss (taxable transaction);
- Buyer purchases member stock and seller realizes a loss (non-recognition transaction);
- Member claims worthless stock deduction with respect to another member's stock.

§ 1.1502-36(b)

Basis Redetermination

To address noneconomic stock losses attributable to, and duplicated losses not eliminated by, allocations under § 1.1502-32

Overview & Definitions

- ULR applies to the transfer of a loss share of a member of the group. If applicable, §1.1502-36(b), (c) & (d) apply *seriatim*.
- Loss share: Share of stock with adjusted basis in excess of value.
- Transfer: broadly defined and generally includes member ceasing to own the share, owning member and subsidiary ceasing to be members of the same consolidated group, and claiming a worthless stock loss.
 - includes intercompany sales of stock
 - excludes section 355 distributions

Basis Redetermination

- If a member transfers a loss share of S stock, all members' bases in all shares of S stock are subject to redetermination –
 - Reduce basis in transferred loss common shares (but not below FMV) by removing positive investment adjustments applied to those shares.
 - If there is still a loss in any transferred share (common or preferred), reduce basis (but not below FMV) by reallocating negative investment adjustments from common shares that are not transferred loss shares –
 - First to transferred loss preferred shares (to reduce disparity among the transferred loss preferred shares),
 - Then to transferred loss common shares (to reduce disparity among all common shares).
 - Apply the positive investment adjustments removed from the transferred loss common shares –
 - First to preferred shares (to value, to eliminate disparity among all preferred shares)
 - Then to common shares (without regard to value, to eliminate disparity among all common shares).
- A zero-sum game - does not change net gain or loss; does not create gain.

Basis Redetermination - Exceptions

- Basis redetermination is not required if –
- Group disposes of entire interest in S in a taxable transaction (although group may elect to redetermine in this case), or
 - If members have no gain or loss on S preferred stock and no disparity in their bases in S common stock

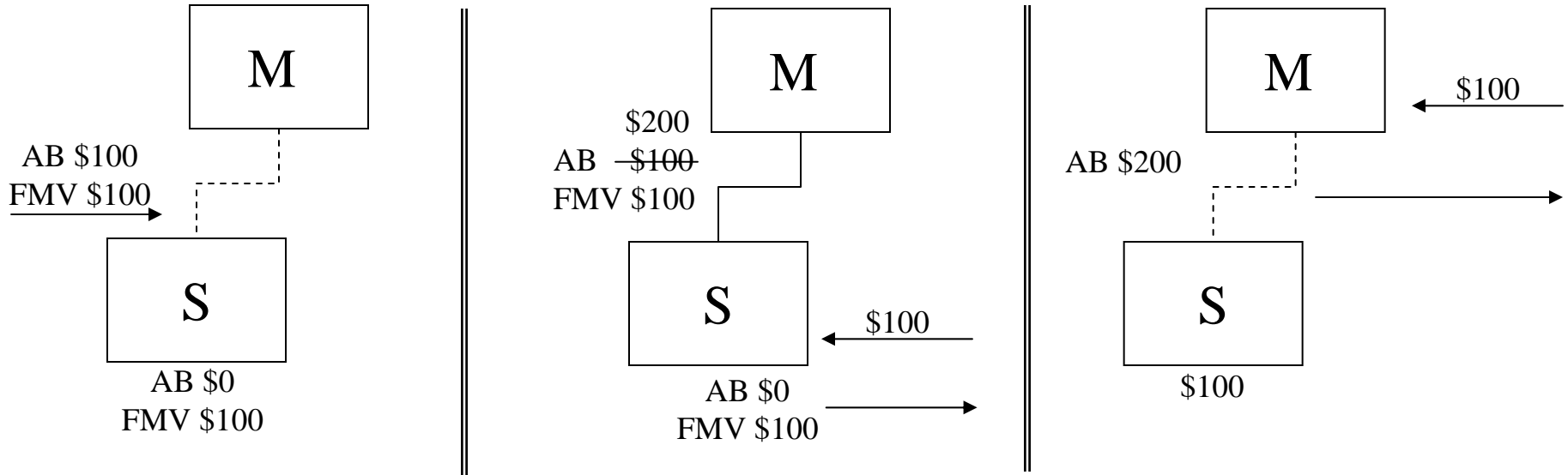
Recordkeeping for Basis Redetermination

- Basis redetermination depends upon the knowledge of each share's value and its investment adjustment history. But see §1.1502-32(g), which requires the group to maintain permanent records to identify the amount and allocation of adjustments. This includes:
 - When were shares issued (or deemed issued)
 - Investment adjustment history for each year and within any year in which shares were issued (or deemed issued)
 - May also require investment adjustment history while held in a prior group (for example, for lower-tier subsidiaries or when acquired in a transferred basis transaction)
- Groups may not monitor annually, particularly given exception for sale of all shares of stock

§ 1.1502-36(c) Basis Reduction

To address noneconomic
“son of mirror” losses

The “Son of Mirror” Problem



- This is the case that prompted the government to issue Notice 87-14 to further the imperative of section 337(d) that the Treasury issue regulations to protect the repeal of the *General Utilities* doctrine. S’s \$100 gain from the sale of its asset generates a \$100 positive –32 adjustment to M’s basis in the S stock.
- Because M’s \$100 “cost” basis in the S stock *already reflects* the \$100 gain before it is recognized, the positive –32 adjustment “duplicates” M’s existing S stock basis and results in M recognizing a \$100 noneconomic S stock loss.
- M’s \$100 S stock loss offsets S’s \$100 gain (disregarding character differences) in the group’s consolidated return, thus “stepping up” the basis of S’s asset with no corporate level tax, a result that is inconsistent with *GU* repeal.

Basis Reduction Rule

- If a transferred S share is a loss share after the application of the basis redetermination rule, M's basis in the share is reduced, but not below value, by the lesser of:
 - The share's net positive adjustment, and
 - The share's disconformity amount

Basis Reduction – Net Positive Adjustment

- The sum of all investment adjustments under §1.1502-32 (computed without regard to distributions) that are reflected in the basis of the share.
 - NPA amount cannot be less than zero
 - NPA includes any positive adjustments to the basis of the S stock during its membership in a prior consolidated group that continue to be reflected in the basis of the S stock (or a successor asset) in the hands of M.
 - Netting among tax years is permitted
 - Note that contributions to capital, though increasing basis, are not “investment adjustments” under -32

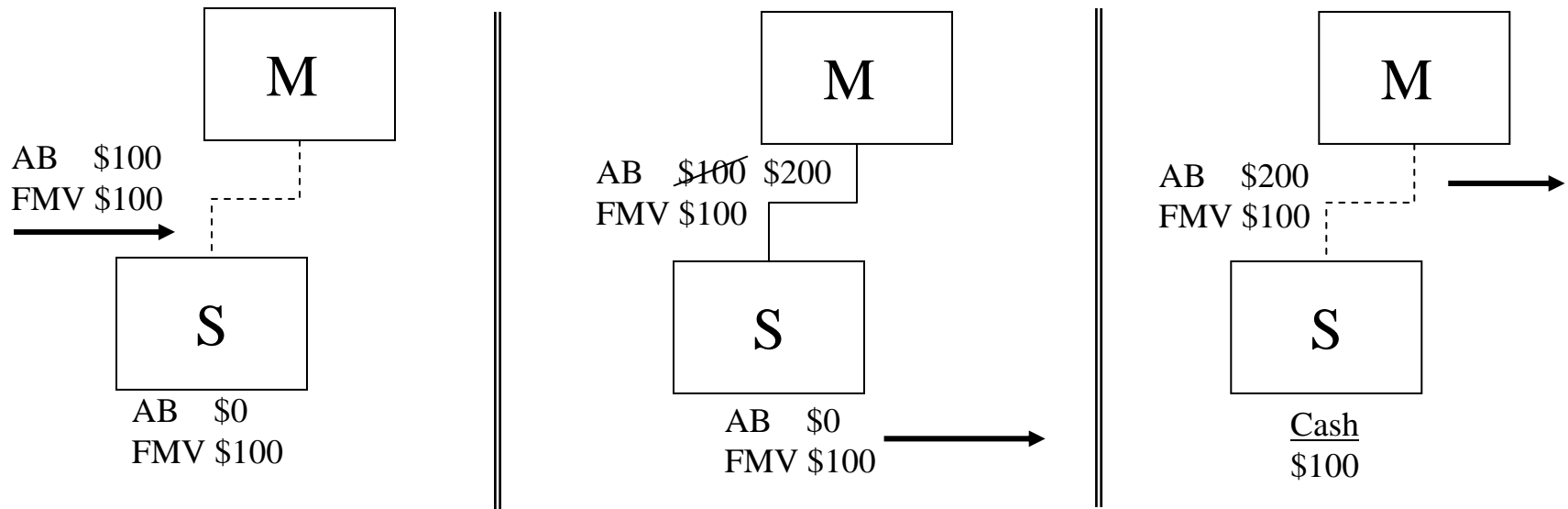
Basis Reduction – Disconformity Amount

- The excess, if any, of M’s basis in the share over the share’s allocable portion of S’s “net inside attribute amount”
 - The “net inside attribute amount” equals:
 - the sum of S’s
 - money,
 - basis in assets other than money,
 - net operating and capital loss carryovers attributable to S (without regard to whether they are waived by the purchaser or limited under section 382 or the SRLY rules), and
 - deferred deductions,
 - minus S’s liabilities.
 - The net inside attribute amount
 - is determined immediately before the transfer, taking into account all other rules of law (e.g., §1.1502-32), and
 - does not include S’s credits, if any
 - Special rule in -36(c)(6) for stock of a lower-tier subsidiary.

Basis Reduction

- The basis reduction rule is based on “simplifying conventions”. Tracing is not an option for either the taxpayer or the Government.
- The “disconformity amount” is the minimum amount of built-in gain in S that, if recognized, would uneconomically increase M’s basis in S. For example if S comes into the group with an outside stock basis of \$100 and a single asset with a value of \$100 and basis of \$0, its disconformity amount is \$100 and remains \$100 if the asset is sold for \$100.
 - The disconformity amount will be less than the built-in gain if S also has assets with built-in loss.
- The NPA is the total net basis benefit of consolidation, and the minimum amount of gross income of S that could have been recognized built-in gain.
 - The NPA may be more than the recognized built-in gain (if any non-built-in income or gain is recognized) or less than the recognized built-in gain (if any non-built-in loss is recognized).
- Although the rule reaches the correct economic result in the simple “son of mirror” case, it may allow “son of mirror” losses that tracing would disallow or may disallow economic losses that tracing would allow.

Basis Reduction Rule Disallows “Noneconomic” Loss – Classic Son of Mirror Case



- **Facts:** M buys the S stock for \$100 when S’s asset has a \$0 basis and \$100 FMV. S sells its asset for \$100. M sells the S stock for \$100.
- **Basis Reduction:** M’s \$100 loss is *disallowed* because \$100 is the lesser of:
 - Disconformity amount: \$100 -- excess of M’s \$200 basis in the S stock over S’s \$100 net inside attributes (money)
 - NPA: \$100 -- \$100 positive –32 adjustments.
- **Result:** M’s \$100 loss is disallowed.

Basis Reduction—Lower-Tier Subsidiaries

- Special rule for lower-tier subsidiary stock: In computing the net inside attribute amount for purposes of the basis reduction rule, S's basis in a share of stock of a lower-tier subsidiary (S1) is treated as
 - Tentatively reduced by the lesser of S1's own net positive adjustments and S1's own disconformity amount. Start at the lowest tier and move up.
 - Allows the generally adopted presumptions to apply at all tiers
 - No tentative reduction if the S1 stock is actually transferred, hence -36(c) actually applies
- Necessary to prevent son of mirror transactions at lower tiers.

§1.1502-36(c): Buyer Beware

- Suppose Buyer buys a member (T) of a consolidated group and T joins a new consolidated group (as its common parent or otherwise). T might or might not be the common parent. T has a subsidiary S.
- Suppose Buyer sells the T stock at a loss. The loss will be disallowed to the extent of the lesser of (1) Buyer's NPA in the T stock, or (2) Buyer's disconformity amount in T, which depends in part on T's prior NPA in the S stock. If the S stock basis was tentatively reduced, that reduction doesn't affect the actual S stock basis.
- Alternatively, suppose T sells the S stock at a loss. The loss will be disallowed to the extent of the lesser of (1) T's NPA in the S stock, including adjustments attributable to periods before the Buyer's acquisition, and (2) T's disconformity amount in S.
- Thus, in either case, for Buyer to apply the rules to S or T in the new consolidated group, Buyer must know not only the stock and asset basis that exists at each level on the purchase date, but also the history of all NPAs in the stock of all direct and indirect subsidiaries of T.
 - If Buyer acquired the T stock in a reorganization such as a “B” reorganization, and T was a subsidiary in another group, the history of NPA's in the T stock itself in the prior group would also be relevant to Buyer.

Attempted “Stuffing” to Avoid the (c) Rules

- Because section 362(e)(2) does not apply to consolidated group intercompany transactions, the -36 rules might be avoided through the stuffing of loss assets into S if section 351 can be satisfied.
- Alternatively, M could stuff a gain asset into S, then sell the S stock at no gain or loss. The noneconomic basis increase in S could shelter the real economic gain in the asset.
- An anti-avoidance rule is intended to prevent (among other things) these attempts to avoid the (c) rules.

§ 1.1502-36(d)

Attribute Reduction

To address
“duplicated” economic losses

Attribute Reduction

- If a transferred share is a loss share after the application of the basis reduction rule, S's attributes are reduced by S's attribute reduction amount, which is the lesser of:
 - *Net stock loss*--the excess, if any, of members' aggregate bases in transferred S shares over the aggregate value of those shares.
 - *S's aggregate inside loss*--the excess, if any, of S's net inside attributes (inside asset basis plus losses minus liabilities) over the value of all outstanding shares of S stock.
- *Attribute reduction rule does NOT apply if the attribute reduction amount is less than 5% of the value of the shares transferred.*
 - However, the group may elect to apply the rule, e.g. in order to reattribute S's losses.

Application of Attribute Reduction Amount: The Basics

- S's attribute reduction amount is applied:
 - First, to reduce recognized losses:
 - >> Capital loss carryovers;
 - >> Net operating loss carryovers; and
 - >> Deferred deductions.
 - Then, to reduce asset basis.
- The selling group may specify the losses to which the attribute reduction amount (ARA) is applied among attributes other than asset basis. To the extent the group doesn't specify, they are reduced in the following order:
 - Capital loss carryovers (oldest to newest);
 - Net operating loss carryovers (oldest to newest);
 - Deferred deductions (proportionately).

Application of Attribute Reduction Amount: The Basics (cont'd)

- Any ARA not applied to reduce recognized losses is applied to S's assets, other than assets that are Class I assets in §1.338-6(b)(1) (i.e., cash and certain deposit accounts).
- ARA applied to S's assets is first allocated between S's stock in its subsidiaries and S's other assets based on relative basis.
 - ARA allocated to lower-tier stock is applied under lower-tier stock rules
 - ARA allocated to S's other assets is applied under reverse residual method—
 - ARA allocated first to Class VII assets (reducing basis in that class to \$0); then remaining ARA is allocated to assets in each next lower class successively (other than Class I assets)
 - If ARA is less than basis of assets in a class, basis is reduced proportionately within the class

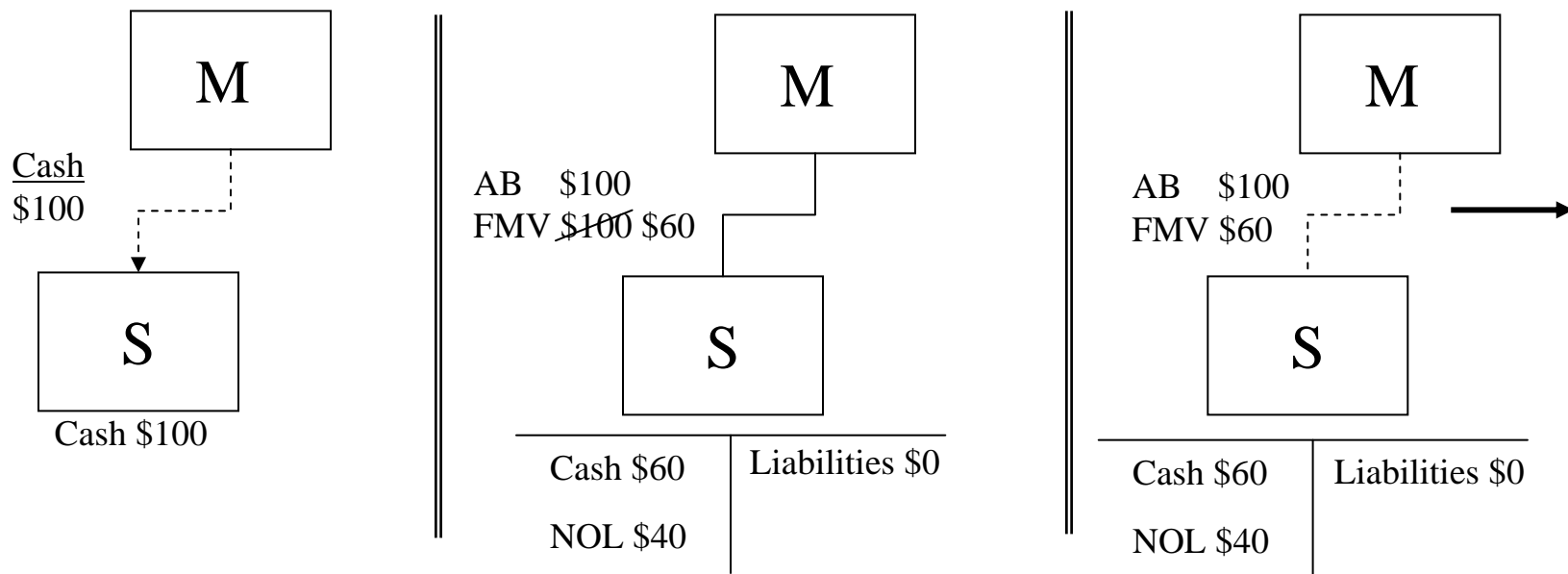
Application of Attribute Reduction Amount: The Basics (cont'd)

- If the ARA exceeds attributes, the ARA has no further effect unless S has contingent liabilities (in which case the excess ARA is suspended and applied as attributes attributable to those liabilities are taken into account).
- Reductions are effective immediately before transfer of S shares.
- Attribute reduction is not treated as a noncapital, nondeductible expense so as to prevent duplicative stock basis reductions under -32.

§1.1502-36(d)(6) Election

- Group can avoid or reduce attribute reduction by electing to reduce members' bases in transferred loss shares, reattribute S's attributes to P (but only if S leaves the group), or both.
 - Can specify amount elected (or not elected).
 - Can only reattribute up to ARA. No effect given to election for any amount in excess of ARA. However, P can make a protective election to reduce basis.
 - Can reattribute section 382 limitation to which reattributed losses are subject.
 - Stock basis reduction is deemed elected if the stock loss would be permanently disallowed.
- P can specify the losses to be reattributed; otherwise, losses are reattributed in the manner in which they would have been reduced under the default rule.
- The election is made by a statement on or with the group's return for the taxable year of the transfer. Statement by S is not required.
- In effect, the parties can convert what would otherwise be a current capital loss for the seller, or an NOL carryover subject to section 382 for the buyer, to an NOL carryover not limited by section 382 for the seller.

Loss Duplication With NOLs



- **Facts:** M contributes \$100 to S. S spends \$40 on deductible R&D that generates a \$40 consolidated NOL carryover. M sells the S stock for \$60.
- **Basis Reduction:** M's \$40 loss is *allowed* because \$0 is the lesser of:
 - Disconformity amount: \$0 -- excess of M's \$100 basis in the S stock, over S's \$100 net inside attributes (cash and NOLs)
 - NPA: \$0 – no positive or negative investment adjustments
- **Loss Duplication Result:** M's \$40 loss is allowed, but S must reduce its NOL from \$40 to \$0 to prevent duplication. The group may elect to reduce M's stock basis and retain the NOL in S or it can elect to reattribute the NOL to P.

Computation of Attribute Reduction Amount: Lower-Tier Subsidiary

- **Rule:** For purposes of attribute reduction when S holds shares of a lower-tier subsidiary (S1):
 - S’s S1 shares are treated as a single share, and
 - S’s basis in S1 is its “*deemed basis*” in that single S1 share.
- S’s “deemed basis” in S1 stock is equal to the greater of:
 - The sum of S’s actual bases in each share of S1 stock, and
 - The portion of S1’s net inside attribute amount allocable to S’s shares of S1 stock.
- Deemed basis measures the total amount of potential loss duplication in the S chain, whether due to loss that is reflected in S1 stock basis or in S1’s attributes.
- Deemed basis also affects the allocation of ARA to the lower-tier subsidiaries.

Application of Attribute Reduction Amount: Lower-Tier Subsidiary

- Two mechanisms prevent over-reduction in either lower-tier attributes or stock basis:

Conforming limitation on reduction of lower-tier attributes:

- Generally, prevents tier-down attribute reduction from reducing lower-tier attributes below members' basis in lower-tier stock (after reduction).
- Applicable where deemed basis is driven by basis in lower-tier stock.

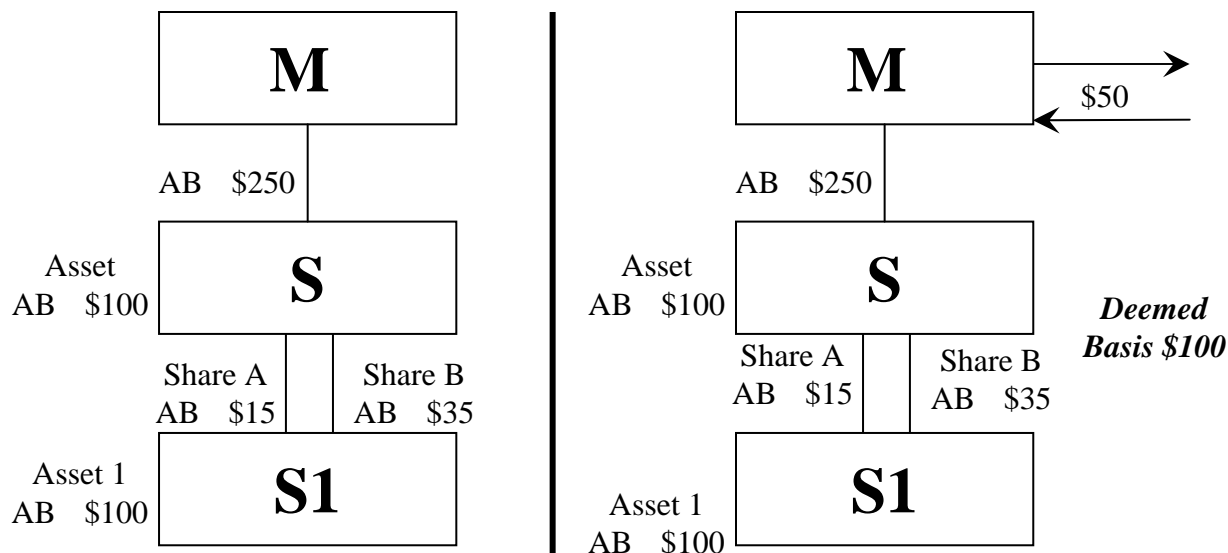
Stock basis restoration:

- Reverses the reduction of lower-tier stock basis to the extent necessary to conform stock basis to its allocable portion of the lower-tier subsidiary's net inside attributes (after reduction).
 - Applicable where deemed basis is driven by lower-tier attributes.
- P can elect out of either rule to simplify computations.

Application of Attribute Reduction Amount: Lower-Tier Subsidiary (cont'd)

- S's ARA is *allocated* between S1 stock and other assets using the deemed basis in the S1 stock.
- The ARA allocated to the deemed S1 share is *apportioned* to the actual individual S1 shares that were not transferred in a *taxable* transaction, in a manner that reduces loss in, and basis disparity among, preferred shares, and then basis disparity among common shares.
- The ARA apportioned to individual shares is *applied* to reduce:
 - the basis of preferred shares and transferred common shares to, but not below, value
 - the basis of nontransferred common shares without limit (can create an ELA).
- All of S's ARA that is allocated to the deemed S1 share becomes an ARA of S1 ("tier-down ARA"), even if not apportioned or applied to reduce the basis of any individual shares of S1 stock
 - Tier-down ARA applies to S1's attributes under rules applicable to all ARA (treated like direct ARA, subject to same rules/limitations).

Application of Attribute Reduction Amount: Lower-Tier Subsidiary (cont'd)



- **Facts:** M owns the S share with a basis of \$250. S owns Asset with a basis of \$100 and the only two shares of S1. S holds S1 Share A with a basis of \$15 and S1 Share B with a basis of \$35. S1 owns Asset 1 with a basis of \$100. M sells the S share to P1, the parent of another consolidated group, for \$50.
- Because S and S1 remain consolidated with each other (in the P1 group), the S1 shares are not transferred in the transaction.
- **ARA:** The ARA is \$150, the lesser of:
 - » M's \$200 net stock loss -- \$250 basis of the S share, less its \$50 value.
 - » S's \$150 aggregate inside loss -- S's net inside attribute amount of \$200 less the S share's \$50 value. S's net inside attribute amount equals its \$100 basis in Asset plus the deemed basis in the single S1 share of \$100 (the greater of the \$50 actual basis in the S1 shares and S1's \$100 net inside attributes).

Buyer Concerns Arising from Attribute Reduction

- Attribute reduction might arise any time the purchase price of S stock is less than the total net attributes of S, and the selling group has a loss on the S stock. A potential buyer of S will generally want P to elect to reduce stock basis instead of acquiring S with reduced attributes.
- The attribute reduction amount may not be known at closing
 - S's attributes may be subject to audit adjustment.
 - Purchase price may be subject to adjustment.
 - Buyer normally would not know or care about the selling group's stock basis, or whether the selling group has a tax loss on the sale, and would want to be protected regardless of that basis.
- P can make a “protective election” to reduce stock basis at the time of sale in order to prevent any future attribute reduction to the buyer, even though the amount of the potential attribute reduction may not be known at that time.
- Attribute Reduction can affect purchase accounting.

Anti-Avoidance Rules

- An anti-avoidance rule is intended to prevent (among other things) these attempts to avoid the (c) rules.
- Under -36(g), if a taxpayer acts *with a view* to avoid the purposes of -36, or to apply -36 to avoid the purposes of any other rule of law, appropriate adjustments will be made to carry out the purposes of -36 or such other rule of law.
- *Preamble to Proposed -36: “This rule is an important safeguard to ensure that only transfers made in the ordinary course of business enjoy the benefits and avoid the burdens arising from the principles adopted in these proposed regulations”.*

Worthless Stock Losses

Worthlessness

- Three requirements for wholly worthless stock and securities:
 - The stock or security was not worthless prior to the year in which the loss is claimed;
 - The stock or security was worthless in the year the loss is claimed; and
 - The deduction is only available in the year worthlessness occurs (taxpayer should not be allowed to pick and choose which year to claim the deduction, thus enabling the taxpayer to claim it in a more beneficial tax year). *See Avery v. Commissioner, 22 F.2d 6 (5th Cir. 1927).*
 - Case law has been very inconsistent in determining the year of worthlessness.
 - The stock or security had a tax basis.
- Note that this is an all or nothing test. Either the taxpayer proves the stock is wholly worthless and the taxpayer is allowed the full deduction to the extent of tax basis or the taxpayer fails the test and is allowed no deduction.

Determination of Worthlessness

- Case law provides worthlessness is established by a showing of:
 - (1) insolvency, and
 - (2) the security has no potential recognizable future value, marked by either:
 - (a) an identifiable event, or
 - (b) no reasonable expectation the stock will have liquidating value in the future based on the level of indebtedness of the subsidiary.
- The taxpayer must satisfy both prongs of the worthlessness test for the year in which it claims the worthless stock deduction, but fail the test in all prior years.

Section 165(g)(3)

- Worthless stock deduction may be classified as an ordinary loss provided:
 - The deduction is claimed by a domestic corporation that owns 80% of the vote and value of the worthless corporation. (Note that the worthless corporation may be foreign.)
 - More than 90% of the worthless subsidiaries gross receipts for all years are from sources other than dividends, interest, royalties and similar “passive” sources.

Consolidated Group Considerations

- § 1.1502-80(c): Worthless stock deduction is deferred until:
 - the subsidiary disposes or abandons substantially all of its assets (including when an insolvent subsidiary dissolves into its parent), or
 - immediately before the subsidiary ceases to be a member of the group
- § 1.1502-36: Need to consider potential for reduction of the loss under the new unified loss rules (-36(c)) and elimination of the subsidiary's tax attributes (-36(d))
- § 1.1502-34: 165(g)(3) 80% vote and value test measured by aggregating all subsidiary stock owned by consolidated group
- § 1.1502-13: Need to consider complex issues related to intercompany obligations under 1.1502-13(g)

State Tax Considerations

States generally conform to section 165(g), but several areas of non-conformity give rise to potential state tax benefits that may differ from federal deductions in many states:

- Nonconformity to §§ 1.1502-32 & 1.1502-36: Stock basis/amount of loss may differ.
- Nonconformity to §§ 1.1502-80(c) & 1.1502-19(c)(1)(iii): De-coupling from federal deferral rules may accelerate timing
- Nonconformity to § 1.1502-34: 165(g)(3) 80% vote and value test must be met by direct ownership for most states