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Affiliated and Related Corporations

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AFFILIATED AND RELATED CORPORATIONS

SUBMITTED BY THE COMMITTEE ON AFFILIATED AND RELATED CORPORATIONS:
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Legislation

In section 844(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1600 ("2004 Act"), Congress added the following sentence to the end of section 1502: "In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." Section 844(c) provides that the change applies to all taxable years, including those preceding the enactment of the 2004 Act.

The amendment was prompted by *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), which invalidated the "duplicated loss" piece of Regulation section 1.1502-20 ("the old LDR rule"). House Conference Report 108-755 (2004) states that the amendment overturns *Rite Aid* "to the extent it suggests that [Treasury] is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of a Code provision." Comparatively, *Rite Aid Corp.* justified its invalidation of the "duplicated loss" piece of the old LDR rule on the grounds that it did not deal with a "consolidated" problem.

However, the amendment apparently does not authorize Treasury to readopt the "duplicated loss" piece of the old LDR rule. Section 844(b) of the 2004 Act states that notwithstanding the amendment, the Code shall be construed by treating Treasury Regulation section 1.1502-20(c)(1)(iii) (as in effect on January 1, 2001) as being inapplicable to the factual situation in [*Rite Aid*]. Moreover, House Conference Report 755 confirms that the amendment "nevertheless allows the result of [*Rite Aid*] to stand with respect to the type of factual situation presented in the case."

Despite that limitation, the report explains that the amendment neither overrules the elective application of the old LDR rule under Temporary Regulation section 1.1502-20T(i) (discussed below) nor "prevent[s] or invalidate[s] the various approaches Treasury has announced it would apply or that it intends to consider in lieu of [the old LDR rule]." Congress pointed to Temporary Regulation sections 1.337(d)-2T and 1.1502-35T in note 595 of the report for examples of such approaches, each discussed below.

*Important Developments Editor: Patti M. Richards.

Regulations

Temporary Regulation Section 1.337(d)-2T

Temporary Regulation section 1.337(d)-2T was part of the vanguard regulatory response to *Rite Aid*. Replacing the old LDR rule in part, it disallowed a consolidated group's recognized loss on subsidiary stock, except to the extent that the group proves that the loss is not attributable to recognized built-in gain on asset dispositions. Although, as provided by section 7805, the regulation expired in March 2005, it was refined and interpreted in several significant ways in 2004.

In Treasury Decision 9118, 2004-15 I.R.B. 718, Treasury modified Temporary Regulation section 1.337(d)-2T(c) to provide that, in computing the stock loss attributable to built-in gain, gain recognized on an asset disposition is reduced by expenses "directly related" to that gain recognition. As stated in the decision, the change is intended to clarify that "stock loss is not disallowed to the extent the taxpayer establishes that the loss . . . is not attributable to recognized built-in gain reduced by expenses directly related to the recognition of that gain, including, in certain cases, federal income taxes related to the recognition of such gain." Some of these changes are discussed extensively in Don Leatherman, *Menu of Recent Consolidated Developments*, 639 PLI/Tax 605 (2004).

Even with Treasury's clarification, Temporary Regulation section 1.337(d)-2T literally requires tracing. To trace, a group must value a subsidiary's assets when the subsidiary joins the group and again on certain other occasions. The group must then determine to what extent, if any, the subsidiary recognizes built-in gain on those assets.

In Notice 2004-58, 2004-39 I.R.B. 520, the Service offered the "basis discomformity" method as an alternative to tracing. Under this method, a group's disallowed loss on a share of subsidiary stock is equivalent to the smallest of the following three amounts: (1) the gain amount, which is "the sum of all gains (net of directly related expenses) recognized on asset dispositions of the subsidiary that are allocable to the share while the subsidiary is a member of the group;" (2) the discomformity amount, which is the excess, if any, of: (a) the share's basis, over (b) the share's interest in the subsidiary's net asset basis (*i.e.*, the excess of (x) the sum of the subsidiary's money, aggregate asset basis (other than stock basis of lower-tier subsidiaries), loss carryforwards, and deferred losses over (y) the subsidiary's liabilities); or (3) the net positive adjustment for the share under Regulation section 1.1502-32, excluding reductions for distributions under Regulation section 1.1502-32(b)(2)(iv).

The first two of these amounts include the subsidiary's share of corresponding amounts for any of its lower-tier subsidiaries. Note that a consolidated group is not required to adopt the same method for each disposition or deconsolidation of subsidiary stock.

Notice 2004-58 was issued on September 27, 2004, shortly before the House Conference Report on the 2004 Act was filed on October 7, 2004. Because

House Conference Report 755 states that the 2004 Act does not "prevent or invalidate the various approaches that Treasury announced it will apply" in lieu of the old LDR rule, it may offer implicit support for the notice's basis discomformity method. However, in illustrating those possible alternative approaches, the report did not refer to the notice or mention the basis discomformity method, although it did refer to Temporary Regulation section 1.337(d)-2T, to which the method applies. Additionally, the House Conference Report 755 stated that "[i]n exercising its authority under section 1502, [Treasury] is . . . authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions."

Temporary Regulation Section 1.1502-20T(i)

Temporary Regulation section 1.1502-20T(i) provides that for past periods to which the old LDR rule otherwise would apply, consolidated groups can elect to compute their disallowed loss on subsidiary stock by using Temporary Regulation section 1.337(d)-2T or a variation of the old LDR rule, in place of the old LDR rule, provides these alternatives. Because Treasury refined how disallowed loss was computed under Temporary Regulation section 1.337(d)-2T, Treasury Decision 9154, 2004-40 I.R.B. 560, extended the time to make, amend, or revoke the Temporary Regulation section 1.1502-20T(i) election.

As amended by Treasury Decision 9154, Temporary Regulation section 1.1502-20T(i) provides that a group can make, amend, or revoke that election by including the required statement in: (1) a timely filed original return for a taxable year that includes any date on or before August 26, 2004; or (2) an amended return filed before the date such original return is due. The due date for the original return includes any extensions.

Regulation Section 1.1502-32(b)(4)(v)

If a selling group elected under Temporary Regulation section 1.1502-20T(i) to apply an alternative to the old LDR for a past subsidiary ("S") stock sale, the election could increase S's loss carryovers to post-sale years. However, as provided in Regulation sections 1.1502-32(b)(2)(i) and (3)(i), increasing those loss carryovers could hurt the purchasing group. The carryovers might expire unused (or be absorbed) in a closed year, and to account for the expiration or absorption, the purchasing group would have to reduce its S stock basis.

Temporary Regulation section 1.1502-32T(b)(4)(v) addresses this potential problem. As originally drafted, it provided that those loss carryovers would expire before S joined the purchasing group, thereby avoiding the purchasing group's basis reduction. However, this early expiration could disadvantage the purchasing group if the carryover loss would free another loss that could be carried forward for use in an open year.

To allow the purchasing group to use these "cascading" losses, Treasury Decision 9155, 2004-40 I.R.B. 562, amended Temporary Regulation section 1.1502-32T(b)(4)(v) to allow the group to choose not to apply the "early expiration" rule. The group makes this choice simply by taking a position consistent

with that choice on an original or amended return for each relevant year. If the group does not make this choice, the "early expiration" rule automatically applies.

Regulation Section 1.1502-31

Regulation section 1.1502-31 was also caught in *Rite Aid*'s wake; Treasury accordingly amended it in Treasury Decision 9122, 2004-19 I.R.B. 886. In part, Regulation section 1.1502-31(a) determines a consolidated group's stock basis in its former common parent ("T") when the group acquires T stock in a group structure change. Such a change occurs when T becomes a subsidiary but the group continues under the principles of Regulation section 1.1502-75(d)(2) or (3) (*e.g.*, in a reverse acquisition). Generally, under subsections (b) and (c), the group's basis in its T stock is equivalent to T's net asset basis (*i.e.*, the difference between T's aggregate asset basis and its liabilities).

Before its amendment by Treasury Decision 9122, the net-asset basis rule applied even when the group made a taxable acquisition of T stock and took a cost basis in that stock absent Regulation section 1.1502-31. As a result, a consolidated group could later sell its T stock, suffer an economic loss, but incur no tax loss, a result inconsistent with *Rite Aid*, which concluded that the loss-duplication rule of Regulation section 1.1502-20 was invalid when it denied a loss that would have been available to a corresponding nonconsolidated group.

Treasury Decision 9122 amended Regulation section 1.1502-31(b)(2) to apply the net-basis rule only to the extent that the T stock otherwise would be transferred-basis property as defined by section 7701(a)(43) (*i.e.*, acquired in a transaction in which the transferee's basis in the T stock would otherwise be determined by reference to the transferor's basis in that stock). Additionally, Regulation section 1.1502-31(d)(2)(ii) provides that if all T stock is not subject to redetermination (*e.g.*, because the group did not acquire all T stock in a transferred-basis transaction), the percentage of T's net-asset basis taken into account in the redetermination is equivalent to the percentage by value of the T stock subject to redetermination. Furthermore, subsection (h) provides that the amendment applies to group structure changes that occur after April 26, 2004, although a group may apply the amendment to a group structure change that occurred on or before April 26, 2004, and in consolidated return years beginning on or after January 1, 1995.

Temporary Regulation Section 1.1502-35T

To limit loss duplication, Temporary Regulation section 1.1502-35T provides that a group may redetermine its basis in subsidiary ("S") stock and its loss on S stock may be suspended and subsequently disallowed. It also describes when S's loss carryovers may be treated as expired. This regulation, amended by Announcement 2004-10 and Treasury Decision 9118, is discussed in greater detail in Don Leatherman, *A Primer on § 1.1502-35T*, 597 PLI/Tax 9 (2003).

In Announcement 2004-10, 2004-7 I.R.B. 501, the Service corrected a technical defect in Temporary Regulation section 1.1502-35T(c)(5)(i). Under Tempo-

rary Regulation section 1.1502-35T(c), if a consolidated group recognizes a loss on S stock but S remains a group member, the loss is suspended to the extent duplicated in S tax attributes. To the extent not subsequently reduced, the suspended loss is allowed as provided in Temporary Regulation section 1.1502-35T(c)(5)(i).

Before it was corrected by Announcement 2004-10, Regulation section 1.1502-35T(c)(5)(i) stated, broadly speaking, that a group could take a suspended loss on S stock into account at the time when S *or* any S successor was no longer a group member. This rule, taken together with sections 362(b) and 381(c), would suggest that if the group suspended an S stock loss but merged S into another member, it could take the suspended loss into account because S was no longer a group member, even though its successor might later use S's duplicated loss.

As corrected by Announcement 2004-10, Temporary Regulation section 1.1502-35T(c)(5)(i) now requires that, before any suspended loss is taken into account, S *and* any S successor may no longer be group members. The announcement treated the correction as clarification of an obvious error, such that the correction is effective as of the original date of the regulation. As stated in section 1.1502-35T(j), the temporary regulation applies to events on or after March 7, 2002, and no later than March 11, 2006, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after March 14, 2003.

Treasury Decision 9118, 2004-15 I.R.B. 718, amended Temporary Regulation section 1.1502-35T(f) to clarify when loss carryovers attributable to S expire. Under Temporary Regulation section 1.1502-35T(f), as amended, all losses attributable to S are treated as expired if either of the following events occurs: (1) a group member treats S stock as worthless under section 165 and Regulation section 1.1502-80(c), and on the first day of the group's next year S (or its successor) is a group member; or (2) a group member recognizes a loss on S stock and on the following day S is not a group member and does not have a separate return year. These S losses expire as of the day following the last day of the group's consolidated return year that includes the event. Furthermore, the expired losses are *not* treated as noncapital, nondeductible expenses for purposes of Regulation section 1.1502-32. Thus, the loss expiration does not result in a negative adjustment for S (or any other member) under Regulation section 1.1502-32. Comparatively, Temporary Regulation section 1.1502-32T(b)(3)(iii)(A) generally treats expired losses as noncapital, nondeductible expenses.

Temporary Regulation Section 1.1502-80T(c)

Under Regulation section 1.1502-80(c), often a group cannot treat S stock as worthless before substantially all of S's assets are disposed of, abandoned, or destroyed for federal income tax purposes. Regulation section 1.1502-80(c) also provides that S stock cannot be treated as worthless under section 165 before it is treated as disposed of under Regulation section 1.1502-19(c)(1)(iii). Regulation section 1.1502-19(c)(1)(iii)(A) further states that a group is treated as disposing of S stock when substantially all of S's assets are disposed of, aban-

doned, or destroyed for federal income tax purposes. Thus, under this provision, a group cannot take a worthless stock deduction on S stock if it transfers S stock to S's creditors, but might if it instead transfers S's assets to those creditors.

Treasury Decision 9118, 2004-15 I.R.B. 718, added Temporary Regulation section 1.1502-80T(c), allowing the group a worthless stock deduction on the group's transfer of S stock to the S creditors. In relevant part, Temporary Regulation section 1.1502-80T(c) reads as follows:

> If stock of a member would otherwise be treated as worthless under the principles of section 165, then, notwithstanding [the general rule in Regulation section 1.1502-80(c)], such stock may be treated as worthless under section 165 immediately prior to the time such member ceases to be a member of the group.

This rule applies to taxable years beginning after March 18, 2004, and before March 18, 2007, but taxpayers may apply this rule to taxable years beginning after January 1, 1995, and on or before March 18, 2004.

Temporary Regulation Section 1.1502-28T

On August 29, 2003, the Service issued Temporary Regulation section 1.1502-28T and complementary regulations describing how a consolidated group accounts for a debtor member's cancellation of indebtedness income ("COD"). Under Temporary Regulation section 1.1502-28T, if the debtor member has COD excluded from gross income under section 108(a) ("excluded" COD), the group reduces its tax attributes under sections 108 and 1017 as follows: 1) the debtor member reduces its attributes under a "debtor-first" rule; 2) if the debtor has reduced its basis in another member's stock, the other member also reduces its attributes under "look-through" rules; and 3) under a "fan-out" rule, if the debtor's excluded COD exceeds its attributes reduced under the first step, the group reduces its remaining consolidated attributes.

In Treasury Decision 9117, 2004-15 I.R.B. 721, Treasury amended Temporary Regulation section 1.1502-28T to: (1) limit how section 1245 applies to reductions in subsidiary stock basis; (2) state when an excess loss account (an "ELA") triggered under Regulation section 1.1502-19(c)(1)(iii)(B) is taken into account; and (3) clarify how a creditor member that reduces its basis in intercompany debt takes the reduction into account. In Proposed Regulation section 1.67265-03, 69 Fed. Reg. 12,091 (2004), Treasury also proposed regulations describing the timing of attribute reductions under Temporary Regulation section 1.1502-28T.

Section 1245 and Section 108(b) Basis Reduction

If an asset's basis is reduced under sections 108 and 1017, the basis reduction is treated as a depreciation deduction for purposes of section 1245 and section 1250. Under section 1017(d)(1), the asset is treated as section 1245 property if it is not section 1250 property. Consequently, sections 1245(a) and (b) allow the basis reduction to be recaptured as ordinary income when the asset is disposed of, and on rare occasions it may be recaptured even when a non-recognition rule

otherwise applies.

For instance, formerly under the "debtor-first" rule and section 108, a debtor member could reduce its basis in subsidiary stock. Under section 1017(d)(1), the stock would be treated as section 1245 property and the basis reduction as a depreciation deduction in applying section 1245. Thus, if the subsidiary then liquidated, the debtor member could recapture part of its realized gain as ordinary income under section 1245, even if the liquidation qualified for general non-recognition under section 332. Section 1017(d)(1) treats the subsidiary stock as section 1245 property. Comparatively, section 1245(b)(3) excepts non-recognition transactions from section 1245 when the taxpayer receives transferred-basis property preserving the section 1245 gain. If the subsidiary also had reduced its asset basis under a "look-through" rule and the group took a transferred basis in those assets, the group could recognize the recapture gain a second time when it sold subsidiary assets.

To prevent that duplication, Treasury Decision 9117 amended Temporary Regulation section 1.1502-28T. Under the amendment, a basis reduction in subsidiary stock is treated as a depreciation deduction in applying section 1245 only to the extent that it exceeds the total amount of subsidiary attributes reduced under the "look-through" rules. Temporary Regulation section 1.1502-28T(d)(3) states that this change applies to COD that occurs "after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due without regard to extensions after March 12, 2004." Groups may elect to apply this change to any COD that occurs after August 29, 2003.

ELA Triggered Under Regulation Section 1.1502-19(c)(1)(iii)(B)

Treasury Decision 9117 also describes when a consolidated group accounts for any ELA triggered because of a disposition under Regulation section 1.1502-19(c)(1)(iii)(B). That trigger occurs when the group has an ELA in debtor member stock and the debtor member has "black-hole" COD (*i.e.*, excluded COD not applied to reduce attributes under section 108, section 1017, or Temporary Regulation section 1.1502-28T), as also illustrated in Regulation section 1.1502-32(b)(3)(ii)(C) and Temporary Regulation section 1.1502-32T(b)(3)(ii)(C)(*1*). Temporary Regulation section 1.1502-19T(b)(1)(ii) allows the group to include the ELA in income, but only up to the "black-hole" COD. Under Temporary Regulation section 1.1502-28T(b)(6)(ii), added by Treasury Decision 9117, the group includes that amount in income for the taxable year in which the debtor member realized the excluded COD. This amendment has the same effective date as the section 1245 change discussed above.

Intercompany Receivables

Finally, Treasury Decision 9117 clarifies how a creditor member accounts for a basis reduction in its intercompany debt under Temporary Regulation section 1.1502-28T. Some commentators have asked whether the creditor excludes any income attributable to the basis reduction when the debt is satisfied as noted in the decision. Because an exclusion would be inconsistent with the intent of

section 108 to merely defer income, Treasury Decision 9117 established Temporary Regulation section 1.1502-13T(g)(3)(ii)(B)(4) to amend Regulation section 1.1502-13 and clarify that the creditor member cannot exclude income attributable to the basis reduction when the intercompany debt is satisfied. It also clarifies that the basis reduction does not result in income realization to the group when the reduction occurs. These clarifications, according to the temporary regulation, apply to transactions or events occurring during a taxable year the original return for which is due (without extensions) after March 12, 2004.

Timing of any Section 108(b) Attribute Reduction

If a debtor has excluded COD, section 108(b) requires the debtor to reduce certain attributes. The attribute reduction must be made after the determination of tax imposed by chapter 1 of the Code for the taxable year of the discharge. Furthermore, section 1017(a) states that basis can be reduced only for property held by the taxpayer at the beginning of the taxable year following the discharge year.

It is sometimes puzzling to implement these statutory directives when a consolidated group disposes of member stock during a year that a debtor member excludes COD. If the section 108(b) attribute reduction occurs during the exclusion year, the reduction can affect the group's gain or loss on its disposition of member stock, arguably contrary to section 108(b)(4). If the attribute reduction must occur in the following year, the group might effectively skirt the attribute reduction requirement.

Proposed Regulation sections 1.1502-11(b) and (c), 69 Fed. Reg. 12,091 (2004), attempt to resolve these issues and prevent circular computations. Under the proposed regulations, a consolidated group would apply the following multi-step process if, in any year, the group has both disposed of subsidiary ("S") stock and has also excluded COD.

First, the proposed regulation would govern any limitation on its use of the S losses and loss carryovers under Regulation section 1.1502-11(b)(2) and (3). Under Regulation section 1.1502-11(b)(2) and (3), the consolidated group determines the S deductions and losses it can take into account by computing its taxable income but excluding its gain or loss on S stock.

In a second series of steps, the proposed regulation directs the group to make the following four tentative computations.

First, the group computes its basis in S stock under Regulation section 1.1502-32 and Temporary Regulation section 1.1502-32T, accounting for all items for the year except excluded COD and the corresponding section 108(b) attribute reductions. Additionally, the proposed regulation notes that S's losses and deductions are limited as provided in the previous step. Second, using the S stock basis determined in the previous step, the group computes its gain or loss on any dispositions of S stock except under Regulation section 1.1502-19(c)(1)(iii)(B). Third, the group computes its taxable income or loss for the disposition year (and any prior years to which losses may be carried), including any gain or loss from S stock dispositions computed in the previous step. Fourth, the group

reduces remaining attributes under Temporary Regulation section 1.1502-28T.

In a third series of steps, the group makes the following four final computations. First, it computes its basis in S stock under Regulation section 1.1502-32 and Temporary Regulation section 1.1502-32T, reflecting the group's taxable income or loss and the attribute reduction under steps (c) and (d) of the tentative computations. Second, using the S stock basis determined in the previous step, the group computes its gain or loss on the S stock, *including* any ELA on S stock triggered under Regulation section 1.1502-19(c)(1)(iii)(B). Third, the group computes its taxable income or loss for the disposition year (and any prior years to which losses may be carried back). In this computation, it takes into account any gain or loss from S stock dispositions computed in the previous step and any limitation under Regulation section 1.1502-11(b) computed in the first step. To avoid circular computations, attributes cannot offset an ELA triggered under Regulation section 1.1502-19(c)(1)(iii)(B) and Temporary Regulation section 1.1502-19T(b) to the extent they were absorbed or used in steps (c) and (d) of the tentative computations. Fourth, the group reduces remaining attributes under Temporary Regulation section 1.1502-28T.

To prevent circularity, the attribute reduction in the last step is limited in two ways. The first limitation applies if S or an S lower-tier subsidiary realizes excluded COD. If this limit is applicable, then Proposed Regulation section 1.1502-32(c)(2)(ix)(A) states that the aggregate amount of excluded COD that is applied to reduce attributes for the other members cannot exceed the amount applied to reduce their attributes under step (d) of the tentative computations. The attribute reductions for S and its lower-tier subsidiaries are not so limited.

Proposed Regulation section 1.1502(c)(2)(ix)(B) instead applies the second limitation if a member other than S or an S lower-tier subsidiary realizes excluded COD. The aggregate amount of excluded COD that is applied to reduce attributes (other than credits) for S and its lower-tier subsidiaries cannot exceed the amount applied to reduce their attributes (other than credits) under step (d) of the tentative computations. The attribute reductions for other members are not limited. If this second limitation applies, Temporary Regulation section 1.1502-28T(a)(4) applies to reduce the attributes of the other members that are of the same type before reducing attributes of other types.

Proposed Regulation section 1.1502-11(c)(7) would apply to dispositions of S stock after the date the proposed regulations are published as temporary or final regulations in the Federal Register.

Proposed Regulations Under Section 265

Under section 265(a)(2), no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from the taxes imposed by subtitle A of the Code. Regulation sections 1.1502-13(c)(1)(i), (c)(6), (g)(5) and *ex. 1(d)* illustrate that if section 265(a)(2) disallows all or a portion of an interest deduction on a loan between members of a consolidated group, the creditor member ("S") excludes a corresponding amount of interest income.

Proposed regulation 1.265-2(c), 69 Fed. Reg. 25,535 (2004), would change the result to S if: (1) S incurs or continues debt to a non-member (the "non-member" debt); (2) the non-member debt is directly traceable to an intercompany obligation extended by S to another member ("B"); and (3) section 265(a)(2) applies to disallow a deduction for all or a portion of B's interest expense on the S-B debt. If those conditions are met, S would include its interest income on the S-B loan in gross income, except to the extent that income exceeds S's interest expense on the portion of the non-member debt that is directly traceable to the S-B debt. There has been criticism of the proposed regulation, among them, Lee A. Shepherd, *Virtual Repeal of Disallowance for Carrying Tax-Exempts*, 106 TAX NOTES 894, Feb. 21, 2005. Comparatively, Revenue Ruling 2004-47, 2004-21 I.R.B. 941, 942 (Sit. 3) provides an example where P and S were members of an affiliated, non-consolidated group. S's activities were not taken into account in applying section 265 to P's interest expense on a non-member loan, when the loan proceeds were not linked to any funds transferred by P to S.

Manufacturer's Incentive Payments: Proposed Amendment to Regulation Section 1.1502-13

Under Proposed Regulation section 1.1502-13, 69 Fed. Reg. 50,112 (2004), Treasury proposed amending Example 13 of Regulation section 1.1502-13(c)(7) regarding manufacturer's incentive payments. A more extended discussion of this proposed regulation can be found in Jasper L. Cummings, Jr., *If You Can't Deduct a Rebate, You Haven't Tried Hard Enough*, 104 TAX NOTES 1301, Sept. 13, 2004. The proposed regulation would add two factual variations to the example. In each case, one member of a consolidated group ("B"), a manufacturer, in form makes an incentive payment to a second member ("S"), a finance company, for a product sold to a non-member.

In the first proposed factual variation, an independent dealer sells B's product to a customer under a retail installment sales contract with a $100 face amount but a $90 value. The dealer sells the contract to S for $100, and B pays S $10 to account for the $10 overpayment.

The proposed regulation assumes that on a separate-entity basis, B would deduct its incentive payment, while S would take a $90 basis in the installment contract ($100 consideration paid reduced by the $10 incentive payment). It also assumes that if S and B were treated as a single corporation, "S-B" would still have a $10 deduction (reflecting the $10 excess payment for the contract) and would still take a $90 basis in the contract. Thus, under the matching rule, B is entitled to a $10 deduction, S takes a $90 basis in the installment sales contract, and S also takes $10 into account as income over the contract's term, rather than in the year it receives the $10 payment.

In the second proposed factual variation, B sells its product to an independent dealer and S finances the purchase, loaning the dealer $100 at a below-market interest rate but receiving $10 from B to make up for the below-market rate. Under Regulation section 1.1273-2(g)(4), the $10 payment from B to S is characterized as two separate $10 payments, one from B to the dealer and the second

from the dealer to S. Because of that characterization, B is not treated as making an intercompany transfer to S, and Regulation section 1.1502-13 does not apply to the transaction.

Cases and Rulings

Notice 2004-37

Notice 2004-37, 2004-21 I.R.B. 947, considers the "value" test of section 1502(a)(2). Under this test, for a corporation to be a subsidiary in an affiliated group, group members must own stock of the corporation that comprises at least 80% of its total stock value.

The notice announced that Treasury would issue regulations that would: (1) deem the value test met if the group treated it as met based on a good faith determination of value (the "good faith" exception); and (2) disregard a subsidiary's inadvertently ceasing to be a member because of changes in the relative values of different classes of stock (the "inadvertence" exception). Section 1504(a)(5)(C) and (D) direct Treasury to issue regulations to that effect.

The notice also outlines circumstances in which the Service would provide relief under those exceptions, pending issuance of regulations (or an amended notice). The notice warns that this interim relief could vary from, and be broader than, the relief ultimately provided by regulations.

Implementing the good faith exception in sections 3.01 and 3.02 of Notice 2004-37, the notice provides that if a consolidated group determines in good faith that the value test is met for a corporation ("S"), that test will be deemed met for S until a designated event occurs. The notice also provides that the value test is deemed met before the designated event occurs even if the group later knows or should know that the good faith determination was incorrect. Following such an event, the value test will still be deemed met for S if the group again makes a good faith determination that the test is met.

Implementing the inadvertence exception, section 3.03 of Notice 2004-37 provides that the value test will be deemed met for S if: (1) the group does not meet the value test for S because of a change of relative values of different classes of S's stock; (2) that change is not attributable to a designated event; and (3) immediately before the change, the group met the value test for S. Thus, a group may fail to meet either exception following a designated event. Section 3.04 of the notice identifies the following such events: (1) S issues its stock to a non-member; (2) S redeems stock owned by a member other than in complete liquidation; (3) a member directly or indirectly transfers S stock to a non-member; (4) after May 6, 2004, S makes a distribution on its stock to a member (or person related to a member under section 267(b) or section 707(b)) or engages in certain transactions that are in substance like distributions; (5) the group claims a worthless stock deduction for any S stock; (6) S engages in a recapitalization described in section 368(a)(1)(E); and (7) the group takes a position on its consolidated federal income tax return that the value test is not satisfied for S for purposes of any value provision. Section 3.01 of the notice defines a value

provision as either (1) any provision of the Code or regulations for which "ownership of stock, as defined in section 1504, representing 80% (or any lesser threshold percentage of the total [stock] value) is relevant, or (2) any such provision that refers to an "affiliated group" as that term is defined in section 1504.

Under sections 3.01 and 3.04(7) of Notice 2004-37, a group is not required to treat the value test as met for S if the good faith or inadvertence exception applies. However, the group must treat S consistently for all value provisions (*i.e.*, the group must treat the value test as met for all value provisions if it treats the test as met for one such provision under either exception).

"Loss Duplication" Legal Advice Memoranda

In two identical Chief Counsel Advice Memoranda, 2004-23-027 (May 17, 2004) and 2004-31-014 (May 17, 2004), the Service considered whether the *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934), doctrine applied to a pre-Temporary Regulation section 1.1502-35T case. Under that doctrine, a consolidated group cannot enjoy duplicate tax benefits for the same economic loss. The Service concluded that the *Ilfeld* doctrine applied to the cases considered in the advice memoranda.

The advice memoranda also illustrated how broadly the Service may define a duplicated loss. In each factual situation considered by the memoranda, P and S were members of a consolidated group, and P owned all S stock with an $80 basis and value. P contributed property with a $120 basis and $20 value to S in exchange for new S stock (comprising 20% of all S stock), taking a $120 basis in that stock as provided in sections 351 and 358(a).

In the first situation, P sold the new S stock for $20, recognizing a $100 loss, and S then sold the loss asset for $20, also recognizing a $100 loss. In Regulation section 1.1502-32(b)(3)(iii), (b)(2)(iii) and (c)(1), the Service concluded that the P group enjoyed a $200 tax benefit from a single $100 economic loss and disallowed S's $100 asset loss under the *Ilfeld* doctrine. Because of disallowance, the group treated S's asset loss as a noncapital, nondeductible expense, and P presumably reduced its basis in the old S stock by $80, from $80 to $0.

In the second situation, the steps were reversed, such that S sold its loss asset before P sold the new S stock. On its sale of the asset, S recognized a $100 loss, which the group apparently absorbed. Under Regulation section 1.1502-32(b)(2)(i) and (3)(i), P reduced its new S stock basis by $20, from $120 to $100, and its old S stock basis by $80, from $80 to $0. Thus, on its sale of the new S stock for $20, P recognized an $80 loss. The Service concluded that the P group enjoyed a $180 tax benefit from a single $100 economic loss and disallowed P's $80 stock loss under the *Ilfeld* doctrine. In appropriate cases, the advice memoranda also stated that the Service would disallow the stock loss under the anti-abuse rule of Regulation section 1.1502-32(e), rather than under the *Ilfeld* doctrine.

Note, however, that because P reduced its basis in the old S stock by $80 to account for S's asset loss, the loss disallowance in either case could effectively eliminate a portion of the group's economic loss. Because of the basis reduction, if P later sold its old S stock (and no section 338(h)(10) election were made for

the sale), P would increase its recognized gain (or reduce its recognized loss) on the S stock by $80, thereby eliminating the overall tax benefit for $80 of its $100 economic loss. Thus, the advice memoranda show that the Service broadly defines a duplicated loss.

Technical Advice Memorandum 2004-47-037

In Technical Advice Memorandum 2004-47-037 (Aug. 24, 2004), the Service considered how a consolidated group applied section 384 when it made a stock acquisition of a target group that was a "gain corporation." Section 384(c)(4) defines a "gain corporation" as a corporation with a net unrealized built-in gain, and subsection (c)(6) provides that members of the same affiliated group are treated as one corporation. Under section 384, the acquiring group's pre-acquisition loss cannot offset any of the target group's recognized built-in gain. The technical advice memorandum addressed how the acquiring group should compute its pre-acquisition loss for the acquisition year.

Under section 384(c)(3), the acquiring group's overall loss for the acquisition year is allocated ratably to each day of the year, except when regulations provide otherwise. Despite the absence of regulations, the Service has allowed groups to use the "closing of the books" method by private letter ruling, exemplified, for instance in Private Letter Ruling 2002-38-017 (June 11, 2002). Although the acquiring group apparently asked to use that method, the Service refused, arguing that the group's request could be granted only by analogy to Regulation section 301.9100 and that the request had to be denied because it involved prohibited hindsight.

Accordingly, the Service concluded that the acquiring group had to compute its pre-acquisition loss by allocating its acquisition-year loss ratably to each day of that year. This allocation might be made (1) by segregating the tax items of the former target group members from those of the other members of the acquiring group (the "separate approach") or (2) by combining all tax items of the acquiring group, including those of the former target group members (the "combined approach").

The Service favored the combined approach for the following reasons: 1) the consolidated return regulations used a combined approach to compute a group's consolidated taxable income; 2) the combined approach was consistent with similar rules under section 382; 3) the combined approach did not require additional ordering rules for the typical case, and Congress provided no ordering rules (the failure to provide ordering rules, the Service stated, was a "glaring omission" if Congress intended groups to use the separate approach); and 4) the combined approach achieved consistent results for stock acquisitions and mergers.