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The Scope of the General Utilities Repeal

Don Leatherman

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The Scope of the *General Utilities* Repeal

By Don Leatherman*

Don Leatherman examines the scope of the *General Utilities* repeal and discusses how the repeal should be implemented.

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I. Introduction

More than a quarter of a century ago, Congress repealed the *General Utilities* doctrine, authorizing the Treasury to issue regulations to prevent circumvention of the repeal. Although the Treasury has issued several sets of regulations in response, it has never systematically defined the scope of the repeal. Instead, the regulations and other administrative guidance more selectively attack concerns raised by the repeal, almost all of which arise because of the dual nature of stock: A corporate shareholder can choose to treat a subsidiary's stock as a separate asset or, in certain cases, as an indirect interest in subsidiary assets, a choice facilitated by Code Sec. 332, the consolidated return regulations, the reorganization provisions and the interplay of Subchapter C and passthrough regimes.[1] Unchecked, that choice would allow corporations to readily avoid the repeal, but the choice has been severely restricted by Congress and the Treasury.

This article considers the extent to which the response should be further developed and refined. It concludes that the Treasury and the Internal Revenue Service (the IRS) should adopt a general rule to implement the repeal. It also concludes that they should simplify the uniform loss rules under Reg. §1.1502-36 and bring final Proposed Reg. §1.337(d)-3 with some modifications. This article first considers the scope of

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the *General Utilities* repeal before considering how the repeal should be implemented. It ends with a brief conclusion.[2]

II. Scope of the Repeal

A. The *General Utilities* Doctrine

Under the *General Utilities* doctrine, a corporation recognizes neither gain nor loss on its distribution of property to its shareholders. The doctrine can be traced to the Supreme Court case that bears its name, *General Utilities & Operating Co. v. Helvering*.[3] In that case, a corporation was poised to sell an appreciated asset when its counsel realized that the sale and later distribution of the sales proceeds would result in two levels of tax, a corporate tax on the sale and a shareholder tax on the distribution. To avoid the corporate tax, the corporation instead distributed the appreciated asset to its shareholders, who reported a shareholder-level dividend but took a fair market value basis in the distributed asset. The shareholders then quickly sold the asset, recognizing no further income or gain.

The IRS vigorously argued that the corporation should also be taxed on the distribution, an argument that evolved as the case wound its way through Board of Tax Appeals, the Circuit Court of Appeals and the Supreme Court. Although he convinced the circuit court, the IRS fell short at the other levels.

At the Board of Tax Appeals, he argued that the distributing corporation had declared a cash dividend of about $1 million and satisfied the dividend obligation by distributing appreciated property, thereby recognizing gain under the predecessor to Code Sec. 1001.[4] The court rejected that argument because in fact the corporation declared a dividend of the asset and not a dividend of cash.

On appeal, the IRS argued in addition that the property sale, though in form made by the shareholders, should be attributed to the corporation.[5] Although the court of appeals favored the new argument,[6] the Supreme Court, on appeal, rejected it on procedural grounds (*i.e.*, that it was raised for the first time on appeal).[7] The Supreme Court also sided with the trial court (and circuit court) on the first argument (*i.e.*, that the distributed asset was not used to satisfy a corporate debt).[8]

In its Supreme Court brief, the IRS advanced yet a third argument—that a corporation must recognize taxable income on a distribution of appreciated property to its shareholders since the transfer was a "sale or other disposition" under what is now Code Sec. 1001. In its decision, the Supreme Court greeted this argument with a studied silence, and commentators disagreed about whether the Court rejected the third argument on the merits or on procedural grounds (*i.e.*, because it was raised too late in the proceeding).[9] Despite the Court's silence, the former explanation became popular with courts (and of course practitioners), and the *General Utilities* doctrine was born.[10]

In 1954, Congress codified that doctrine in Code Sec. 311(a), a section providing that no gain or loss was recognized to a corporation on a distribution of property with respect to its stock.[11] It provided a companion nonrecognition rule for liquidating distributions under Code Sec. 336.[12] By enacting those rules, Congress blessed a partial integration of the corporate and individual tax regimes.[13] It recognized, however, that despite its merits, the codification raised some administrative and systemic concerns.[14]

As part of the codification, Congress addressed an administrative concern raised by the *Court Holding Company* doctrine.[15] In that case, a corporation negotiated the sale of an appreciated asset in anticipation of liquidation, reaching an oral agreement with a buyer about the terms and conditions of sale. Alerted by counsel that its sale would result in a significant tax, the corporation instead liquidated, distributing the asset to its two shareholders, a husband and wife. Three days later, the shareholders sold the asset on the previously agreed terms to the same buyer. If form were respected, there was no corporate-level tax. The Supreme Court concluded, however, that the shareholders served as a conduit for a sale by the corporation.[16] In substance, therefore, the corporation was treated as selling the asset, incurring a tax and then distributing the sales proceeds in liquidation to its shareholders, who also incurred a tax.

By way of contrast, in *Cumberland Public Service*,[17] the Supreme Court refused to recast a similar transaction, concluding that the shareholders of a liquidating corporation had sold the corporation's assets, not as a conduit for the corporation but in their individual capacities.[18] As in *Court Holding Co.*, the Supreme Court reached its conclusion by relying on the trial court's characterization of the transaction. That reliance created uncertainty in planning similar transactions.

Congress addressed that uncertainty in 1954 with Code Sec. 337.[19] Under that provision, a corporation recognized no gain or loss if it sold property

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after it adopted a plan of liquidation, as long as the liquidation occurred within 12 months following that adoption. This rule eased, but did not eliminate, the administrative concern raised by the *Court Holding Co.* doctrine.[20]

In addition to addressing that administrative concern, Congress realized that nonrecognition under the *General Utilities* doctrine should not be absolute. First, if a corporation used the last-in, last-out inventory method, Code Sec. 311(b) provided that the corporation could recognize gain on its distribution of inventory assets.[21] Second, under Code Sec. 311(c), a corporation also recognized gain to the extent that a shareholder assumed a liability in connection with a property distribution and the liability exceeded the adjusted basis of the distributed property.[22] Finally, in legislative history, Congress acknowledged that despite the *General Utilities* doctrine, a corporation may include an amount in gross income under the assignment-of-income doctrine on its distribution of property.[23]

Over time, courts continued to chip away at the *General Utilities* doctrine.[24] Beginning in 1969, Congress also began to erode the doctrine,[25] adding exceptions to the nonrecognition rule of Code Sec. 311(a), exceptions that by 1984 had all but swallowed the rule.[26] Finally, in the Revenue Act of 1986 (the "1986 Act"), Congress overturned most remaining vestiges of the *General Utilities* doctrine.[27] Code Sec. 311(b) now provides that if a corporation makes a nonliquidating distribution of appreciated property (other than the distributing corporation's own obligation) to a shareholder, it recognizes gain as if it had sold the property to the shareholder at fair market value. (Under Code Sec. 311(a), it recognizes no loss on a corresponding distribution of loss property.) Further, as a general rule, Code Sec. 336(a) provides that a corporation recognizes gain or loss on its liquidating distribution of appreciated property.

B. The *General Utilities* Repeal

In overturning, or "repealing," that doctrine (an action commonly called the "*General Utilities* repeal"), Congress offered tantalizing hints about the scope of the repeal, both in the relevant legislative history and in the sections passed in conjunction with the repeal, but its scope has never been systematically defined, either by statute, case law or regulation.

Despite its uncertain scope, the repeal has fundamentally altered the taxation of business income. The repeal was substantially completed with the 1986 Act, an act that also effected a systemic change in the corporate tax regime, de-linking that regime from the individual tax regime, marking the end of the partial integration of the two regimes: Not only did the 1986 Act sound the death knell of the *General Utilities* doctrine, it also eliminated an individual's capital gains preference and provided a higher maximum tax rate for corporations than individuals.[28] Of these changes, only the *General Utilities* repeal tolerated any administrative discretion.[29]

That discretion is far from unlimited. The repeal cannot be implemented merely as an anti-abuse rule or series of such rules because it defines a realization and recognition event for purposes of Code Sec. 1001.[30] Thus, its application should not vary depending on the business purpose of a transaction.

In addition, although its outer boundaries may be uncertain, the repeal, in the main, now seems adequately defined both by the legislative history for the 1986 Act that described the repeal and by complimentary Code provisions enacted since the repeal. At a minimum, it should generally apply if a transaction otherwise eliminates a level of corporate tax, whether through a distribution, sale or transfer of an asset. That elimination may occur through the elimination of gain or the creation of a noneconomic loss.[31] Further, the repeal arguably should also apply if a transaction duplicates an economic loss or permits an "undue" deferral of corporate-level gain, particularly if that gain is deferred and shifted to another corporate taxpayer.[32] The repeal should not apply, however, when a statutory provision clearly provides for gain elimination, and that elimination is consistent with the policy underlying the provision.[33]

That suggested scope is consistent with the legislative history to 1986 Act, but that legislative history merely illustrated the repeal's scope. The House Report noted that the *General Utilities* doctrine allowed a corporation to distribute an appreciated asset to a shareholder without gain, allowing the shareholder to take a fair market value basis in the asset at the cost of a shareholder-level tax.[34] At a minimum, therefore, the *General Utilities* repeal should require a corporation to recognize gain when it distributes appreciated property to a shareholder and the shareholder takes a fair market value basis in the asset.

Not only did the Senate fail to define the repeal's scope, it failed to follow the House in proposing the repeal, but the proposal reappeared as a revenue raiser in the Conference bill. The Conference Report also failed to define the repeal's scope, although it

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recognized that the repeal may be circumvented if corporations were permitted to create artificial (or noneconomic) losses.[35] To combat that circumvention, Congress granted the Treasury broad regulatory authority in Code Sec. 337(d) to prevent circumvention of the repeal, stating:

> The repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain or a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of Subchapter C).[36]

Thus, at least as an initial matter, Congress ceded to the Treasury the difficult task of defining the repeal's scope.

C. The Initial Administrative Response

Partially in response, the IRS issued Notice 87-14,[37] which anticipated regulations that, among other things, would target the "son-of-mirrors" transaction, a transaction that created noneconomic loss.

> **Example—Son-of-mirrors transaction.[38]** P buys all of the stock of T for $1,000, and T has two assets, Wanted Asset and Unwanted Asset. Each asset has a $100 basis and $500 value. T distributes Wanted Asset to P, recognizing a $400 gain,[39] which is deferred under the intercompany transaction rules.[40] P accounts for the distribution by reducing its T stock basis by $500, from $1,000 to $500[41] but including no amount in gross income because of the distribution.[42]
>
> P sells the T stock to X for $500, its fair market value. Immediately before the sale, T takes its deferred $400 gain on Wanted Asset into account.[43] Consequently, P increases its T stock basis by $400 to account for that gain, from $500 to $900.[44] Thus, on P's sale of the T stock, P recognizes a $400 loss, the excess of P's T stock basis ($900) over its amount realized ($500).[45] If P's stock loss offset T's gain on Wanted Asset (or other P group income), the group would eliminate corporate-level gain without tax, contrary to the *General Utilities* repeal. Notice 87-14 eliminated that noneconomic loss.[46]

Notice 87-14 attacked a clear target of the *General Utilities* repeal—the elimination of corporate-level tax. That elimination could occur directly (through the elimination of corporate gain) or indirectly (through the creation of noneconomic corporate loss). As Notice 87-14 illustrates, the *General Utilities* repeal targets either direct or indirect elimination transactions, whether they involve liquidating or nonliquidating distributions, sales or other transfers of assets.

D. The 1987 Legislation

When the repeal was enacted, it was unclear whether it applied to a "mirror" transaction. In this transaction (and the cousin-of-mirrors transaction), a consolidated group (or nonconsolidated, affiliated group in the cousin-of-mirrors transaction) could dispose of appreciated target assets without gain. Through a series of steps, the group would transfer appreciated target assets to a subsidiary and then sell the subsidiary stock at no gain (and sometimes at a loss). Although these transactions could preserve all of the built-in gain in the target assets at the corporate level, that gain was deferred and shifted to a new corporation or consolidated group. Legislation enacted in 1987 hampered that deferral and shift.[47]

> **Example—Mirror transaction.** The P group plans to buy all stock of T, which owns two businesses, Business U, with a $30 basis and $100 value and Business W, with a $40 basis and $100 value. The acquiring group intends to keep Business W but dispose of Business U.
>
> The group forms two acquisition subsidiaries, S1 and S2, funding each with $100 and taking a $100 basis in the stock of each subsidiary. Each subsidiary acquires one-half of the T stock. Shortly after the purchase, T liquidates, with S1 acquiring the Business U assets and S2 the Business W assets. For purposes of Code Sec. 332(b)(1), each P group member is treated as owning any stock owned by another member.[48] Thus, S1 and S2 are each treated as owning all T stock; Code Sec. 332 applies to their receipt of liquidating distributions from T, and neither

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recognizes any gain or loss on the liquidation. Further, under the law in effect before 1987, Code Sec. 337 arguably also applied to T on its liquidation. Assuming that it applied, T recognized no gain (or loss) on its distributions to S1 and S2.

P then sells the S1 stock to X for $100, recognizing no gain or loss. Note that if T had sold Business U assets directly to X, it would have recognized a $70 gain. This "mirror" transaction deferred that gain recognition, although at a cost of the Business U assets retaining a $30 basis.

Despite language in the legislative history that supported immediate recognition absent a regulatory change, some believed that gain deferral occasioned by a mirror transaction was properly allowed following the 1986 Act's repeal of the *General Utilities* doctrine.[49] This dispute was enlivened by a debate that played out in the Congressional Record between Democratic House and Republican Senate members. Representative Rostenkowski asserted that gain could not be deferred in a mirror transaction "merely because the underlying assets of the subsidiary do not obtain a stepped-up basis."[50] Senators Dole and Packwood disagreed, asserting that the *General Utilities* repeal did not affect the treatment of mirror transactions.[51]

Although Rostenkowski may have lost that skirmish, Dole and Packwood lost the war because in 1987, Congress acted to definitively shut down the mirror transaction.[52] Although the House report justified the legislative change to prevent gain deferral, the Conference Report described the change without offering a rationale.[53] Nevertheless, the change certainly limited gain deferral, consistent with a companion piece that targeted a transaction that exploited Code Sec. 304 to defer or eliminate gain.

Example—Cousin-of-mirrors transaction.[54] P owned all stock of S1 and S2, and S1 owned all stock of S3 with a $20 basis. S1 sold the S3 stock to S2 for $100, its fair market value. If this sale occurred immediately after the effective date of the 1986 Act, Code Sec. 304 applied to the sale and S1 might recognize no net income on the sale.

Code Sec. 304(a)(1) applied, for example, if a person transferred the stock of one controlled corporation to another corporation and received property in exchange.[55] For this purpose, a person controlled a corporation if it owned, actually and constructively, at least 50 percent, by vote or value, of the corporation's stock.[56] Code Sec. 304(a)(1) applied to S1's sale of the S3 stock because S1, a person, not only controlled S3 before the sale, actually owning all S3 stock, but also controlled S2 after the sale, constructively owning all of its stock.[57]

When Code Sec. 304(a)(1) applied, the acquiring corporation (*i.e.*, S2) was treated as making a distribution in redemption of its stock, but the character of the redemption under Code Sec. 302(b) was determined by looking to the stock of the target corporation (*i.e.*, S3).[58] Because S1 owned, actually and constructively, all S3 stock before and after the transaction,[59] the deemed redemption was not described in Code Sec. 302(b) and must have been one to which Code Sec. 302(d) and Code Sec. 301 applied.[60]

Assume that S2 had at least $100 of current earnings and profits, and S1 treated the full $100 payment as a dividend. It therefore included none of that $100 amount in gross income.[61] Further, because S1 owned no S2 stock, it could not reduce any basis in the S2 stock because of the deemed redemption.[62] However, S1 increased its earnings and profits by $80 (*i.e.*, the $100 dividend amount minus its $20 basis in the relinquished S3 stock), resulting in an $80 increase in P's S1 stock basis.[63]

S2 recognized no gain or loss when it acquired the S3 stock, treating the acquisition as a contribution to its capital.[64] However, S2 reduced its earnings and profits by up to $100. As a result, P's basis in its S2 stock was up to $100 lower because of the Code Sec. 304 transaction.[65]

Thus, the transaction increased P's basis in its S1 stock by $80, at a cost of reducing its basis in its S2 stock by up to $100, eliminating gain or creating loss in that S1 stock while creating gain or eliminating loss in the S2 stock. Although P could later sell S1 stock at a reduced gain (or increased loss), the transaction might merely defer, rather than eliminate, gain within the corporate system because of P's basis adjustment to the S2 stock.[66]

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Thus, the 1987 legislative change attacked gain deferral rather than gain elimination, and that attack should be considered an aspect of the *General Utilities* repeal. Note that even though the repeal is identified with the 1986 Act, it is imprecise to say that the act implements the *General Utilities* repeal. The statutory repeal actually began in 1969 and was implemented in stages over many years, including in 1987.

The 1987 legislative change is also consistent with and furthers the repeal, complementing an earlier attack on the deferral and shifting of corporate gain.[67] In 1984, Congress repealed part of the *General Utilities* doctrine when it amended Code Sec. 311 to require a corporation generally to recognize gain on its distribution of appreciated property to a corporate shareholder.[68] Before the amendment, the distributing corporation recognized no gain, but the corporate shareholder took the property with a carryover basis, preserving the gain. Congress made the change because it found the shift in gain and attendant tax liability "inappropriate," noting that the distribution may allow the gain's character to change.[69] Because the character, and therefore the amount, of tax could change through the shift, Congress rejected "surrogate" taxation even though no gain escaped a corporate-level tax.[70]

Finally, the 1987 legislative change is better viewed as merely clarifying the 1986 Act, not adopting a new rule.[71] Thus, limitations on gain deferral should be considered part of the *General Utilities* repeal.

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E. Other Statutory Provisions

Other statutory provisions also implement aspects of the repeal. Among other things, those provisions attack the selective recognition of loss, the duplication of one economic loss, surrogate taxation and gain deferral, while sometimes forgoing policy purity for a more administrable rule.

1. 1986 and Prior Changes

For example, Congress appeared to attack the selective recognition of loss when it amended Code Sec. 311 to require a corporation to recognize gain but not loss on its distribution of property. Without this rule, a corporation might "cherry pick" losses, choosing to recognize loss by distributing loss property, but defer gain by retaining gain property.[72] That concern may also have motivated Code Sec. 336(d)(3) (providing that a corporation recognizes no loss on its distribution of loss property to a minority shareholder as part of a Code Sec. 332 liquidation)[73] and Code Sec. 337(b)(1) (providing that a liquidating corporation recognizes neither gain nor loss when it satisfies a debt to the controlling parent as part of a Code Sec. 332 liquidation).[74] The legislative history, however, does little to describe the rationale for these changes.

In amending Code Sec. 311, Congress may also have had the following concern: If loss could be recognized on a distribution, a corporation and controlling shareholder may be tempted to undervalue distributed property, producing phantom losses at the corporate level and understating dividend income at the shareholder level, income that later may be converted to more favorably taxed capital gain. Although Code Sec. 311's loss-disallowance rule still tolerates the undervaluation, it eases the concern. It also makes it more likely that the chronically underfunded IRS will have to deal with only one taxpayer, the shareholder, to address any possible undervaluation.

In the 1986 Act, Congress also added Code Sec. 336(d)(1) and (2), provisions that target the creation of duplicate loss at the shareholder and corporate levels and also serve as a substitute for applying Code Sec. 267 to liquidations.[75] Under Code Sec. 336(d)(1), a liquidating corporation cannot recognize a loss on a property distribution to a "related person"[76] if the distribution is not *pro rata* or if the distributed property is "disqualified property."[77] A "related person," defined by reference to Code Sec. 267, includes an individual who owns, actually and constructively, at least 50 percent (by value) of the corporation's stock.[78] "Disqualified property" is property acquired by the liquidating corporation in a transaction to which Code Sec. 351 applied (or as a capital contribution) within five years of the distribution date.[79]

Like Code Sec. 336(d)(1), Code Sec. 336(d)(2) restricts a liquidating corporation's loss and is also an "anti-stuffing" rule aimed at preventing double deductions.[80] The rule is triggered by a distribution, sale or exchange of property that had been acquired in a Code Sec. 351 transaction (or as a contribution to capital) if the following additional condition is met: The property's acquisition was "part of a plan a principal purpose of which was to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation."[81] Property acquired by the liquidating corporation "after the date two years before the date a corporation adopts a plan of liquidation" is presumed to have been acquired with that principal purpose.[82]

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Although Code Sec. 336(d) offers relatively modest clues about the scope of the *General Utilities* repeal, Code Sec. 1374 yields a richer vein to mine. It suggests that Congress was concerned with not only the possible elimination of corporate tax but also its deferral and that it was willing to sacrifice absolute precision for administrability.

Code Sec. 1374 applies when a C corporation converts to an S corporation. As the intuitive response to the conversion, the corporation could have been treated as constructively liquidating, with the corporation and its shareholders recognizing gain or loss on the conversion,[83] but Code Sec. 1374 takes a different tack: If the S corporation recognizes pre-conversion built-in gain during the recognition period (*i.e.*, generally the 10 years following the conversion), that gain is subject to a corporate-level tax. Thus, unlike the more intuitive approach, Code Sec. 1374 defers the tax on pre-conversion built-in gain, imposing tax when the gain otherwise would have been recognized absent the conversion. This approach affords taxpayers the benefit of deferral, an integral aspect of this portion of the *General Utilities* repeal.

It is not clear, however, why the built-in gain is tracked only for 10 years, although that approach may be justified for up to three reasons. First, it makes Code Sec. 1374 more administrable. Second, if gain was deferred for more than 10 years, Congress may have believed such deferral was the substantial equivalent of nonrecognition. Following that reasoning, if a corporation engages in a transaction that defers gain for more than 10 years, that transaction could be viewed as the equivalent of a gain-elimination transaction. Finally, Congress may have been concerned that Code Sec. 1374 treated the corporation and shareholder too harshly in the following way: A C corporation's taxable income is taxed when earned to the corporation, but taxed to the shareholder only on distribution. If Code Sec. 1374 applies to an S corporation's income, however, it is subject to a corporate and immediate shareholder tax. Thus, the S corporation shareholder loses the benefit of deferral, and Congress may have incorporated a 10-year rule, at least in part, to balance the loss of that benefit.

Whatever the relevant reasons, when Congress adopted Code Sec. 1374, it took into account deferral while trying to craft an administrable rule. Consistently, rules implementing the *General Utilities* repeal should consider deferral and administrability, not just gain elimination and loss creation.

2. Other Complimentary Changes

Congress has made other statutory changes that compliment the *General Utilities* repeal, including under Code Secs. 355(d), 358(h), 362(e) and 1059. Those changes target loss duplication, gain deferral and gain elimination.

Code Sec. 355(d) targets gain elimination.[84] Under that provision, a distributing corporation recognizes gain on its distribution of appreciated stock in a distribution otherwise qualifying for nonrecognition under Code Sec. 355 if one person holds "disqualified" stock that constitutes 50 percent or more (by vote or value) of the stock of the distributing or controlled corporation immediately after the distribution.[85] Congress concluded not only that nonrecognition by those distributing corporations was inconsistent with the *General Utilities* repeal (because the distributions "resemble[d] sales") but also, more fundamentally, that the repeal properly could apply to stock distributions.[86]

Code Secs. 358(h) and 362(e) attack loss duplication.[87] Code Sec. 358(h) may apply, for example, if, in a Code Sec. 351 exchange, (i) one corporation ("P") transfers property with a fair market value basis to a wholly owned corporation ("S") in exchange for S nonvoting preferred stock described in Code Sec. 1504(a)(4), (ii) S assumes P's deductible liability, and (iii) P would otherwise take a basis in the S stock received in the exchange exceeding its value (because of the liability assumption).[88] Under Code Sec. 358(h)(1), the transferor (*e.g.,* P) generally must reduce its basis in the stock received (but not below value) by the amount of the assumed deductible liability.

If Code Sec. 358(h) did not apply and P and S joined in filing consolidated returns, some argued that P could sell the S preferred stock, recognizing a loss, and S could enjoy a corresponding deduction when it then paid the deductible liability, thereby duplicating the loss.[89] Code Sec. 358(h) eliminates that duplicate loss.

Code Sec. 362(e)(2) also eliminates loss duplication when a shareholder transfers property with a net built-in loss to a corporation in a Code Sec. 351 exchange.[90] That built-in loss is eliminated at the corporate level or, by election, at the shareholder level.[91] Thus, the effect of Code Sec. 362(e)(2) is to preserve the net built-in loss at the shareholder or corporate level, but not at both.

Finally, Code Sec. 1059 targets the creation of a noneconomic loss. Under that section, if a corporate shareholder receives an "extraordinary dividend" on

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any share of stock[92] and the shareholder has not held the stock for more than two years on the dividend announcement date, the shareholder must reduce its basis in that stock by the nontaxed portion of the dividend (*i.e.*, generally the dividends received deduction).[93] If the reduction exceeds basis, the shareholder treats the excess as gain from the sale or exchange of stock.[94]

Consider the following example:

> **Example—Extraordinary dividends.** P acquires all T stock for $10,000,000. Assume that P and T do not join in filing a consolidated return, that P pays tax at a 35-percent rate and that T has at least $4,000,000 of earnings and profits. Shortly after the purchase, T distributes $4,000,000 to P. P qualifies for an 80-percent dividends-received deduction because it owns all T stock.[95] Thus, P includes $800,000 of the dividend in its gross income (20 percent of $4,000,000) and incurs a $280,000 tax (35 percent of $800,000).
>
> Because of the distribution, T's value declines to $6,000,000, and P quickly sells the T stock for that amount. Absent Code Sec. 1059, P recognizes a $4,000,000 loss ($10,000,000 basis less $6,000,000 amount realized). If P can fully utilize that loss, it will enjoy a $1,400,000 tax benefit from the loss. Overall, therefore, P will enjoy a $1,120,000 tax benefit from its ownership of T,[96] even though it suffered no net nontax economic loss.[97]

Troubled by that potential benefit, Congress enacted Code Sec. 1059. If Code Sec. 1059 applied to the dividend that P received in the example above, P would reduce its basis in the T stock by $3,200,000 (the nontaxed portion of the dividend)[98] and would recognize only an $800,000 tax loss on the sale ($6,800,000 basis minus $6,000,000 amount realized). Overall, then, P would have a $0 net tax loss ($800,000 taxable dividend minus $800,000 sales loss), matching its economic loss.

In summary, if P acquired the T stock and Code Sec. 1059 did not apply, P would enjoy a noneconomic loss. Code Sec. 1059 may be justified to prevent that noneconomic loss, particularly when P buys the stock from an individual. If P buys the stock from a corporation, Code Sec. 1059's justification is more nuanced because its application could result in duplicate corporate-level gain. However, the section's application in that case may be justified for the following reason: Not only would it be difficult to craft and administer a rule that excepted that case, but it seems likely that, in the absence of Code Sec. 1059, the tax benefit of P's loss would exceed the tax cost of the seller's gain (*e.g.*, because the seller had available losses to offset the gain).[99] Overall, then, the transaction would reduce corporate tax, justifying the application of Code Sec. 1059.[100]

III. Implementing the Repeal

At a minimum, the *General Utilities* repeal should be implemented to prevent a corporation from eliminating corporate-level gain without tax, unless that elimination is specifically allowed under a Code section and consistent with that section's purpose.[101] A regulation under Code Sec. 337(d) should be added providing that general rule.

That regulation cannot be the sole means to implement the repeal, however. In at least some circumstances, technical rules are necessary to implement the repeal, particularly in applying the consolidated return regulations and in coordinating Subchapters C and K. For example, a consolidated group could readily avoid the repeal absent a rule like the unified loss rule of Reg. §1.1502-36, although that rule in certain important respects should be modified and simplified. Further, corporations could also use partnerships to circumvent the repeal, even with Code Secs. 704(c), 732(f) and 737, among other partnership rules, and the Treasury should finalize Reg. §1.337(d)-3, with modifications, to address some of those concerns. Finally, it may be necessary for Congress to modify Code Sec. 362(e)(2) to prevent loss duplication with reorganizations under Code Sec. 368(a)(1)(B). This section describes those concerns.

A. A Possible General Rule

First, the Treasury should craft a regulation under Code Sec. 337(d) providing, as a general rule, that a corporation cannot eliminate corporate-level gain without tax, unless that elimination is specifically allowed under a Code section and consistent with that section's purpose.[102] Although some may argue that Code Sec. 337(d) should be implemented only by specific rules (*e.g.*, Reg. §1.1502-36), the better approach is that those specific rules should be supplemented by a general rule.

There is some force, however, behind arguments to forego the suggested general rule or, in fact, any

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general rule. First, the suggested general rule would attack holes in the Code and regulations, an attack arguably better left to Congress. More broadly, the legislative history does not explicitly call for a general rule. Finally, any general rule arguably should be implemented only following explicit Congressional approval because the *General Utilities* repeal has been implemented using only specific rules for over 26 years.

Despite the force of those arguments, the better view supports implementing the suggested general rule. First, the rule is consistent with the repeal, and the statute and legislative history both support adopting a broad rule. Consistent with the repeal, a corporation's economic income should be included in gross income, unless an exception to the inclusion clearly applies.[103] Second, narrower, more specific rules provide incentives for tax-avoidance transactions that skirt those rules. Those transactions create deadweight costs and may provide greater benefits to the more sophisticated (*i.e.*, those more likely to exploit the avoidance transactions).[104] Finally, the typical Congressional response to tax-avoidance transactions complicates the Code; the suggested general rule avoids at least some of that complexity. Thus, to avoid that complexity, limit incentives for tax-avoidance transactions and further the repeal, the suggested general rule should be implemented.

The rule may be illustrated by the following examples:

Example—Applying Code Sec. 1031 and the reorganization provisions to eliminate gain. P acquires T assets in a Code Sec. 368 reorganization. In the reorganization, T transfers all of its assets to P in exchange (or deemed exchange) for P stock plus land with a $35,000 basis and $60,000 value. Among other assets, T transfers land with a $50,000 basis and $60,000 value. T distributes (or is deemed to distribute) the P stock and land it receives in the reorganization to its shareholders.

For its transfer of land, P will receive property worth $60,000. Under Code Sec. 1001(a), it will have a $25,000 realized gain (the excess of the $60,000 amount realized over the $35,000 basis). Under Code Sec. 1001(c), P will recognize that gain, unless another section of the Code prevents its recognition.

Code Sec. 1031 may prevent the gain recognition because P will receive land from T in the exchange. If P held the land exchanged for use in a trade or business or for investment and will hold the land received from T for either of those purposes, P should be treated as exchanging its land for T's land, that exchange should be a Code Sec. 1031 exchange, and P should not recognize its realized $25,000 gain on the exchange.[105]

T may also be considered to exchange land for $60,000 worth of land. Because T's land has a $50,000 basis, T will realize a $10,000 gain on the exchange ($60,000 amount realized less $50,000 basis).[106] T's exchange cannot be described in Code Sec. 1031, however, because T will not hold the land it receives for a qualifying purpose.[107] Instead, as part of the plan of reorganization, it will transfer the land to its shareholders. Consequently, T will recognize its realized $10,000 gain, unless another Code section prevents its recognition.

Because the exchange is part of a reorganization, T will not recognize the realized gain on the exchange. Under Code Sec. 361(b)(1)(A), a party to a reorganization does not recognize gain when it receives boot in the reorganization if it distributes that boot to its shareholders as part of the plan of reorganization.[108] Because T will be a party to a reorganization and will distribute the land to its shareholders as part of the plan of reorganization, it will recognize no gain on its receipt of that land from P.

T may recognize any gain, however, on its distribution of the land to its shareholders. A target recognizes gain (but not loss) on its distribution of nonqualifying property to its shareholders as if it sold that property for fair market value consideration.[109] Nonqualifying property is all property other than, generally, stock or stock rights in (or obligations of) the target or another party to the reorganization.[110] Thus, the land that T receives from P is nonqualifying property, and T will recognize gain on its distribution to the extent the land's value exceeds its basis.

Because T will take a fair market value basis in the land under Code Sec. 358(a)(2), T does not recognize gain on the distribution (assuming that

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the land is distributed immediately following its receipt). Code Sec. 358 applies to a party to a reorganization that transfers assets in a Code Sec. 361 exchange in whole or in part for stock or securities of another party to the reorganization.[111] Under that section, the target takes a substituted basis in acquiror stock received in the reorganization, but takes a fair market value basis in any boot received.[112] Accordingly, T will take a fair market value basis in the land received from P and will recognize no gain when it distributes the land to its shareholders, and, surprisingly, T's $10,000 inherent gain on its land is eliminated in the reorganization.

Because corporate-level gain is eliminated and not deferred (violating the policies behind both Code Sec. 361 and Code Sec. 1031), the proposed regulatory provision should apply. However, there are two possible candidates for its application. Either T could recognize its realized $10,000 gain on the land it surrenders in the exchange, or P could recognize its realized $25,000 gain on the land it surrenders in the exchange. The better recognition candidate is T, not P. P's exchange is consistent with the policy behind Code Sec. 1031 because P would take a basis in the land received in the exchange that preserves its built-in gain. In contrast, T's transfer of the land violates the policy behind Code Sec. 361 and its companion provision Code Sec. 362(b) because T's gain would not be preserved in P's basis in the transferred land, violating the inherent principle upon which those sections rest—that any of the transferor's realized but not recognized gain or loss is preserved in the transferee's hands.[113] Thus, T should recognize its $10,000 gain.

Example—Duplicating loss in a reorganization. *Variation 1*. Assume that S1 transfers its assets to X in a reorganization described in Code Sec. 368(a)(1)(C) (a C reorganization). In the reorganization, X acquires all S1 assets in exchange for $900 of its voting stock and GainCo stock with a $60 basis and $100 value. S1 liquidates, distributing the X voting stock to P solely in exchange for its S1 stock and transferring the GainCo stock to its sole creditor in full satisfaction of its debt to that creditor.[114]

S1 and X, but not P, are parties to the reorganization.[115] S1 recognizes no gain or loss on its transfer of property to X, even though it receives boot (*i.e.*, the GainCo stock) in exchange, because it "distributes" that boot pursuant to the plan of reorganization.[116] S1 recognizes no gain or loss on its distribution of the X stock to P because the X stock is qualified property.[117] Assuming that S1 transfers the GainCo stock to its creditor just after it received it, S1 also recognizes no gain or loss on that transfer because it takes a basis in that stock equal to its value.[118]

X recognizes no gain or loss to the extent it acquires S1 property for its stock.[119] However, it recognizes its realized $40 gain on its exchange of the GainCo stock for $100 of S1 assets.[120] Because S1 recognizes no gain on the transfer of its assets to X, X also succeeds to S1's adjusted bases in the transferred S1 assets.[121]

Variation 2. The facts are the same as in *variation 1*, except that S1 holds one share of P stock, which it transfers to X in the reorganization. The results are the same, although the analysis apparently differs.

For the same reasons noted in *variation 1*, S1 recognizes no gain or loss on its transfer of property to X, and it recognizes no gain or loss on its distribution of the X stock to P. Further, X recognizes no gain or loss to the extent it acquires S1 assets for X stock, but it recognizes a $40 gain on its exchange of the GainCo stock for $100 of S1 assets. X also succeeds to S1's adjusted basis in the transferred S1 assets.

S1 also recognizes no gain or loss on its transfer of the GainCo stock to its creditor, assuming that it transfers the stock to its creditor just after it received it, although the analysis seems to change. S1 apparently determines its basis in that stock under Code Sec. 362(b), not Code Sec. 358(a)(2), because of the priority rule in Code Sec. 358(e). In relevant part, Code Sec. 358(e) states that Code Sec. 358 does not apply to a corporation if it transfers stock of its controlling parent, in whole or in part, for the property received in the exchange. Because S1 exchanged P stock for a portion of the X assets and P controlled S1 (owning all of its stock),[122] S1 apparently does not determine its basis in the X assets received under Code Sec. 358.

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Instead, S1 apparently determines its basis in those assets under Code Sec. 362(b).[123] Under that section, S1's basis in an X asset will equal X's basis, increased by any gain X recognized on the transfer of that asset. Thus, because X recognized a $40 gain on its transfer of the GainCo stock, S1's basis in the stock is $100, and S1 recognizes no gain or loss on its transfer of that stock to its creditor.[124]

Variation 3. The facts are the same as in *variation 2*, except that instead of transferring GainCo stock, X transfers LossCo stock, with a $1,000 basis and $100 basis. The analysis and results are the same as in *Variation 2*, except as follows:

First, X recognizes a $900 loss on its use of LossCo stock.[125] Second, S1 takes a $1,000 basis, rather than a fair market value basis, in the LossCo stock. Under Code Sec. 362(b), the acquiring corporation's basis in assets is adjusted for gain, but not loss, recognized by the transferor. When S1 transfers the LossCo stock to its creditor in satisfaction of its debt, S1 also apparently recognizes a $900 loss ($1,000 basis minus $100 debt satisfied).[126] Thus, the same loss provides two corporate-level benefits.

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The duplicated loss in the preceding example may eliminate corporate-level gain, inconsistent with the *General Utilities* repeal. Further, the basis carryover is inconsistent with the purpose of Code Sec. 362(b) merely to defer realized but not recognized gain or loss. Thus, the proposed regulatory provision should apply by requiring S1 to take a $100 basis in the LossCo stock under Code Sec. 1012, preventing the duplication of loss and a circumvention of the repeal.[127]

Example—Duplicating recognized loss through a B reorganization. P acquires all of the X stock in exchange for its voting stock in a reorganization described in Code Sec. 368(a)(1)(B) (a B reorganization). Assume that X has one shareholder, Fred, and his basis in the X stock was $100, but its value was only $10. Also assume that the P stock is nonqualified preferred stock described in Code Sec. 351(g).

Because the P stock is nonqualified preferred stock, neither Code Sec. 354 nor Code Sec. 356 applies to Fred's exchange because Fred receives no qualified property in the exchange.[128] Thus, under Code Sec. 1001, Fred recognizes a $90 loss.[129] Under Code Sec. 362(b), however, P succeeds to Fred's $100 basis in the X stock because Code Sec. 362(b) does not require the corporate transferee to reduce basis for any loss recognized by the transferor on the exchange.

For the same reasons noted in connection with the preceding example, the proposed regulatory rule should apply. The transaction creates a duplicated, loss that may eliminate corporate-level gain, so that a basis carryover under Code Sec. 362(b) would be inconsistent with that provision's purpose merely to defer realized but not recognized gain or loss. Thus, P should take a $10 basis in the X stock under Code Sec. 1012, preventing the duplication of loss.[130]

B. The Dual Nature of Subsidiary Stock

The dual nature of subsidiary stock presents a significant challenge in implementing the *General Utilities* repeal because subsidiary stock is treated sometimes as a separate asset and sometimes as an indirect interest in the subsidiary's assets. For example, if a parent corporation sells subsidiary stock, it generally treats the stock as a separate asset and recognizes any realized gain or loss.[131] If, however, the parent owns an affiliated interest in subsidiary stock and the subsidiary liquidates in a Code Sec. 332 liquidation, the parent recognizes no gain or loss on the liquidation.[132] Further, if the parent and subsidiary join in filing consolidated returns, they combine income and loss, with an effect in some ways like a liquidation. In either case, the parent's subsidiary stock is closely tied to the subsidiary's assets.

Thus, if the parent has a loss in affiliated subsidiary stock, it may sell that stock, recognizing the loss. If, instead, it has a gain in that stock, it may engage in a liquidation (or quasi-liquidation) transaction, avoiding that gain. That choice raises the specter of selective loss recognition and gain deferral, posing a real conundrum in implementing the repeal because in important ways Congress seems to tolerate that choice despite the repeal.

Congress certainly has embraced that a parent generally recognizes gain or loss on its sale of subsidiary stock (and gain on its distribution of that stock).[133] In fact, that sale or distribution may result in a triple tax, although the potential for multiple taxation is a

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longstanding aspect of the corporate tax system, not something created by the *General Utilities* repeal.[134]

Further, if a parent owns an affiliated interest in a subsidiary, it may liquidate that subsidiary without recognizing gain or loss, assuming that the liquidation is described in Code Sec. 332(b).[135] The subsidiary also recognizes no gain or loss on its distributions to the parent (Code Sec. 337(a)), but the parent takes transferred bases in the distributed subsidiary assets (Code Sec. 334(b)(1)) and also succeeds to important tax attributes of the subsidiary (Code Sec. 381(a)). Thus, the parent steps into the subsidiary's shoes, and the parent and subsidiary are treated like one economic unit.

That treatment makes innate sense when the parent has formed the subsidiary and has always owned all subsidiary stock. Then, if the parent receives dividends from the subsidiary, the parent has no net taxable income.[136] If the subsidiary liquidates when the parent's subsidiary stock has appreciated in value, that appreciation represents existing or future earnings that could be distributed (when earned) without tax, justifying the elimination of the parent's built-in gain in subsidiary stock. Stated differently, the parent and subsidiary can readily be treated as one economic unit, supporting the elimination of that built-in gain.

The case is less straightforward, but still compelling, even if the parent has not always owned an affiliated interest in subsidiary stock, following a longtime IRS position, legislative history and historic dividend theory. Since at least 1975, the IRS has concluded that Code Sec. 332 could apply to a subsidiary's liquidation if a parent owned a minority interest in the subsidiary, but then purchased enough subsidiary stock to create affiliation before the subsidiary adopted a plan of liquidation.[137] Congress appeared to not only tolerate but implicitly endorse this result as part of the *General Utilities* repeal. In describing a Code Sec. 332 liquidation, it looked to affiliation, however formed, as the touchstone.[138] Further, it expanded the potential reach of Code Sec. 338(h)(10), granting the Treasury regulatory authority to allow a Code Sec. 338(h)(10) election for an affiliated, nonconsolidated target.[139] Under that type of election, the parent recognized no gain or loss on its target stock, whenever acquired, because the target was deemed to liquidate under Code Sec. 332.[140] Thus, following the repeal, Congress believed that in a subsidiary liquidation described in Code Sec. 332, the parent recognized no gain or loss, no matter when it had acquired the subsidiary stock.

That nonrecognition is also consistent with historic dividend theory. Until 1936, corporations enjoyed a 100-percent DRD for all dividends, but the DRD was reduced to 85 percent in 1936, when Congress introduced graduated rates, rates that mostly benefitted smaller corporations.[141] It rationalized graduated rates because "[t]he advantages and protections conferred on corporations by Government increase[d] in value as the size of the corporation increase[d]."[142] Whatever their merit, graduated rates raised the following concern: A person might avoid tax by forming numerous subsidiaries to benefit from multiple sets of graduated rates.[143] Ostensibly to address that concern, Congress reduced the DRD for corporate shareholders from 100 to 85 percent.[144] Thus, historically, the DRD was reduced to accommodate graduated rates, and absent graduated rates, the DRD should be 100 percent, regardless of the corporate shareholder's percentage interest in the subsidiary, since a 100-percent DRD helps avoid multiple corporate tax on the same economic income.

In summary, in a Code Sec. 332 liquidation, the parent's gain in subsidiary stock represents existing or future earnings, no matter when that stock was acquired, and historically those earnings could be distributed without tax. Code Sec. 332, which views the parent and subsidiary as an economic unit, follows that historic approach.

A reduced DRD may be justified, however, to make it more costly for a corporation to do the following: acquire an interest in stock pregnant with a dividend, receive the dividend and then promptly sell that stock at a noneconomic loss.[145] Nonetheless, it seems clear that the corporation recognizes a loss on the stock sale. In addition, an affiliated parent may recognize loss on both a stock sale and subsequent liquidation when the parent sells enough subsidiary stock to break affiliation and the subsidiary then liquidates,[146] a result sanctioned by *Granite Trust*.[147]

In *Granite Trust*, a parent sold enough subsidiary stock to assure that the subsidiary's later liquidation would not be described in the predecessor to Code Sec. 332. On the subsidiary's liquidation, the parent recognized a loss, a loss that would have gone unrecognized if Code Sec. 332's predecessor had applied. The court concluded that the predecessor's application was functionally elective, citing 1954 legislative history that "strongly" and "inescapably" supported its conclusion.[148]

In repealing the *General Utilities* doctrine, Congress never questioned that functional electivity. In fact, in

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Code Sec. 338, Congress adopted a related provision that made the election explicit when the parent and subsidiary were affiliated: If a buyer bought the target stock from the parent in a qualified stock purchase, the parent recognized its gain or loss on the target stock, unless the purchaser and parent made a Code Sec. 338(h)(10) election.[149] That approach suggests that Congress continues to endorse functional electivity after the repeal.[150]

The treatment of Code Sec. 332 liquidations should inform the treatment of upstream and downstream Code Sec. 368 reorganizations: In each case, a parent's gain (or loss) in subsidiary stock should be eliminated without recognition. As with a Code Sec. 332 liquidation, the corporations in an acquisitive reorganization combine to create an economic unit, and the surviving corporation is treated as a continuation of the terminating corporation.[151] Gain nonrecognition in each case is also consistent with historic dividend theory.[152]

In addition, as with a Code Sec. 332 liquidation, that nonrecognition for an upstream or downstream transaction may be functionally elective. If the parent liquidates, rather than combining with the subsidiary, it may recognize loss (or gain) on the liquidation.[153] In other words, the form of the transaction may control the tax consequences, not an uncommon occurrence under Subchapter C.[154] Because the tax treatment of upstream and downstream transactions may be functionally elective, the most readily administrable rule would simply follow the characterization of transaction. If the transaction is characterized as a reorganization, the parent would not recognize its gain or loss on subsidiary stock; if it is characterized as a Code Sec. 331 liquidation, the parent would.

The trick, then, would be to characterize the upstream and downstream transaction, and the IRS and taxpayers should focus on that characterization. That characterization requires drawing a line, and inevitably, there will be little substantive difference between cases just above and below the line.

Note that the most difficult of those transactions to treat as a reorganization may be a downstream transaction where the parent's only significant asset is subsidiary stock.[155] If the parent's shareholders receive newly issued subsidiary stock that is identical to the parent's stock, the transaction is little different in substance than if the parent had simply distributed its stock.[156] On that latter distribution, assuming that Code Sec. 336 applied, the parent would recognize any realized gain.[157] Certainly, it would be reasonable (if not highly preferable) to characterize that transaction as a liquidation.

C. Consolidated Issues– The Unified Loss Rules

More ink has been spilled in coordinating the *General Utilities* repeal with the consolidated return rules than with any other set of rules. The principal focus has been on loss disallowance rules, rules currently found in Reg. §1.1502-36, which are discussed below. Another consolidated concern is basis shifting, a topic that this article will not address.[158]

1. Background

The first significant regulatory response to the *General Utilities* repeal was the loss disallowance rule of Reg. §1.1502-20. In general, that regulation provided that a consolidated group was not allowed a loss deduction on its disposition of subsidiary stock.[159] This loss disallowance was 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."[160] Further, the loss on any share of subsidiary stock was allowed to the extent it exceeded the sum of three factors: the share's allocable portion of the subsidiary's extraordinary gain, positive adjustments and duplicated loss.[161] If a group did not own a subsidiary for too long,[162] the three factors were intended to allow the group to recognize its economic loss when it sold the subsidiary stock, except to the extent the loss was duplicated in the basis of subsidiary assets (or loss carryovers). In practice, the three factors were less than perfect and proved a source of some irritation.

Reg. §1.1502-20 was invalidated, at least in part, by the Court of Appeals for the Federal Circuit in *Rite Aid Corp*.[163] The court concluded that the rule exceeded the Treasury's delegated authority under Code Sec. 1502.[164]

Rite Aid had sold the stock of a subsidiary member, recognizing a loss. Because that loss was less than the subsidiary member's "duplicated loss" (as computed under Reg. §1.1502-20(c)), the government disallowed the entire stock under Reg. §1.1502-20.

The Court of Federal Claims had supported the disallowance, but on appeal, the Federal Circuit reversed. The lower court had concluded that Reg. §1.1502-20 was valid, explaining that:

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> The duplicated loss rule in [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."[165]

Because the lower 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 (a single-entity approach), it concluded that Reg. §1.1502-20 did not deny the Rite Aid group its economic loss. It noted that the group could have recognized the built-in loss on the subsidiary assets, either by selling the assets directly or by joining with the buyer to make a Code Sec. 338(h)(10) election for the sale of the subsidiary stock.[166] It also noted that by not making the election, Rite Aid likely benefitted from the asset loss, since the buyer presumably paid more for the subsidiary stock because of that built-in loss.[167]

Without discussing the lower court's rationale, the Federal Circuit concluded that Reg. §1.1502-20 denied Rite Aid its economic loss. The court used as its model an affiliated, nonconsolidated group.[168] A nonconsolidated group could sell subsidiary stock and recognize a stock loss under Code Sec. 165(a) without being restricted by Reg. §1.1502-20, while the buyer could preserve any built-in loss in the subsidiary assets. Perhaps reasoning that consolidated groups should be treated no worse than nonconsolidated groups, the court found Reg. §1.1502-20 invalid, stating that:

> ... the duplicated loss factor distorts rather than reflects the tax liability of consolidated groups and contravenes Congress' otherwise uniform treatment of limiting deductions for the subsidiary's losses.[169]

Citing 1928 legislative history, the court suggested that Congress granted broad regulatory authority for the consolidated return regulations to deal with "problems" in filing consolidated returns.[170] The court added that "in the absence of a problem created from the filing of consolidated returns, [the Treasury] is without authority to change the application of the tax code provisions to a [consolidated group]."[171] Reg. §1.1502-20, the court concluded, did not address any such problems.[172]

For many reasons, the Federal Circuit's decision in *Rite Aid* seems misguided, including that the court did not adequately account for the *General Utilities* repeal.[173] Under the repeal, a corporation should not enjoy duplicate benefits for the same economic loss. If Reg. §1.1502-20 did not apply, Rite Aid enjoyed duplicate benefits, selling the subsidiary stock and recognizing a loss, while receiving additional consideration to compensate for the inside subsidiary loss.[174]

Further, under the repeal, a corporation must recognize gain when it sells an appreciated asset and the asset takes a stepped-up basis. 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 Code Sec. 382).

The corollary justifies the duplicated loss rule under Reg. §1.1502-20. It could apply only if the group sold its subsidiary stock at a loss, but the loss was duplicated in the subsidiary's attributes. Because of the investment adjustment rules under Reg. §1.1502-32, a consolidated group appropriately is treated as an economic unit and a single entity.[175] Under a single-entity approach, the stock and asset losses should be viewed as the "same" loss, so that a consolidated group would violate the corollary if it recognized a subsidiary stock loss that was duplicated (*i.e.*, preserved) in the subsidiary attributes. In several possible ways, therefore, the *General Utilities* repeal supported the duplicated loss rule under Reg. §1.1502-20.

Nevertheless, the Federal Circuit's decision in *Rite Aid* stands, and Congress quickly responded to *Rite Aid*, adding the following sentence to the end of Code Sec. 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.[176]

The amendment overturns *Rite Aid* "to the extent [*Rite Aid*] suggests that [the Treasury] is required to identify a problem created from the filing of consolidated returns in order to issue regulations

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that change the application of a Code provision."[177] However, it apparently does not authorize the Treasury to re-adopt the "duplicated loss" piece of Reg. §1.1502-20.[178] Despite that limitation, the amendment supports using presumptions to disallow subsidiary stock loss[179] and also supports reducing subsidiary attributes to deal with duplicated loss.[180]

2. An Overview of the Rules

This portion of the article describes the rules in Reg. §1.1502-36. For those schooled in the consolidated return area, the examples set out below may be of the most interest.[181] For those unfamiliar with the area, the description will aid in understanding the examples and the suggestions for revising Reg. §1.1502-36 that follow.[182]

The regulation has three basic rules, a basis-redetermination rule, basis-reduction rule and attribute-reduction rule. Each rule is discussed in turn.

a. The Basis-Redetermination Rule. Reg. §1.1502-36(b) contains a basis-redetermination rule, which "supplement[s] the operation of the investment adjustment system [of Reg. §1.1502-32]" and is intended "to prevent the realization of noneconomic loss and facilitate the elimination of duplicated loss when members hold [subsidiary ("S")] stock with disparate bases."[183] Under this rule, a group may reallocate previously applied investment adjustments among its members' S shares, but the group's aggregate S stock basis will remain the same.[184] Through the reallocations, the basis-redetermination rule performs a function similar to Code Sec. 704(c), although less precisely.

i. Transfer Requirement. For the basis-redetermination rule to apply, a member ("M") must transfer an S loss share.[185] Generally, M transfers an S share on the earliest of the following[186]:

(i) the date that M ceases to own the share because of a transaction in which, but for Reg. §1.1502-36, the member would recognize gain or loss[187];
(ii) the date that M and S cease to be members of the same consolidated group[188];
(iii) the date that a nonmember acquires the share from M; and
(iv) the date that the S share becomes worthless under Code Sec. 165(g) and Reg. §1.1502-80(c) (if the share is not treated as a capital asset) or the last day of the tax year which includes that date (if the share is treated as a capital asset).

However, M is not treated as transferring an S share if M ceases to own the share because of:

(i) a Code Sec. 381 transfer in which M or S acquires assets from the other, as long as M recognizes no gain or loss on the share[189]; or
(ii) a distribution of the share to a nonmember in a transaction to which Code Sec. 355 applies if the share is qualified property under Code Sec. 355(c) or Code Sec. 361(c).[190]

ii. Operation of the Rule. *(A) Scope.* If M transfers an S loss share, the basis-redetermination rule applies, except in the following two cases:

(i) there is no disparity among members' bases in shares of S common stock,[191] and no member owns S preferred stock with built-in gain or loss[192]; or
(ii) all S shares held by a members are transferred to one or more nonmembers in one fully taxable transaction.[193]

If the second of these exceptions would apply, however, the group's common parent ("P") may elect to apply the basis-redetermination rule, and if stock of more than one subsidiary is transferred, the election may be made for one or more of the subsidiaries.[194]

(B) General Application. If the basis-redetermination rule applies to M's transfer of an S loss share, positive adjustments may be reallocated from transferred S loss common stock, and negative adjustments may be reallocated from shares of S common stock that are not transferred loss shares.[195] More specifically, and subject to the limitations described below, the reallocations occur as follows:

(i) M's basis in each transferred loss share of S common stock is reduced (but not below its value) by removing positive adjustments previously applied to the basis of the share.[196]
(ii) If a transferred S share is still a loss share after the first step, M reduces its basis in the share (but not below its value) by reallocating negative adjustments to the share from members' S common shares that are not transferred loss shares.[197] If there are both preferred and common transferred loss shares, the reallocation is made first to the preferred shares and then to the common shares.[198]
(iii) The positive adjustments removed in the first step are first reallocated to increase the member's basis in gain shares of S preferred stock (but not above their value).[199] Any remaining amount is reallocated to increase the group's basis in common stock.[200]

The group makes these reallocations (both to and from members' shares of S stock) using any "reasonable" method or formula that, to the greatest

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extent possible, reduces the basis disparity among the members' S preferred stock and among the members' S common stock to the greatest extent possible.[201] To the extent possible, the reallocations are made first with respect to the earliest available adjustments.[202]

The basis-redetermination rule has the following implicit presumption: The investment adjustment rules do not specially allocate built-in gain or loss on assets contributed to S by a member. That presumption may be wrong if S has tracking stock, potentially affording a group tax benefits exceeding its economic loss.

Example—Tracking stock. P owns all S1 and S2 stock, and for valid business reasons, P, S1 and S2 form S3, each transferring $100 to S3 for S3 interests. S3 is a partnership that will elect to be taxed as a corporation, and it acquires three assets, Assets 1, 2 and 3, each for $100. S1's S3 interest ("Share 1"), which is nonvoting, will be allocated 90 percent of the profits and 100 percent of losses relating to Asset 1, plus five percent of any other S3 profits. S2's S3 interest ("Share 2"), which is also nonvoting, will be allocated 90 percent of the profits and 100 percent of the losses relating to Asset 2, plus five percent of any other S3 profits. P's S3 interest ("Share 3"), the only voting interest, will be allocated all remaining S3 profits and losses.

Initially, each asset generates at least $100 of profits, all of which are distributed to the S3 owners.[203] Over time, however, Asset 1 declines in value to $0, Asset 2 retains its $100 value, and Asset 3 appreciates in value to $200, although each asset still has a $100 basis. Each share also still has a $100 basis, but Shares 1, 2 and 3 have $5, $105 and $190 values, respectively.[204]

S1 sells Share 1 to a nonmember for $5.[205] That share is a transferred loss share and under the basis-redetermination rule, $95 of positive adjustments are reallocated from Share 1 to Shares 2 and 3, $5 to Share 2 and $90 to Share 3.[206] Thus, each S3 share has a basis equal to its value, and S1 recognizes no gain or loss on the sale of Share 1.

Later, S3 sells Asset 1 for $0, recognizing a $100 loss, all of which is absorbed by the P group. Because Share 1, the S3 interest now owned by a nonmember, bears all of that loss, none of the negative adjustment for the loss is allocated to Shares 2 or 3.[207] Thus, P and S2 retain fair market value bases in those shares.

P and S2 sell their S3 shares for $190 and $105, respectively, each recognizing no gain or loss. Thus, because of the basis-redetermination rule, the group enjoyed a $100 loss on Asset 1 and also offset potential gain using used $95 of reallocated basis associated with that loss. Consequently, the group enjoyed an aggregate $195 tax benefit from a $100 economic loss.

The example illustrates that the basis-redetermination rule not only may fail to adequately deal with misallocations under Reg. §1.1502-32, it may allow the group to enjoy a noneconomic loss.[208]

b. The Basis-Reduction Rule. The basis-reduction rule is intended to prevent noneconomic loss and promote the clear reflection of the group's income.[209] Thus, among other transactions, the basis-reduction rule targets the "son-of-mirrors" transaction.

i. General Rule. If a member ("M") transfers a subsidiary ("S") share and the share is a loss share after applying the basis-redetermination rule (and other applicable rules of law), the share's basis is reduced by the smallest of:
(i) its net positive adjustment,
(ii) its disconformity amount, or
(iii) the excess, if any, of its basis over its value.[210]

(A) Net Positive Adjustment. A share's net positive adjustment equals the sum of all investment adjustments reflected in the share's basis (or, if greater, $0).[211] For this purpose, investment adjustments include the adjustments described in Reg. §1.1502-32(b)(2) for taxable income and loss, tax-exempt income and noncapital, nondeductible items.[212] Note that these adjustments also include any noncapital, nondeductible expenses arising because of an election under Reg. §1.1502-36(d)(6) to reattribute attributes of S or a lower-tier subsidiary.[213]

(B) Disconformity Amount. A share's disconformity amount is the excess, if any, of:
(i) M's basis in the share, over
(ii) the share's allocable portion of S's net inside attribute amount.[214]

S determines its net inside attribute amount as of the transfer.[215] That amount equals the sum of S's net operating and capital loss carryovers,[216] deferred deductions,[217] money and basis in noncash property, reduced by the amount of S's liabilities.[218]

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Generally, if S owns a share of lower-tier subsidiary ("L") stock, it computes its net inside attribute amount using its basis in that share, adjusted for any gain or loss recognized in the transaction on that share.[219] However, if S owns any L shares *not* transferred in the same transaction, it instead uses a special basis amount for those shares.[220]

ii. Netting Rule. Finally, solely to compute the basis reduction required under Reg. §1.1502-36(c), the bases of any transferred S loss shares are reduced by any gain taken into account by members on S gain shares, provided that:

(i) the gain and loss shares are transferred in the same transaction (whether or not they have the same material terms[221]); and

(ii) the gain is taken into account as of the transaction.[222]

The reduction is made in proportion to each loss share's relative built-in loss.[223] The group will take this reduced basis for a loss share into account in computing the share's disconformity amount, one of the three items compared in determining any reduction under the basis-reduction rule.[224]

iii. An Example.

Example—"Son-of-mirrors" lives. P buys S's sole share for $70 from Y, an unrelated corporation and common parent of a consolidated group. S has two assets, inventory with a $0 basis and $30 value and land with a $70 basis and $40 value. S sells the inventory for $30, recognizing $30 of ordinary income. As a result, P increases its S stock basis by $30, from $70 to $100.[225]

P sells its S share to X, an unrelated corporation, for $70. The basis-redetermination rule does not apply because P sold all S stock to a nonmember in a taxable transaction.[226] Further, P is not required to reduce its basis in its S share under the basis-reduction rule. Although the S share has a $30 net positive adjustment[227] and its basis exceeds its value by $30, its disconformity amount is $0.[228] Because P reduces its S share basis by the smallest of those three amounts (*i.e.*, $0), it retains its $100 basis in the S share and recognizes a $30 loss on its sale to X.

Although the attribution-reduction rule will apply to require S to reduce its basis in the land by $30, from $70 to $40,[229] this transaction may still allow a benefit that should be targeted by the *General Utilities* repeal. For example, for regulatory or other business reasons, it may have been impossible for S to sell its land, and the Y group may have been unable to fully utilize any loss on the S stock (or land).[230] Thus, it may have sold the S stock to P to maximize the benefit of that loss, a benefit facilitated by the basis-reduction rule.

c. Attribute-Reduction Rule.

i. The Attribute Reduction Amount. If a transferred subsidiary ("S") share is still a loss share after taking into account the basis-redetermination and basis-reduction rules (and other applicable rules), the attributes of S (and its lower-tier subsidiaries) may be reduced by the smaller of:

(i) S's net stock loss, and

(ii) its aggregate inside loss.[231]

The regulations refer to this amount as the "attribute reduction amount."[232] This rule does not apply absent the group's election, however, if the aggregate attribute reduction amount in the transaction is less than five percent of the total value of the shares transferred by members in the transaction.[233]

S's net stock loss is computed by looking to the S shares that members transfer in the transaction and equals the excess, if any, of (A) the aggregate basis of those shares over (B) their aggregate value.[234] For this purpose, the shares' aggregate basis is computed after taking into account any adjustments required under the basis-redetermination and basis-reduction rules.[235]

S's aggregate inside loss equals the excess, if any, of (A) S's net inside attribute amount (NIAA) over (B) the value of all outstanding S shares.[236] As under the basis-reduction rule, S's NIAA generally equals the sum of S's net operating and capital loss carryovers, deferred deductions, money and basis in noncash property, reduced by the amount of S's liabilities.[237] However, S's computation of its NIAA is modified if S holds lower-tier subsidiary stock because S must take its "deemed basis" in that stock into account.[238]

ii. Reducing Attributes. If the attribute-reduction rule applies, S may reduce the following categories of attributes:

(A) capital loss carryovers;

(B) net operating loss carryovers;

(C) deferred deductions; and

(D) the basis of any other property, other than cash and cash equivalents.[239]

Those reductions are effective immediately before the transfer of relevant S loss share and are *not* treated as noncapital, nondeductible expenses for purposes of Reg. §1.1502-32.[240]

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The common parent may specify the allocation of the attribute reduction among the first three categories of attributes.[241] Absent that specification, those attributes are reduced in the order set out above.[242] Capital loss carryovers are reduced before net operating loss carryovers, but within either category, carryovers from the earliest years are reduced first.[243] Deferred deductions are then proportionately reduced.[244]

If S's attribute reduction amount does not exceed its total attributes in the first three categories, all of the attribute reduction amount must be applied to reduce those attributes.[245] If S's attribute reduction amount equals or exceeds its total attributes in the first three categories, S eliminates those attributes, and any excess attribute reduction amount reduces S's basis in its noncash assets, including any lower-tier subsidiary stock.[246]

If S owns lower-tier subsidiary stock, that excess is first allocated between that stock and its other noncash assets.[247] If S owns no lower-tier subsidiary stock, that excess is allocated entirely among those other noncash assets. For convenience, I call the portion of the excess allocated to noncash assets other than lower-tier subsidiary stock the "non-cash ARA."

Any portion of the noncash ARA allocated to an asset reduces the asset's basis.[248] The noncash ARA is allocated, in order, to Class VII assets, then Class VI assets, then Class V assets, then Class IV assets, then Class III assets and finally Class II assets.[249] The amount allocated to any class cannot exceed the aggregate basis of the assets in the class, and if the allocable amount is less than that aggregate basis, the amount is allocated in proportion to the bases of each asset in the class.[250]

If the attribute reduction amount exceeds the available attributes in the four categories listed above, the excess is disregarded and has no further effect, except as follows: That excess is suspended "[t]o the extent of any liabilities of S that are not taken into account for tax purposes before the transfer."[251] The suspended amount is "applied proportionately to reduce any amounts attributable to S that would be deductible or capitalizable as a result of such liabilities being taken into account by S *or any other person*."[252]

Example—Duplicate benefit. P owns all five shares of the only class of outstanding S stock. It has a $200 basis in each share, and S owns one asset with a $1,000 basis and $500 value.

P sells one S share to X for $100.[253] Neither the basis-redetermination rule nor basis-reduction rule applies.[254] Thus, P recognizes a $100 loss on the sale.

S must reduce its attributes by its attribute reduction amount, which is $100 or the smaller of:

(i) $100, its net stock loss,[255] and

(ii) $500, its aggregate inside loss.[256]

Under the attribute reduction rule, S reduces the basis in its asset by $100, from $1,000 to $900.[257]

Later, S sells the asset to a nonmember for $500, recognizing a $400 loss, and the P group absorbs the loss. P reduces its S stock basis by $320 (80 percent of $400), from $800 to $480.[258] S buys other assets for $500.

P sells its remaining S stock to Y for $400. Assume that the basis-redetermination and basis-reduction rules do not apply.[259] Thus, P recognizes an $80 loss. Further, because S's net inside attributes (*i.e.*, its $500 asset basis) equal the S stock value, S is not required to reduce its attributes under the attribute-reduction rule.

Overall, unless an anti-abuse rule applies (and it is not clear that one would), the P group has enjoyed a $580 tax loss ($100 loss on P's sale of the S share to X, a $400 loss on S's asset sale, and an $80 loss on P's sale of the S shares to Y) but suffered only a $500 economic loss (*i.e.*, the decline in value of S's asset).[260]

Thus, despite its detail, the attribute-reduction rule may still allow the group to benefit from an noneconomic loss.[261]

iii. Special Lower-Tier Subsidiary Stock Rules. A tangled set of rules applies to determine the attribute reduction amount when S owns lower-tier subsidiary ("L") stock.[262] The reduction itself is applied from the top down the chain, but to allocate the reduction, "deemed basis" computations must first be made from the bottom up.

(A) Deemed Basis. Generally, for purposes of determining the attribute reduction amount, any L shares that S holds immediately before the transaction are treated as a single share, and in computing its aggregate inside loss, S uses the L shares' "deemed basis."[263] That deemed basis equals the greater of:

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(i) the sum of S's basis in each share of L stock, adjusted for any gain or loss recognized on the transfer of L shares as part of the transaction whether or not allowed; and
(ii) the portion of L's net inside attribute amount allocable to S's L stock.[264]

If S owns a chain of lower-tier subsidiaries, the deemed basis is computed first for the lowest-tier subsidiary (or subsidiaries), and then computed successively up the chain.[265]

(B) Allocating the Attribute Reduction Amount. If S's attribute reduction amount exceeds its total loss carryovers and deferred deductions, S eliminates those attributes, and any excess attribute reduction amount reduces S's basis in its noncash assets, including any L stock.[266] If S has L stock and other noncash assets, that amount is allocated between the two groups of assets in proportion to the aggregate "adjusted" deemed bases of the L stock and the aggregate bases of the other noncash assets.[267]

The "adjusted" deemed basis of L stock equals its deemed basis (computed as described above), minus the following amounts:
(i) the value of S's transferred L shares; and
(ii) the excess, to the extent allocable to S's nontransferred L shares, of L's "non-loss" assets over its liabilities.[268]

L's "non-loss" assets are:
(i) its cash and cash equivalents,
(ii) if L owns any lower-tier subsidiary ("G") stock, the value of L's transferred G stock, and
(iii) for each direct and indirect lower-tier subsidiary, the portion of the subsidiary's "non-loss" assets (net of liabilities) allocable to the subsidiary's nontransferred shares.[269]

If any of S's attribute reduction amount is allocated to its L shares, it is apportioned among those shares and applied to reduce their bases as follows: No amount is apportioned to any transferred L share if gain or loss was recognized on the transfer.[270] Instead, the apportioned amount is allocated among S's other L shares, first to S's basis in loss shares of L preferred stock and then to S's basis in all remaining shares of L common stock, subject to the following rules:
(i) the allocations must reduce basis disparity to the greatest extent possible;
(ii) if an allocation is made to a preferred share or is made to a common share transferred in a nonrecognition transaction, the allocation cannot reduce the share's basis below its value; and
(iii) the allocation to any other common share is applied to reduce basis without regard to the share's value.[271]

If any portion of the amount allocated to S's L shares cannot be applied to reduce their bases (*e.g.*, because they are all transferred shares on which gain or loss was recognized), it has no further effect on S's attributes.[272]

(C) Tiering Down the Attribute Reduction Amount. The full portion of S's attribute reduction amount allocated to its L shares is an attribute reduction amount of L, even if not fully applied to reduce S's basis in its L shares.[273] That "tier-down" amount, together with any amount computed for transferred L shares (the "direct" attribute reduction amount), is applied to reduce L's attributes under Reg. §1.1502-36(d).[274]

(D) Other Adjustments. The regulations also contain two rules that may restore L's attributes or L stock basis to better conform inside and outside bases.[275] The first rule limits the attribute reduction amount that tiers down from S to L. That "tier-down" amount is limited to the excess of L's net inside attribute amount allocable to the L shares held by members as of the transaction, over the following sum:
(i) L's direct attribute reduction amount,[276] plus
(ii) the aggregate value of L shares transferred by members in the transaction for which any gain or loss was recognized,[277] plus
(iii) the aggregate basis of other L shares transferred by members in the transaction, reduced by any direct attribution reduction amount for the transfer of those shares,[278] plus
(iv) the group's aggregate basis in any nontransferred L shares held as of the transaction.[279]

Second, after the attribute-reduction rule is applied to all transferred subsidiary stock, a basis reduction in an L share under that rule may be restored. The reduction is reversed to the extent necessary to conform the basis of any L share held by a member to the share's allocable portion of the L's net inside attribute amount ("L's NIAA").[280] L's NIAA is generally computed as provided in Reg. §1.1502-36(c)(5)[281] with the following modifications:
(i) the computation takes into account L's actual basis in any subsidiary stock, after the application of Reg. §1.1502-36(d); and
(ii) L's NIAA is reduced by any attribute reduction amount suspended because of L's "contingent" liabilities.[282]

These restoration adjustments are made up the chain from the lowest- to the highest-tier sub-

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sidiary, are computed and applied separately at each tier, and do not tier-up to affect the bases of higher-tier shares.[283]

Finally, a group may elect not to restore L stock basis or L attributes.[284] By making either election, the group would forego a potential tax benefit, but it might make the tier-down computations (relatively) simpler.[285]

iv. Elections to Reduce Potential for Loss Duplication. The regulation also offers a group facing attribute reduction a combination of two elective alternatives to reduce or limit attribute reduction.[286] First, the group may elect to reduce its basis in transferred S loss shares.[287] Second, if S becomes a nonmember, the group may elect to reattribute loss carryovers or deferred deductions.[288] If the common parent elects both to reattribute a subsidiary's attributes and reduce subsidiary stock basis, the reattribution is given effect before the stock basis reduction.[289] The group reduces its attribute reduction amount to the extent that, by election, it reduces its basis in transferred S loss shares or reattributes loss carryovers or deferred deductions.

3. Revising the Unified Loss Rules

The Treasury and the IRS deserve plaudits for the unified loss rules. They are detailed, clearly written and extraordinarily well considered, in short, a masterful technical achievement. In fact, because they were crafted with such care, it is easy to gauge whether their basic structure should be retained or another approach adopted.

Another approach should be adopted. The unified loss rules can reach results inconsistent with the *General Utilities* repeal, as the examples set out above illustrate. More problematically, the rules are overwhelmingly complex, both to understand and administer, a complexity that often can be traced to allowing subsidiary stock to be treated sometimes as a separate asset and sometimes as an indirect interest in subsidiary assets. Other than a few highly paid experts, it seems unlikely that most can apply the rules as intended, even in the typical case. Further, consolidated groups rarely maintain the information necessary to implement the rules (*e.g.*, records of the investment adjustments kept with sufficient precision) and will often find it difficult and costly to uncover that information on a stock sale. Finally, it seems unlikely that most agents will have the expertise (or patience) to apply the rules correctly. Thus, the rules may be applied unevenly, often to the disadvantage of the fisc.

If the approach of Reg. §1.1502-36 is abandoned, there is one obvious candidate to take its place—the approach reflected in Reg. §1.1502-20, the regulation that Reg. §1.1502-36 ultimately replaced. The Reg. §1.1502-20 approach was much simpler to understand and apply,[290] although legislation may be necessary to return to that approach. The Treasury and the IRS should seek that legislation.[291]

D. Partnership Issues

Although a partnership in some ways is treated as an entity separate from its partners, it also is sometimes treated as an aggregate of its partners. That aggregate treatment may raise questions about how the corporate and partnership tax rules interact.

The first part of this section describes how those two sets of rules generally are coordinated. The second and third parts describes how that coordination may be affected by the *General Utilties* repeal.

1. Coordinating Subchapters C and K–In General

If a partnership holds stock of a corporate partner and the partner pays a dividend on that stock or the partnership sells the stock, any income, gain, or loss allocated to the partner is eliminated.

Example—Coordinating Code Secs. 705 and 1032. P and X form partnership PX, with each contributing $50 for an undivided 50-percent interest in the partnership capital and profits. Among other assets, PX buys P stock for $50. In its first year, P pays a $6 dividend on PX's P stock, half of which is allocated to P. Under Code Sec. 702(b), P characterizes its $3 share of the dividend as a payment directly to itself (*i.e.*, essentially as a payment between divisions). Because a payment between corporate divisions does not result in an accession to overall corporate wealth, P excludes the payment from its gross income.[292] However, because the value of P's partnership interest increases by the amount of the payment, for purposes of Code Sec. 705, P must treat the dividend as exempt income and increase its basis in its PX interest by $3.[293]

Suppose that the P stock held by PX increases in value by $20, and PX sells the stock to an unrelated person for $70. Under Code Sec. 1001(a), PX realizes a $20 gain, half of which is allocated to P. Under Code Sec. 702(b), P characterizes

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the gain as if P had realized the gain on a sale or exchange of its stock. Because a corporation recognizes no gain or loss on the sale or exchange of its stock, P excludes that gain from its gross income.[294] Under Code Sec. 705(a)(1), P increases its PX basis by $10 to account for that excluded gain.[295]

Thus, if the partnership sells partner stock, the partner may increase its basis in its partnership interest to account for that gain. However, if that increase occurred unchecked, the partner could effectively recognize a loss associated with the sale of its stock, inconsistent with Code Sec. 1032.

Example—Avoiding Code Sec. 1032. X, Y and Z form partnership XYZ as equal one-third partners. Z contributes P stock with a $0 basis and $100 value for its XYZ interest. Subsequently, when XYZ is still worth $300 and the P stock is still worth $100, P buys Z's interest in XYZ for $100. Assume that the partnership has not made a Code Sec. 754 election.

The partnership sells the P stock for $100. Under Code Sec. 704(c), the entire $100 gain on the P stock is allocated to P as Z's successor.[296] Assume that P increases its basis in its PXY interest by $100, from $100 to $200. Later, in liquidation of its PXY interest, P receives $100. Under Code Sec. 731(a)(2), P recognizes a $100 loss under Code Sec. 731, a noneconomic loss traced to the partnership's sale of the P stock, a recognition inconsistent with Code Sec. 1032.

Reg. §1.705-2 addresses the Code Sec. 1032 avoidance illustrated by the preceding example by determining P's basis adjustment under Code Sec. 705 as if the partnership had had a Code Sec. 754 election in effect.[297] Thus, P could not avoid Code Sec. 1032 because it would take into account no net gain on the partnership's sale of the P stock, it would not increase its PXY basis to account for the sale, and it would not recognize loss on the distribution.

2. Reg. §1.337(d)-3– The May Company Regulations

As the preceding examples illustrate, if a corporation is a partner in a partnership that holds the partner's stock, that corporation is treated for tax purposes in many ways the same as if it directly held that stock (*i.e.*, it is equivalent to treasury stock). That practical equivalence supports treating a corporate partner as redeeming its stock when a partnership acquires stock of the partner or a corporation acquires an interest in a partnership that owns the corporation's stock. Proposed regulations, in fact, take that approach, proposing a deemed redemption and also a distribution rule.[298]

a. The Deemed Redemption Rule.

i. Partner Stock. As proposed, the deemed redemption rule would apply "at the time of, and to the extent that any transaction ... has the economic effect of an exchange by a partner of its interest in appreciated property for an interest in the stock of the partner owned, acquired, or distributed by the partnership."[299] If the partner recognizes gain, appropriate adjustments are made to the partner's basis in its partnership interest and the partnership's basis in its assets.[300]

Example—The deemed redemption rule. P and X form a partnership as 50-percent partners, with P contributing an asset with a $0 basis and $100 value and X contributing P stock with a $100 basis and $100 value. Because the transaction has the economic effect of an exchange by P of appreciated property for an interest in P stock, the deemed redemption rule applies. P is treated as exchanging an asset with a $0 basis and $50 value for 50 percent of the partnership's P stock. Under Code Sec. 311(b), P recognizes a $50 gain. The partnership's basis in the asset contributed by P and P's basis in its partnership interest should both increase by $50, from $0 to $50.[301]

Note that if rules like those found in Proposed Reg. §1.337(d)-3 did not apply, a corporation could avoid Code Sec. 311(b) gain by transferring appreciated property to a partnership for a partnership interest and later receiving a distribution of its stock in liquidation of its interest. If the distribution followed the contribution by at least seven years, the corporation could avoid gain on the contribution (Code Sec. 721), distribution (Code Sec. 731) and subsequent sale of the stock (Code Sec. 1032).[302]

In its recent report on Reg. §1.337(d)-3, the New York State Bar Association supported applying the deemed redemption rule in the preceding example (*i.e.*, when a partnership holds stock of a corporate partner), a sensible conclusion for three possible reasons, each noted in the report.[303]

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First, as the discussion above shows, if a partnership owns stock of a partner ("P"), P's partnership interest resembles treasury stock to the extent it represents an interest in that stock (the "treasury stock theory").[304] If dividends are paid on the P stock and allocated to P, P has no income. Further, if the partnership sells the P stock, any gain or loss allocated to P is not recognized. Therefore, P holds an interest that resembles treasury stock, and applying the deemed redemption rule when P acquires that interest makes sense.

Second, the deemed redemption rule may be justified because if P acquires an interest in a partnership that owns P stock, the acquisition effects a corporate contraction (the "corporate contraction theory"), essentially depleting P's assets.[305] That depletion can be demonstrated by considering the perspective of a P creditor: The partnership arrangement removes P assets that the creditor may use to satisfy its claim against P. Although a P creditor may acquire an interest in the P stock held by the partnership to satisfy its debt, that interest will be subordinate to its creditor's interest.[306]

Finally, and most critically, the deemed redemption rule may be justified because it seems rare that a partnership would have a nontax business purpose for holding P stock.[307] In the typical case, the partnership appears to be used to "effect an economic redemption of the [P] stock" and to defer (or eliminate) gain on that redemption.[308]

It is true that since the "May Company" regulations were proposed, various partnership rules have been enacted or strengthened making it more likely that P cannot avoid gain through the "May Company" gambit,[309] but those provisions still allow P to defer that gain. That deferral seems hard to justify because P effects a redemption through a scheme that generally has no business purpose apart from saving tax. The deemed redemption rule prevents that deferral.

Note that those partnership provisions would still allow P to effect an economic redemption using loss property and preserve the loss, inconsistent with Code Sec. 311(a),[310] but so do the proposed regulations. The deemed redemption rule should also address that concern.

Example—Loss property. P and X form a partnership as 50-percent partners, with P contributing an asset with a $150 basis and $100 value and X contributing P stock with a $100 basis and $100 value. Although the transaction has the economic effect of an exchange by P, the deemed redemption rule does not apply because P has not effected an exchange of appreciated property for an interest in P stock.[311] Thus, if the partnership later sells the contributed property, P may be allocated and take into account the built-in loss,[312] even if it later receives the P stock in redemption of its partnership interest.[313]

To prevent the avoidance of Code Sec. 311(a), the deemed redemption rule should be modified to apply to P's transfer of loss property. If so modified, P's loss would be disallowed under Code Sec. 311(a), the partnership would take a fair market value basis in the property transferred by P, and P would reduce its partnership basis by the amount of the disallowed loss.

The deemed redemption rule should be modified in at least one additional way. That rule applies when P increases its interest in its stock held through a partnership. The converse situation may also prove problematic, however, since P may effectively recognize loss associated with its stock by *reducing* its interest in its stock.

Example—Reverse "May Company" transaction. P, Fred and Mary form a partnership, each contributing $100 cash. Thus, P takes a $100 basis in its partnership interest. The partnership buys $100 of P stock and other assets. Assume that P has a 99-percent interest in the P stock (worth $99) and a 0.5-percent interest in the other assets (worth $1). The P stock held by the partnership declines in value to $80, and the partnership liquidates P's interest, distributing $80.20 worth of assets other than P stock to P.[314] Under Code Sec. 731(a), P recognizes no gain or loss on the distribution, but under Code Sec. 732(b), it takes a $100 basis in the distributed assets. If P then sells those assets, it recognizes a $19.80 loss.

If the partnership had sold the P stock for $80 while P was a partner, the partnership would have had a $20 loss, P would have been allocated a $19.80 share of that loss (99 percent of $20), P would have reduced its outside basis by the same amount under Code Sec. 705(a)(2), but under Code Secs. 702(b) and 1032, P would not have recognized that loss. Thus, the transaction in the example allows P to avoid Code Sec. 1032 and indirectly recognize a stock loss.

To address that concern, the deemed redemption rule could be modified as follows: Immediately before P reduces its interest in P stock held through

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a partnership, P should make the adjustment to its partnership basis that it would have made if the partnership had then sold the P stock for its fair market value. If that rule were in place in the previous example, P would reduce its partnership basis by $19.80 (*i.e.*, its allocable share of the partnership's built-in loss on P stock) and would take only an $80.20 basis in the distributed assets, preventing P from avoiding Code Sec. 1032.[315]

ii. Affiliate Stock. Proposed Reg. §1.337(d)-3 applies not only to P stock but also to stock of a P affiliate.[316] For example, the deemed redemption rule applies when P acquires a partnership interest and the partnership owns stock of a P affiliate. This application cannot be justified, however, by the treasury stock theory because P would recognize any allocable gain on the partnership's sale of affiliate stock and would include any allocable affiliate dividends in gross income.[317] However, both the corporate contraction theory and business purpose doctrine may support applying the deemed redemption rule to affiliate stock.

The corporate contraction theory plays a prominent role in the NYSBA report's analysis. The report recommends restricting the application of the deemed redemption rule so that it applies to affiliate stock only when P (*i.e.*, the partner) is a direct or indirect subsidiary of the affiliate.[318] If, instead, the affiliate is a subsidiary of P, the report recommends that the deemed redemption rule should not apply on that the partnership's acquisition of subsidiary stock. It points primarily to the corporate contraction theory to distinguish the cases: In the first, a corporate contraction arguably occurs because the affiliate indirectly owns its stock (as P's parent), but not in the second.[319] Note that if the affiliate is P's subsidiary and P and the affiliate combine, the corporate contraction theory could then apply, and the report recommends that the deemed redemption rule should apply at that time.[320] In addition, if P owns a partnership interest, the partnership owns subsidiary affiliate ("S") stock, and P contributes its partnership interest to S, the report recommends that the deemed redemption rule also then apply.[321]

The report also considers brother-sister arrangements, relying on the lack of a corporate contraction to recommend not applying the deemed redemption rule to those arrangements.[322] For example, suppose that P owns all stock of S1 and 90 percent of the stock of S2. S1 and an unrelated person enter into a partnership, with S1 contributing appreciated property and the other partner contributing the remaining 10-percent interest in S2 stock. Because there is no direct or indirect corporate contraction of S2 (as when a subsidiary is a partner in a partnership that acquires parent stock), the report recommends that the deemed redemption rule not apply when the partnership is formed.[323] However, if S1 and S2 merge, if S2 merges into P (and the partnership exchanges its S2 stock for P stock), or if P contributes its S1 stock to S2 (so that S2 becomes S1's parent), the corporate contraction theory would apply, and the report recommends that the deemed redemption rule then apply.[324]

Although a corporate contraction theory may justify limiting the deemed redemption rule, that limitation makes the rule more difficult to administer. Further, it may strain the resources of the IRS (and the memories of taxpayers) to audit (and report) the appropriate amount of gain when it is later triggered under the more refined rule.

In any case, a focus on the corporate contraction theory misses a critical point: It seems rare that a partnership would have a nontax business purpose for holding stock of a partner or its affiliate, and it seems hard to justify accommodating transactions lacking a valid nontax business purpose, particularly when the added precision imports real complexity. The better approach is to retain the deemed redemption rule for affiliate stock.[325] That absolute rule could be softened by allowing taxpayers to seek its waiver by private letter ruling in any case where a partnership's ownership of affiliate stock does not jeopardize the *General Utilities* repeal.

b. The Distribution Rule. In addition to the deemed redemption rule, Proposed Reg. §1.337(d)-3 includes a distribution rule, which applies if a corporate partner receives a distribution of its stock and other property.[326] Under the distribution rule, the distribution of stock is treated as a separate transaction that occurs before the distribution of the other property. This rule is overbroad and, except for transition purposes, should be eliminated.[327]

Example—Overbreadth of the distribution rule. P and X form a partnership as 50-percent partners, with P contributing an asset with a $0 basis and $100 value and X contributing P stock with a $100 basis and $100 value. Because the transaction has the economic effect of an exchange by P of appreciated property for an interest in P stock, the deemed redemption rule

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applies. P is treated as exchanging an asset with a $0 basis and $50 value for 50 percent of the partnership's P stock. Under Code Sec. 311(b), P recognizes a $50 gain. The partnership's basis in the asset contributed by P and P's basis in its partnership interest should both increase by $50, from $0 to $50.[328]

Sometime later, the partnership liquidates when the value and bases of the relevant assets is unchanged. (Assume that Code Sec. 704(c)(1)(B) does not apply.) The partnership distributes a 50-percent interest in each asset to each partner. Thus, P receives P stock worth $50 (*i.e.*, the amount of stock deemed "redeemed") and a one-half interest in the asset it contributed, worth $50. P is first treated as receiving its stock in redemption of one-half of its partnership interest with a $25 basis and under Code Sec. 311(b) recognizes a $25 gain. P is also deemed to receive the remaining asset in a liquidating distribution and takes a $25 basis in that asset.[329]

Thus, overall, P recognizes a $75 gain on stock worth only $50, a result that is possible only because the distribution rule applies an entity approach, while the deemed redemption rule applies an aggregate approach. This double-counting would be avoided if P treated the distribution of P stock by the partnership just like a distribution of cash with a value equal to that stock. Then, in the example, if the partnership distributes P stock and the other asset to P in liquidation, P would be treated just like it had received cash of $50 (*i.e.*, the value of the distributed P stock) and the other noncash asset. In the example, P would recognize no gain or loss because the cash deemed distributed would equal P's basis in its partnership interest,[330] and P would take a $0 basis in the other asset.[331]

Note that the distribution rule could also result in an avoidance of Code Sec. 1032, as the following example illustrates.

Example—Avoiding Code Sec. 1032. The facts are the same as in the preceding example. Thus, P and X form a partnership as 50-percent partners, with P contributing an asset with a $0 basis and $100 value and X contributing P stock with a $100 basis and $100 value. Because the transaction has the economic effect of an exchange by P of appreciated property for an interest in P stock, the deemed redemption rule applies. P is treated as exchanging an asset with a $0 basis and $50 value for 50 percent of the partnership's P stock. Under Code Sec. 311(b), P recognizes a $50 gain. The partnership's basis in the asset contributed by P and P's basis in its partnership interest should both increase by $50, from $0 to $50.[332]

Sometime later, the partnership liquidates when the bases of the relevant assets is unchanged but the value of each asset has fallen to $50. (Assume that Code Sec. 704(c)(1)(B) does not apply.) The partnership distributes a 50-percent interest in each asset to each partner. Thus, P receives P stock worth $25 (*i.e.*, the amount of stock deemed "redeemed") and a one-half interest in the asset it contributed, also worth $25. Under the distribution rule, P is first treated as receiving its stock in redemption of one-half of its partnership interest with a $25 basis and under Code Sec. 311 recognizes no gain or loss. P is also deemed to receive the remaining asset in a liquidating distribution, and takes a $25 basis in that asset.[333]

Note that if the partnership had sold the P stock immediately before the distribution, it would have had a $50 loss on that stock ($100 basis minus $50 amount realized), half of which would have been allocated to P. Under Code Sec. 702(b). P would have treated that loss as a loss from the sale of its stock, which it would not recognize under Code Sec. 1032. However, under Code Sec. 705(a)(2)(B), it would reduce its basis in its partnership interest by that disallowed loss. Instead, in the transaction, P takes a $25 basis in the distributed nonstock asset, basis essentially shifted from the P stock, thereby avoiding Code Sec. 1032.

The troubling result could be avoided if immediately before the partnership distributed the P stock to P, P made the adjustment to its partnership basis that it would have made if the partnership had then sold its P stock for its fair market value. If the partnership had sold the P stock, it would have recognized a $50 loss, half of which would have been allocated to P, reducing its basis in its partnership interest by $25, from $50 to $25.[334] If, as was earlier proposed, P treated the distribution of P stock by the partnership just like a distribution of cash with a value equal to that stock, P would be treated just

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like it had received cash of $25 (*i.e.*, the value of the distributed P stock) and the other noncash asset. Then, P would recognize no gain or loss because the cash deemed distributed would equal P's basis in its partnership interest,[335] and P would take a $0 basis in the other asset.[336]

The distribution rule, as originally proposed, not only provided a backstop to the deemed redemption rule but also targeted back-end partnership planning.

Example—Back-end planning. P holds a partnership interest with a $20 basis and $100 value. Assume that the partnership owns a disregarded entity that holds assets with an $80 basis and $100 value. Sometime before the partnership liquidates, it "checks the box" to treat the disregarded entity as a corporation. The partnership is deemed to contribute the entity's assets to a corporation, recognizes no gain or loss on the contribution and takes an $80 basis in the "stock" deemed received.[337] Further, the entity takes an $80 basis in the contributed assets.[338] The partnership distributes the stock to P in liquidation of P's partnership interest, and under Code Sec. 732, P takes a $20 basis in the "stock."[339]

Under the distribution rule, before its modification by Notice 93-2,[340] P would have recognized an $80 gain on the distribution.[341] That result arguably may be justified because P's basis in the entity's stock may be irrelevant. It could benefit from the entity's asset bases by liquidating the entity under Code Sec. 332, acquiring the entity's assets with an $80 basis or joining with the entity in filing consolidated returns. Note that because of Notice 93-2, the distribution rule would not apply in this example, so that P would not recognize gain under that rule.

c. Code Sec. 732(f). At least in part, Code Sec. 732(f) now addresses the same back-end planning, but it addresses a partnership issue (*i.e.*, the avoidance of Code Sec. 732), not the *General Utilities* repeal,[342] and to the extent that Code Sec. 732(f) accommodates the repeal, it is by accident, not design. Although Proposed Reg. §1.337(d)-3 generally should eliminate the distribution rule, the rule should be retained (as originally proposed and before its modification by Notice 93-2) to deal with a distribution that causes a corporate partner and subsidiary to become affiliated. The following discussion demonstrates why Code Sec. 732(f) is an inadequate surrogate for such a distribution rule.

Code Sec. 732(f) applies to a corporate partner if the following requirements are met:

(i) the corporate partner receives a distribution from a partnership of stock of another corporation (the "distributed" corporation);
(ii) the corporate partner and the distributed corporation are affiliated immediately after the distribution (or any time thereafter); and
(iii) the partnership's basis in the distributed stock exceeds the corporate partner's basis in that stock immediately after the distribution.[343]

If Code Sec. 732(f) applies, the distributed corporation must reduce its asset bases by the smaller of (A) the excess noted in (iii) above, or (B) the amount by which the sum of the money and adjusted basis of property held by the distributed corporation exceeds the corporate partner's basis in the distributed corporation's stock.[344] To the extent that the distributed corporation cannot reduce its adjusted basis in its assets by that full amount (which may occur because it holds too much cash), the corporate partner must recognize gain, and it will increase its basis in the stock of the distributed corporation by that amount.[345]

Some may argue that Code Sec. 732(f) could serve as a substitute for the deemed redemption or distribution rule, but Code Sec. 732(f) has some obvious flaws and does not adequately address (nor was it intended to address) the *General Utilities* repeal.

As one flaw, the basis reduction is limited by the gross asset basis of the distributed corporation, rather than its net asset basis.

Example—Gross basis limitation. Assume that a partnership owns all S stock with a $50 basis and $20 value, and S has assets with a $130 basis and $130 value, but also has $110 of liabilities. P holds a partnership interest with a $20 basis and $20 value. The partnership distributes the S stock to P in liquidation of P's interest. Under Code Sec. 732(b), P takes a $20 basis in the S stock.

Code Sec. 732(f) applies to the distribution because P receives the S stock in distribution from the partnership, P and S are affiliated immediately after the distribution, and the partnership's basis in the S stock exceeds P's basis by $30. The basis reduction is limited to the smaller of $30 (that excess) or $110 (*i.e.*, $130, S's gross asset basis, minus $20, P's in its S stock). Thus, S must reduce its asset bases by $30, creating a built-in gain in its assets.[346]

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More appropriately, Code Sec. 732(f)(3)(A) should consider the distributed corporation's net asset value, not its gross asset value.

Further, it is not altogether clear how the distributed corporation would reduce its asset bases. Code Sec. 732(f)(1) provides that the basis reduction is made in accordance with Code Sec. 732(c). The general allocation scheme of Code Sec. 732(c)(1) preserves the basis of inventory and unrealized receivables to the extent possible. The "reduction" rule under Code Sec. 732(c)(3) first reduces the basis of built-in loss assets (in proportion to and to the extent of their built-in loss) and then reduces the bases of all assets proportionately. It is not clear whether the reduction is applied first to assets other than unrealized receivables and inventory (reflecting the priority in Code Sec. 732(c)(1)) or applies to all assets (reflecting the scheme in Code Sec. 732(c)(3)).

Code Sec. 732(f) also appears to assume that if stock of an affiliate is distributed, the partnership's basis in the stock reflects the affiliate's basis in its assets, which often may not be true, particularly when the partnership has purchased the affiliate stock. It also may not be true when the partnership forms the affiliate if Code Sec. 362(e)(2) applies to the formation.

Example—Code Sec. 362(e)(2). P, a partner in partnership PX, owns a 50-percent interest in the partnership with a $100 basis and $100 value. X owns the remaining partnership interest with a $130 basis and $100 value. The partnership owns two assets, Asset 1 with a $100 basis and $100 value and Asset 2 with a $130 basis and $100 value.

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PX forms corporation S, contributing Asset 2 to S for all S stock. Assume that Code Sec. 351 applies to the formation. Because S would take a basis in Asset 2 under Code Sec. 362(a) exceeding its value, Code Sec. 362(e)(2) applies to the contribution. If PX and S do not make an election under Code Sec. 362(e)(2)(C), S reduces its basis in Asset 2 by $30 (the built-in loss) to $100.[347]

Later, PX liquidates, distributing the S stock to P and Asset 1 to X. Under Code Sec. 732(b), X takes a $130 basis in Asset 1, while P takes a $100 basis in the S stock. Even though P would receive no basis benefit from S's liquidation, Code Sec. 732(f) applies to the distribution because P receives the S stock in distribution from the partnership, P and S are affiliated immediately after the distribution, and the partnership's basis in the S stock exceeds P's basis by $30. Under Code Sec. 732(f)(1), S reduces its basis in Asset 2 by $30, from $100 to $70, creating an unwarranted gain in the asset.

Thus, Code Sec. 732(f) has a number of flaws, and for that reason alone, it should not act as a surrogate for the deemed redemption or distribution rule. More troubling, Code Sec. 732(f) may eliminate corporate-level gain, inconsistent with the *General Utilities* repeal, as is illustrated by the following sequence of examples. The first example illustrates a serendipitous case where Code Sec. 732(f) is consistent with the repeal.

Example—Code Sec. 732(f) consistent with the repeal. Individual X owns all S stock with a $100 basis and $100 value. S owns assets, also with a $100 basis and $100 value.

Corporation P owns land with a $0 basis and $100 value. If P sold the land for $100, it would recognize a $100 gain. Together, therefore P and S hold assets with an aggregate $100 built-in gain.

X and P form a partnership as 50-percent partners, with X contributing the S stock and P contributing the land. None of the parties recognize gain or loss on the contribution, X and P take $0 and $100 bases, respectively, in their partnership interests, and the partnership takes a $0 basis in the land and a $100 basis in the S stock.[348]

After more than seven years, the partnership liquidates, distributing the land to X and the S stock to P. Assume that the values and bases of all relevant assets remain the same. Under Code Sec. 732(a), X takes a $100 basis in the land, while P would take a $0 basis in the S stock. Code Sec. 732(f), however, applies to the distribution because the partnership's $100 basis in the S stock immediately before the distribution exceeds P's $0 basis in that stock under Code Sec. 732(a) and P and S are affiliated immediately after the distribution. Because S's aggregate basis in its assets is $100, S reduces its asset bases by $100, from $100 to $0. That basis reduction preserves the $100 corporate-level gain within the system.[349]

Example—Eliminating corporate-level gain despite Code Sec. 732(f). The facts are the same as

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in the preceding example, except that individual X has a $0 basis in his S stock. Thus, X owns all S stock with a $0 basis and $100 value, but S owns assets with a $100 basis and $100 value. If S liquidated, it would recognize no gain or loss, while X would recognize a $100 gain.[350]

Corporation P owns land with a $0 basis and $100 value. If P sold the land for $100, it would recognize a $100 gain. Together, therefore, P and S hold assets with an aggregate $100 built-in gain.

X and P form a partnership as 50-percent partners, with X contributing the S stock and P contributing the land. None of the parties recognize gain or loss on the contribution, X and P take $0 bases in their partnership interests, and the partnership takes $0 bases in the contributed assets.[351]

After more than seven years, the partnership liquidates, distributing the land to X and the S stock to P. Assume that the values and bases of all relevant assets remain the same. Under Code Sec. 732(a), P takes a $0 basis in the S stock. Code Sec. 732(f) does not apply to the distribution because P's basis in the S stock immediately after the distribution equals the partnership's basis in the stock immediately before the distribution.

Sometime later, P liquidates S, in a liquidation to which Code Secs. 332 and 337 apply. P takes a $100 basis in the S assets, eliminating its built-in gain in the S stock.[352] Thus, the overall transaction eliminates $100 of P's gain. Through a combination of Code Sec. 732(a) and Code Sec. 332, a corporation (*i.e.*, P) indirectly exchanged an appreciated asset with a $0 basis and $100 value for assets with a $100 basis and $100 value but recognized no corporate-level gain.[353] Note that under the distribution rule, as originally proposed, P would have recognized a $100 gain on the distribution of the S stock, preventing the elimination of that one level of corporate gain.[354]

In the preceding example, to the extent that X had a positive basis in his S stock, Code Sec. 732(f) would preserve corporate-level gain because S would be required to reduce its asset basis by that X basis amount.[355] Thus, perversely, the extent to which Code Sec. 732(f) would further the *General Utilities* repeal would depend on a fact unrelated to the corporate-level gain.

Even before it was modified by Notice 93-2, the distribution rule in Proposed Reg. §1.337(d)-3 may have been too narrow to deal with all partnership transactions that may avoid the *General Utilities* repeal, as the following two examples illustrate. Nor does Code Sec. 732(f) save the day.

Example—Protracted deferral of corporate-level gain. P owns all S stock with a $100 basis and $100 value, and S owns assets also with a $100 basis and $100 value. Individual X owns C stock with a $0 basis and $100 value, and C owns assets with a $0 basis and $100 value.

X and P form a partnership as 50-percent partners, with P contributing the S stock and X contributing the C stock. None of the parties recognize gain or loss on the contribution, X takes a $0 basis in his partnership interest, P takes a $100 basis in its interest, and the partnership takes $0 and $100 bases in the C and S stock.[356]

After more than seven years, the partnership liquidates, distributing the C stock to P and the S stock to X. Assume that the values and bases of all relevant assets remain the same. Under Code Sec. 732(a), X takes a $0 basis in the S stock, while P takes a $100 basis in the C stock.[357] Code Sec. 732(f) does not apply because P's basis in the C stock exceeds the partnership's basis in the stock immediately before the distribution.

Note, however, that the sequence of steps may lead to an indefinite deferral of corporate-level gain. P could sell the C stock without gain recognition, while S could sell its assets, also without gain recognition.[358] Arguably that deferral is inconsistent with the *General Utilities* repeal but it is not clear how or even whether that deferral should be addressed.

Example—Exploiting Code Sec. 362(e)(2)(C). P holds a partnership interest with a $100 basis and $100 value. The partnership owns a disregarded entity, which holds assets with a $150 basis and $100 value. The partnership checks the box for the disregarded entity and is treated as transferring the entity's assets to a newly formed corporation ("S") in a Code Sec. 351 transfer. Code Sec. 362(e)(2) applies, but S and partnership make the election under Code Sec. 362(e)(2)(C).

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Thus, the partnership takes a $100 basis in S's stock, while S takes a $150 basis in its assets. If the basis reduction is treated as a Code Sec. 705(a)(2)(B) expenditure (as Proposed Reg. §1.362-4(c)(6) concludes), the partners, including P, will reduce their partnership bases in total by $50. Assume that P reduces its basis in it partnership interest by $10, from $100 to $90.[359] The partnership then distributes the X stock to P.[360]

Under Code Sec. 732(a), P takes a $90 basis in the S stock. Under Code Sec. 732(f), S must reduce its basis in its assets by $10, from $150 to $140.[361] However, if P and S join in filing a consolidated return (or if P liquidates S), P has access to the remaining built-in loss in the S assets. Further, if P held more than a 50-percent interest in the partnership, Code Sec. 382 would not limit P's (or the P group's) use of those built-in losses.

To address the concern illustrated by the last example, the distribution rule may include an anti-abuse provision that would require S to conform its net asset basis to P's S stock basis if the partnership and S made the Code Sec. 362(e)(2)(C) election with a view to benefitting P.

3. Hook Interests

The *General Utilities* repeal may be avoided by a partnership buying all stock of (and therefore becoming the sole shareholder of) a corporate partner. Consider the following example:

Example—Hook interest. P owns a 10-percent interest in a partnership with a $10 basis and $100 value and X owns all P stock. Assume that the partnership buys all P stock for $300. P's indirect interest in the acquired stock is therefore worth $30 (10 percent of $300). If the deemed redemption rule applies, P is deemed to exchange 30-percent of its partnership interest with a $3 basis and $30 value for P stock worth $30, recognizing a $27 gain under Code Sec. 311(b).

If the partnership retains the P stock, nothing else apparently happens, even if it converts P's 10-percent interest into a preferred but limited partnership interest. Even with that conversion, no gain (or loss) would escape corporate solution, although P's gain on its partnership interest could be indefinitely deferred. Regulations could provide at a minimum that on the conversion, P recognizes any gain embedded in the partnership interest to prevent that indefinite deferral.

E. Possible Legislative Targets

The following examples illustrate cases that may merit a legislative response:

Example—Duplicating loss through a B reorganization. P acquires all of the X stock in exchange for its voting stock in a B reorganization. Assume that X has one shareholder, Fred, and his basis in the X stock was $100, but its value was only $10.

Under Code Sec. 362(b), P takes Fred's basis in the X stock or $100. Fred receives solely P stock in exchange for his X stock. If Code Sec. 354 applies to his exchange, his basis in the P stock is also $100, even though its value is only $10. Thus, Fred preserves his loss in the P stock, but that loss is duplicated for P.

The duplication illustrated by the example appears inconsistent with Code Sec. 362(e)(2), which targets the duplication of shareholder loss at the corporate level. Because the duplication in the example arises under Code Sec. 362(b), not Code Sec. 362(a), however, Code Sec. 362(e)(2) does not apply, and it is unlikely that the Treasury and the IRS could issue regulations under Code Sec. 337(d) to address this concern, given Code Sec. 362(e)(2)'s breadth. To address this concern, Congress should amend Code Sec. 362(e)(2) to provide that it applies to prevent loss duplication in a B reorganization.

Example—Elective basis rules for a split-up? P owns all stock of S1, S2 and S3 and holds no other assets. All P stock is owned by Q, a domestic corporation. P liquidates, distributing all stock of its subsidiaries to Q. Assume that the liquidation is described in Code Secs. 332 and 337, as well as Code Sec. 355.

If Code Sec. 355 applies to the distribution, Q's basis in the S1, S2 and S3 stock equals its P stock basis, allocated among the shares proportionately by value.[362] If, instead, Code Sec. 332 applies to the distribution, Q succeeds to P's bases in those shares.[363] Whether Code Sec. 332 or Code Sec. 355 apply to the distribution, neither P nor Q should recognize gain or loss.[364]

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Note that Q can assure that Code Sec. 332 applies to the liquidation by making sure that P holds some assets other than the subsidiary stock.[365] Because Q can functionally elect to apply Code Sec. 332 to the transaction, arguably it should be able to elect whether Code Sec. 332 or Code Sec. 355 applies to the liquidation. Congress could confirm that result.

Example—Elective rules for a reorganization. P owns all S1 stock with a $0 basis and $100 value, and S1 owns assets with a $0 basis and $100 value. S1 merges into X, and P receives $40 X stock plus $60 cash. Assume that the merger qualifies as a Code Sec. 368(a)(1)(A) reorganization.

Under Code Sec. 361(b), S1 recognizes no gain or loss because it receives stock of a party to the reorganization (the X stock) and boot (the cash) in the exchange, and it is deemed to distribute the stock and boot to P, its shareholder. Further, under Code Sec. 361(c), S1 recognizes no gain or loss on the deemed distribution. Note that none of Code Secs. 311, 336 or 337 can apply to S1's distribution.[366]

Under Code Sec. 1032(a), X recognizes no gain or loss on its acquisition of S1 assets for its stock. Further, under Code Sec. 362(b), X takes a transferred basis in the S1 assets.

Code Sec. 354 cannot apply to P's exchange because P receives boot in the exchange. If Code Sec. 356 applies, P will recognize a $60 gain (*i.e.*, the smaller of its realized gain ($100) or the value of the boot received ($60)).

Although Code Sec. 356 by its terms applies to P, it appears that Code Sec. 332 may apply as well.[367] Code Sec. 361(c)(4) does not expressly prevent Code Sec. 332 from applying to the deemed liquidation, since it merely prevents the liquidation rules from applying to the target corporation, not its shareholders. If, however, Code Sec. 332 applies, P will recognize none of its realized gain. Although P will take a $0 basis in the X stock (assuming that X and P are not members of the same consolidated group), the transaction will eliminate $60 of P's corporate-level gain without tax.[368]

Arguably, however, that gain elimination does not violate the *General Utilities* repeal because X preserves S1's asset basis and P could have eliminated its gain in its S1 stock before the exchange through a Code Sec. 332 liquidation. In fact, if P had first liquidated S1 and had then transferred the former S1 assets to X in a taxable exchange, it would have recognized only a $100 gain (and X would have taken a cost basis in the assets).[369] In contrast, if Code Sec. 332 applied in the reorganization transaction in the example, the transaction would preserve a $140 gain, albeit a deferred gain.[370] It is not clear whether the *General Utilities* repeal should apply to prevent that deferral, when an alternative transaction would result in a smaller recognized gain. Congress could answer that question through legislation, or perhaps simply provide that Code Sec. 332 cannot apply to a corporate shareholder of the target in an acquisitive reorganization.

Example—Avoiding Code Sec. 1059. P has owned at least 80 percent of the only class of S1 stock since S1 was formed. Thus, P and S1 have always been affiliated, although they do not join in filing a consolidated return. Assume that none of S1's earnings and profits were generated by another corporation.

In anticipation of S1's making a large dividend distribution, P acquires the remaining S1 stock for $1,000, taking a $1,000 basis in the newly acquired S1 stock.[371] S1 then declares and distributes a $2,000 dividend, $400 of which is paid on P's newly acquired S1 stock. Although the dividend paid on that stock equals 40 percent of P's basis in that stock, Code Sec. 1059 does not apply to the distribution.

Under Code Sec. 1059, if a corporation receives an extraordinary dividend on stock that the corporation has not held for more than two years before the dividend announcement date, the corporation must reduce its basis in that stock by the nontaxed portion of the dividend.[372]

Extraordinary dividends do not include qualified dividends on common stock, and the dividend paid by S1 to P on the newly acquired stock is a qualified dividend.[373] The distribution is a qualified dividend because P and S1 are affiliated at the close of the distribution date, and the dividend is paid out of earnings and profits generated in tax years, on each day of which P and S1 were affiliated.[374] Because the dividend is a qualified

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dividend, P is entitled to a 100-percent dividends-received deduction. Thus, P's gross income for the dividend is entirely offset by its dividends received deduction.

Because of the dividend, P's newly acquired S1 stock declines in value to $600, and after holding the stock for more than 45 days,[375] assume that P sells that stock to an unrelated person for that amount. Because Code Sec. 1059 does not apply, P retained its $1,000 basis in that stock and therefore recognizes a $400 loss on its S1 stock sale.

In the preceding example, P enjoys a $400 tax loss but suffers no economic loss. Although the creation of that noneconomic loss is inconsistent with the *General Utilities* repeal, Congress has implemented a comprehensive scheme in Code Sec. 1059 to attack similar losses. Given that scheme, it seems unlikely that the Treasury has the authority under Code Sec. 337(d) to attack that noneconomic loss, although Congress could (and should) address it through an amendment to Code Sec. 1059.

IV. Conclusion

A corporation recognized neither gain nor loss on its distribution of property to its shareholders under the *General Utilities* doctrine, a doctrine that can be traced to a 1935 Supreme Court case that bears its name. First courts, and then Congress, began eroding the doctrine, and by 1986, its repeal was substantially complete. Although Congress offered tantalizing hints, it never defined the repeal's scope. Nor have regulations offered a systematic definition.

At a minimum, the repeal should generally apply if a transaction otherwise eliminates a level of corporate tax, whether through a distribution, sale or transfer of an asset. That elimination may occur through the elimination of gain or the creation of a noneconomic loss. The repeal should not apply, however, when a statutory provision clearly provides for gain elimination, and that elimination is consistent with the policy underlying the provision. The Treasury and the IRS should craft a regulation of general application that reflects those principles.

The most significant regulation that currently implements the repeal is found in Reg. §1.1502-36, the unified loss rules for consolidated groups. Although the rules are a technical marvel, they are extraordinarily complex and sometimes may allow a group member to recognize a noneconomic loss. Those rules should be replaced by a simpler loss disallowance rule modeled on old Reg. §1.1502-20. To assure the validity of the replacement, the Treasury and the IRS should gain a Congressional endorsement of the revised approach.

The Treasury and the IRS have also proposed regulations to deal with a partnership's ownership and distribution of a partner's stock. The regulations proposed deemed redemption and distribution rules. The deemed redemption rule should be retained with some modifications, but the distribution rule generally should be eliminated. A new distribution rule should be added in its place, a rule that applies to a distribution by a partnership to a corporate partner that results in the partner becoming affiliated with a subsidiary.

Finally, Congress should consider a few legislative changes to address lingering questions about the scope of the repeal. These statutory and regulatory changes will help define the repeal's scope, answer important questions that have lingered for over a quarter of a century, and for consolidated groups, substantially simplify the law.

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Endnotes

* I thank the participants at the University of Chicago Federal Tax Institute for their insightful comments, particularly my co-panelists, Jennifer Alexander, Stephen Rose and Eric Sloan.

1 Unless otherwise stated, "Code Sec." references are to the Internal Revenue Code of 1986, as amended (the "Code") and "Reg. §" to applicable regulations under the Code.

2 The article does not consider whether the repeal itself makes sense. *Cf.* David Sholes, *Repeal of* General Utilities *and the Triple Taxation of Corporate Income*, 46 Tax Law. 177 (Fall 1992) (concluding that the repeal was ill-advised).

3 *General Utilities & Operating Co.*, SCt, 36-1 ustc ¶9012, 296 US 200, 56 SCt 185.

4 *General Utilities & Operating Co.*, SCt, 36-1 ustc ¶9012, 296 US 200, 56 SCt 185; *General Utilities & Operating Co.*, 29 BTA 934, 939, Dec. 8389 (1934) (reporting that the government conceded that if property was distributed in kind, no gain or loss resulted to the distributing corporation).

5 This rationale that became known as the *Court Holding Co.* doctrine. *See Court Holding Co.*, SCt, 45-1 ustc ¶9215, 324 US 331, 65 SCt 707.

6 *General Utilities & Operating Co.*, CA-4, 35-1 ustc ¶9082, 74 F2d 972 (agreeing with the rejection by the Board of Tax Appeals of the first argument).

7 *General Utilities & Operating Co.*, SCt, 36-1 ustc ¶9012, 296 US 200, 56 SCt 185.

8 *Id.*

9 *See, e.g.,* Charles Lowndes, *The Tax Burden of the Supreme Court 1935 Term*, 5

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FORDHAM L. REV. 426, 443 (stating that the Supreme Court concluded that a corporation did not realize gain when it distributed appreciated property in kind); Norris Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. PA. L. REV. 907, 920–21 (1941) (stating that the Supreme Court may have disregarded the third argument or dealt with it succinctly in disposing of the first argument); note, *Corporations and Stockholders—Dividend in Kind*, 1 TAX. L. REV. 86 (1945–1946) (asserting that the Supreme Court settled that a corporation realized no income or gain on its distribution in kind of appreciated property because there was no sale or other disposition of property); Gerald Wallace, *A Dissent*, 1 TAX L. REV. 93, 94 (1945–1946) (disagreeing that the Supreme Court passed on that issue because the government had not raised the issue before the Board of Tax Appeals or the Circuit Court); Marcel Singer, *Dividends Distributed in Kind*, 3 TAX L. REV. 250, 253 (1947–1948) (concluding that the Supreme Court "settled" that a corporation realized no income or gain on its in kind distribution of appreciated property); Jacquin Bierman, *Corporate Distribution of Appreciated and Depreciated Property: Gain or Loss to the Distributee*, 8 N.Y.U. Ann. Inst. on Fed. Tax'n. 792, 793 (1950) (concluding that the Supreme Court established that a corporate distributee realized no gain or loss on a distribution of property in kind); Leonard Raum, *Distributions in Kind: Their Tax Aspects*, 9 N.Y.U. Ann. Inst. on Fed. Tax'n. 1029, 1034–36 (1951) (noting that it was generally thought that the Supreme Court concluded that a corporation realized no income or gain when it distributed appreciated property but disputing that conclusion).

[10] *See, e.g., Corporate Investment Co.*, 40 BTA 1156, Dec. 10,928 (1939). Note that the government apparently acquiesced in the view that the Supreme Court in *General Utilities* had concluded that the a corporation recognized no gain on its distribution in kind of appreciated property. Darrell, *supra* note 9 at 921. Note as well that the government had already concluded that a liquidating corporation did not realize gain or loss on its distribution of property in liquidation. *Id*.

[11] Internal Revenue Code of 1954, P.L. 83-591, 68A Stat. 94-95. *See also* H.R. Rep. No. 83-1337, at 37 (1954) (noting that Code Sec. 311 incorporated the *General Utilities* doctrine).

[12] Internal Revenue Code of 1954, P.L. 83-591, 68A Stat. 106.

[13] There were two other critical aspects of this partial integration regime. First, individuals were taxed at a preferential rate on long-term capital gains. Second, the highest corporate marginal rate was lower than the highest individual rate. Together with the *General Utilities* doctrine, these rules made it more likely that the choice to incorporate assets was tax-neutral. *Cf.* Eric Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 840 and 854 (1988) (noting how that those rules offered a "rough equilibrium between the individual and corporate tax systems" mitigating the double tax).

[14] It also limited the cherry-picking of loss when a subsidiary liquidated into its parent and satisfied a debt to the parent as part of the liquidation, providing that no gain or loss could be recognized on that satisfaction. Code Sec. 332(c), Income Revenue Code of 1954, P.L. 83-591, 68A Stat. 103. Without that provision (now found in Code Sec. 337(b)(1)), a liquidating subsidiary could "elect" to transfer loss property to satisfy its debt to the parent, recognizing loss, while transferring gain property on the stock, deferring that gain. *Cf.* I.T. 4109, 1952-2 CB 138 (providing for recognition on the debt satisfaction). *See also Northern Coal & Dock Co.*, 12 TC 42, Dec. 16,772 (1949) (allowing loss recognition); H.R. Rep. No. 83-1337, at 103 (1954) (describing the recognition under *Northern Coal* as a "further problem under present law," a problem addressed by Code Sec. 332(c)).

Congress failed to address a host of other "cherrypicking " issues raised by the codification, including the following: A corporation could sell loss assets, recognizing loss, and distribute the proceeds but distribute gain assets and often eliminate corporate-level gain. Under certain circumstances, however, if the distributee shareholder then sold the distributed gain asset, any gain on that sale could be attributed to the corporation under the *Court Holding Co.* doctrine, but that attribution was far from certain.

[15] *Court Holding Co.*, SCt, 45-1 USTC ¶9215, 324 US 331, 65 SCt 707.

[16] *Id.,* at 334.

[17] *Cumberland Public Service Co.*, SCt, 50-1 USTC ¶9129, 338 US 451, 70 SCt 280.

[18] *Id.*, at 454.

[19] H.R. Rep. No. 83-1337, at 38-39 (1954) (noting that the provision was adopted "to eliminate questions resulting only from formalities"); Sen. Rep. No. 83-1622, at 49 (1954) (justifying Code Sec. 337 to prevent "undue weight" from being "accorded the formalities of the transaction" that otherwise created "a trap for the unwary").

[20] Code Sec. 337 did not eliminate all administrative concerns, even with sales connected to liquidations, since it could sometimes be unclear when a plan of liquidation was adopted.

[21] Internal Revenue Code of 1954, P.L. 83-591, 68A Stat. 94-95. *See also* H.R. Rep. No. 83-1337, at 37 (1954) (justifying this recognition to prevent the avoidance of "tax temporarily deferred under the LIFO method of accounting").

[22] Internal Revenue Code of 1954, P.L. 83-591, 68A Stat. 94-95.

[23] *See* Sen. Rep. No. 83-1622, at 247 (1954) (noting that despite the codification of the *General Utilities* doctrine, Congress intended to preserve the exceptions developed in *First State Bank of Stratford*, CA-5, 48-2 USTC ¶9317, 168 F2d 1004. In *First State Bank of Stratford,* a corporation was taxed under the assignment of income doctrine on income collected on debt instruments (not its own) distributed to its shareholders. The distributing corporation had taken bad debt deductions on the notes, but it distributed them to its shareholders when it appeared some amount would be collected. Although the shareholders actually collected the proceeds, the court taxed the distributing corporation on the collection, using assignment of income principles.

[24] *See, e.g., First Wisconsin Bankshares Corp.*, DC-WI, 74-1 USTC ¶9164, 369 FSupp 1034 (attributing income to a corporation following its contribution to charity of notes previously charged off as worthless using the tax benefit rule and the anticipatory assignment of income). *See also Bush Brothers & Co.*, CA-6, 82-1 USTC ¶9129, 668 F2d 252 (also applying the anticipatory assignment of income doctrine to attribute a shareholders' sale of distributed property to a corporation; note that the Tax Court reached the same result, reasoning that the corporation had an improper tax avoidance motive).

[25] *See* Act Sec. 905(a) of the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 713-14 (applying generally to appreciated property used to redeem stock); Sen Rep. No. 91-522, at 279 (1969) (justifying the change because the redemption had the same effect as if the distributed property had been sold and the stock redeemed with the sales proceeds). *See also* Act Sec. 223(a) of the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 96 Stat. 483-84 (further limiting nonrecognition under Code Sec. 311).

[26] Act Sec. 54 of the Deficit Reduction Act of 1984, P.L. 98-369, 98 Stat. 568-69 (generally requiring gain (but not loss) recognition on property distributions, whether or not redemption distributions); H.R. (Conf.) Rep. No. 98-861, at 821 (1984) (noting that "the theory of section 311 ... is that

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the distribution of property is a realization event"). In fact, by 1986, not only had Congress practically eliminated the *General Utilities* doctrine for nonliquidating distributions, it had enacted numerous exceptions to the doctrine for liquidating distributions. For an example of the various exceptions to the doctrine for liquidating distributions, including those springing from judicial doctrines, *see* LTR 8613040 (Dec. 27, 1985) (providing exceptions for recapture provisions (and similar rules of law) including but not limited to Code Secs. 47, 291(a), 336(b), 341(f), 453B, 617(d), 904(f)(3), 995, 1245, 1248, 1250, 1252, 1253, 1254, the assignment of income doctrine, the clear reflection of income doctrine of Code Secs. 446(b) and 482, and the tax benefit rule).

[27] Act Sec. 631 of the Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2269-2273 (modifying Code Secs. 311, 336, 337 and 338).

[28] Act Sec. 101(a) of the 1986 Act, 100 Stat. 2096 (providing a maximum individual tax rate of 28 percent); Act Sec. 301(a) of the 1986 Act, 100 Stat. 2216-17 (repealing the individual tax preference for capital gains); Act Sec. 610(a) of the 1986 Act, 100 Stat. 2249 (providing a maximum corporate tax rate of 34 percent). *See also* Zolt, *supra* note 13 (noting how these three changes upset the equilibrium between the corporate and individual tax regimes).

[29] In retrospect, eliminating partial integration seems a poor idea, providing tax incentives for C corporations to use debt, rather than equity, and encouraging the use of partnerships and S corporations. *See* Zolt, *supra* note 13, at 854-867. That elimination also encouraged aggressive tax planning by C corporations, and Congressional responses to that planning further complicated the Code. *See, e.g.,* Code Secs. 358(h); 362(d); 362(e).

The Treasury may also have believed it was a poor idea, a belief that may have tempered its response to the *General Utilities* repeal (despite its adoption of the loss disallowance rule in Reg. §1.1502-20). However, partial integration has returned with the re-institution of the capital gains preference. *See* Code Sec. 1(h). Further, Congress may be poised to lower the maximum corporate tax rate below the individual tax rate. With those changes, there will again be relatively robust partial integration, inviting a stronger, more comprehensive response by the Treasury to the *General Utilities* repeal.

[30] H.R. (Conf.) Rep. No. 98-861, at 821 (1984) (noting that "the theory of section 311 ... is that the distribution of property is a realization event"); H.R. (Conf.) Rep. No. 99-841, at II-198 (1986) (labeling the *General Utilities* doctrine as a nonrecognition rule; thus, consistent with the doctrine, gain could be realized and recognized under statutory or judicial rules like depreciation recapture).

[31] As one example, the 1986 legislative history notes that a corporation should not be able to transfer an appreciated asset without recognizing gain if the transferee takes a cost basis in the transferred asset. H.R. Rep. No. 99-426, at 274 (1985).

[32] For example, in 1984 as part of its incremental repeal of the *General Utilities* doctrine, Congress amended Code Sec. 311(d) to require a corporation generally to recognize gain when it distributed appreciated property to a corporate shareholder. Act Sec. 54 of the Deficit Reduction Act of 1984, P.L. 98-369, 98 Stat. 568-69. Before that amendment, the distributing corporation recognized no gain, but the corporate shareholder took a carryover or transferred basis in the distributed property. Congress made the change because it found the shifting of tax liability "inappropriate" and was also worried that the distribution may also allow the gain's character to change. H.R. (Conf.) Rep. No. 98-861, at 821 (1984). Thus, in that instance, Congress rejected the deferral of gain and shifting of tax liability. *See also infra* note 47 and text that accompanies and follows that note (for a discussion of mirror and cousin-of-mirror transactions, transactions that raised similar issues and were limited by Congress in 1987).

[33] Note that the repeal also should have another important consequence. The Treasury and courts should interpret and apply related Code provisions in a manner that is consistent with and furthers the repeal. For example, Code Sec. 355 should be interpreted by taking the *General Utilities* repeal into account, although a complete discussion of the how the repeal affects Code Sec. 355 would require an extensive article. In brief, a few of the issues include the following:

First, the device requirement needs to be interpreted by more consciously taking the repeal into account. Under Code Sec. 355, a distributing corporation recognizes no gain or loss on its distribution of stock of a controlled corporation if certain requirements are met, including the device requirement. *See* Code Secs. 355(c)(1); 361(c)(1). Under that requirement, the transaction cannot be used principally as a device to distribute the earnings and profits of the distributing or controlled corporation, and evidence of a device includes a subsequent sale or exchange of the stock of either corporation. Code Sec. 355(a)(1)(B); Reg. §1.355-2(d)(2)(iii). If a distribution of a controlled corporation stock has a business purpose that contemplates such sales to any significant extent, to both further the repeal and be consistent with the device requirement, the IRS should hesitate to rule that the distribution qualifies under Code Sec. 355.

The IRS should also be cautious in ruling on "North-South" transactions. In those transactions, shareholders contribute property to the distributing corporation as part of the same plan under which the distributing corporation distributes subsidiary stock to those shareholders. Although the contribution and distribution may be independent, the IRS should require strong proof of that independence and not merely follow form. Too loose a standard may allow a contribution and distribution that are in substance a taxable exchange to escape current tax, a result inconsistent with the repeal. Note that if an exchange is taxable and breaks the distributing corporation's control of the subsidiary corporation, the distribution of the remaining subsidiary stock also cannot qualify under Code Sec. 355. Rev. Proc. 2013-3, IRB 2013-1, 113, 124 (§5.02(2)) (providing that rulings would not be issued on "North-South" transactions).

[34] *See* H.R. Rep. No. 99-841, at 274 (1985). *See also* Code Sec. 337(d) (providing broad regulatory authority to "carry out the purposes of" the 1986 Act changes related to the repeal). The House justified the repeal of the *General Utilities* doctrine for three reasons. First, the doctrine distorted business behavior by encouraging liquidations for tax reasons because through a liquidation, a transferee could achieve a stepped-up basis in appreciated assets without tax cost to the transferor, making those assets more valuable in the transferee's hands. *Id., at* 281. Second, the doctrine undermined the corporate tax, granting a permanent exemption from tax for some corporate-level gain. *Id., at* 282. Finally, although the House acknowledged that partial integration of the corporate and individual tax systems may be appropriate, it believed that there were "more efficient and equitable" means to provide that integration. *Id.* (proposing a dividends-paid deduction).

[35] *See* H.R. (Conf.) Rep. No. 99-841, at II-200 (1986) (noting that the repeal may be avoided through transactions that inflate or duplicate losses "actually sustained").

[36] *Id., at* II-204.

[37] Notice 87-14, 1987-1 CB 445.

[38] Unless otherwise stated, in each example, each corporation is a domestic corporation and has one class of stock outstanding. P, the common parent of a consolidated group, owns all stock of S1, S2 and S3, which are all members of the P group. X

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is a person unrelated to P.

[39] That gain equals $500 (the amount realized) minus $100 (the asset's basis). Code Sec. 1001(a).

[40] Reg. §1.1502-14(e)(1) (1986) (providing for the gain deferral). *Cf.* Reg. §1.1502-13(c)(2)(i) (currently also providing for deferral).

[41] Reg. §1.1502-32(b)(2)(iii) (1986). *Cf.* Reg. §1.1502-32(b)(2)(iv) and (b)(3)(v).

[42] Reg. §1.1502-14(a)(1) (1986) (providing that the distribution is eliminated). *Cf.* Reg. §1.1502-13(f)(2)(ii) (providing that no amount is included in gross income).

[43] Reg. §1.1502-13(f)(1)(iii) (1986). *Cf.* Reg. §1.1502-13(d).

[44] Reg. §1.1502-32(b)(1) (1986) (providing an increase to account for undistributed subsidiary earnings and profits). *Cf.* Reg. §1.1502-32(b)(2)(i) and (b)(3)(i) (providing an increase for the subsidiary's taxable income).

[45] Code Sec. 1001(a) and (c).

[46] Subsequent loss disallowance regulations also eliminated or disallowed that loss. *See, e.g.,* Reg. §1.1502-20(a) (2001); Reg. §1.1502-36(c).

[47] *See* Act Sec. 10223(a) of the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, 101 Stat. 1330-411. Note that the mirror transaction would have somewhat less appeal today because of the enactment of Code Sec. 197, which allows a purchaser to amortize the basis of purchased goodwill rather than treating it as a deadweight tax cost.

[48] Reg. §1.1502-34.

[49] Under Code Sec. 337(a) (then and now), a liquidating corporation recognized no gain or loss on its distribution of property to an 80-percent distributee in a Code Sec. 332 liquidation. In 1986, Code Sec. 337(c) defined the 80-percent distributee simply as "the corporation which meets the 80-percent ownership requirements specified in Code Sec. 332(b)." Then (as now) Reg. §1.1502-34 provided that for purposes of *applying* Code Sec. 332(b), a consolidated group member was treated as owning all stock owned by the group. Thus, Code Sec. 332 could apply to a distribution received by a corporate shareholder and member of a consolidated group if the group owned an affiliated interest in the liquidating corporation even if the shareholder did not. It was not clear, however, whether the liquidating corporation could use the same aggregation rule for purposes of applying Code Sec. 337(c) (even though that provision referred to Code Sec. 332(b)).

In addressing that ambiguity, the legislative history to the 1986 stated that:

> The conferees anticipate that, in a consolidated return context, the Treasury Department will consider whether aggregation of ownership rules similar to those in sec. 1.1502-34 of the regulations should be provided for the purposes of determining status as an 80-percent distributee.

H.R. (Conf.) Rep. No. 99-841, at II-202, note 9 (1986); H.R. Rep. No. 99-426, at 283, note 32 (1985) (containing the same language). That language suggests that, absent an amendment to the consolidated return regulations, the aggregation of ownership rule would not apply to determine the tax consequences to the liquidating corporation.

[50] 132 Cong. Rec. H 8358 (daily ed. Sept. 25, 1986); 132 Cong. Rec. E 3389 (daily ed. Sept. 2, 1986) (adding that allowing gain deferral would place new owners "in a favored position over the old owners").

[51] 132 Cong. Rec. S 13958 (daily ed. Sept. 27, 1986); 132 Cong. Rec. S 170 (daily ed. Oct. 17, 1986).

[52] It added the second sentence to Code Sec. 337(c), providing that in determining whether a corporation is an 80-percent distributee for purposes of Code Sec. 337, the consolidated return regulations do not apply. *See* Act Sec. 10223(a) of the Omnibus Budget Reconciliation Act of 1987, PL. No. 100-203, 101 Stat. 1330-411. Thus, a member had to actually own an affiliated interest in another corporation to be an 80-percent distributee for purposes of Code Sec. 337. If Code Sec. 337(c), as amended, applied in the previous example in the text, neither S1 nor S2 would be treated as an 80-percent distributee for purposes of Code Sec. 337, so that the liquidating corporation would recognize gain on the liquidating distribution of its assets. Code Sec. 336(a). Although that gain would be deferred under the intercompany transaction rules, it would be triggered in its entirety when the group sold the S1 stock. Reg. §1.1502-13(j)(4); *id.,* at (j)(9), *Ex. 7; id.,* at (d).

[53] The House report stated that:

> [T]he statute specifically rejects the concept that recognition can be deferred merely because the underlying assets of the subsidiary do not obtain a stepped-up basis. This is because the potential for corporate-level tax in the future, resulting from the low basis of the assets is not the economic equivalent of a current tax on the appreciation at the time of the distribution.

H.R. Rep. No. 100-391, pt. 2, at 1081-82 (1987) (adding that acquirors might otherwise be able to "acquire or resell corporate subsidiaries or other assets with more favorable results than the original owners could obtain"). *See also* Deborah L. Paul, *Triple Taxation*, 56 TAX LAW. 571, 603-04 (citing language by the Senate Budget Committee to the same effect, noting that the legislative history also evidenced a concern with creating an equal playing field for old and new owners of corporations, and adding that the Congressional concern with timing is "understandable"). *Cf.* H.R. (Conf.) Rep. No. 100-495, at 969 (1987) (describing the rule without stating a rationale). An additional rationale to support the legislation is to dampen the incentive for breaking up affiliated groups, although that break up, at times, may be economically efficient.

[54] Lawrence Axelrod, *Section 304, Excess Loss Accounts and Other Consolidated Return Gallimaufry*, 36 TAX NOTES 729 (Aug. 17, 1987); Eric M. Zolt, *The* General Utilities *Doctrine: Examining the Scope of the Repeal*, 65 TAXES 819, 829 (1987).

[55] Code Sec. 304(a)(1). *See also* Code Sec. 7701(a)(1) (defining a person to include a corporation); Code Sec. 317(a) (defining property to include cash).

[56] Code Sec. 304(c)(1) (defining control); *Id.,* at (c)(3) (providing that Code Sec. 318, with modifications not relevant to this example, applies to determine control).

[57] Because P owned all S1 and S2 stock after the sale, S1 was treated as constructively owning all of P's S2 stock (and therefore all S2 stock). Code Sec. 318(a)(3)(C) (providing that if a person owns at least 50 percent by value of a corporation's stock, the corporation is treated as owning all stock owned by the person).

[58] Code Sec. 304(b)(1).

[59] Code Sec. 302(b)(1) (providing for the application of the constructive ownership rules under Code Sec. 318, with modifications not here relevant). Under Code Sec. 318, after the sale, the S3 stock was attributed from S2 to P, and then from P to S1. Code Sec. 318(a)(2)(C) (providing that if a person owns at least 50 percent by value of a corporation's stock, any stock that corporation owns is proportionately (by value) attributed to the person); *Id.,* at (a)(3)(C) (providing that if a person owns at least 50 percent by value of a corporation's stock, the corporation is treated as owning all stock owned by the person); Code Sec. 318(a)(5)(A) (providing that the constructive ownership rules apply iteratively).

[60] Assuming that Code Sec. 302(b)(4) does not apply, the deemed redemption cannot be described in Code Sec. 302(b) because S1 has the same relative economic interest in S2 (100-percent ownership) before and after the redemption.

[61] Reg. §1.1502-14(a)(1) (1986) (providing that the distribution is eliminated).

[62] *See* Rev. Rul. 70-496, 1970-2 CB 74 (concluding that a corporation cannot recover basis under Code Sec. 301(c)(2) following a

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Code Sec. 304(a)(1) sale if it actually owns no stock in the "redeeming" corporation).

[63] Reg. §1.1502-32(b)(1)(i) (1986). S1's earnings and profits should also have been reduced by its basis in the transferred S3 shares. With this reduction, S1's earnings and profits were reduced by the excess of the $100 dividend over S1's basis in its S3 stock.

[64] Code Sec. 304(a)(1); Code Sec. 118(a).

[65] P reduced its positive adjustment by up to $100. Reg. §1.1502-32(b)(1)(i) (1986). Note that if S2 did not have current earnings and profits in the transaction year, P would not reduce its basis in its S2 stock to account for the distribution because the redemption distribution would not be with respect to P's S2 shares and would not create a deficit in current earnings and profits. *Cf. id.,* at (b)(2)(i) and (iii) (1986). Note that if current law applied, to the extent that no member reduced its basis in S2 stock because of the dividend, S1 could not exclude the dividend from gross income. Reg. §1.1502-13(f)(2)(ii) (providing that result).

[66] For a more thorough analysis of this transaction, *see* Axelrod, *supra* note 54. If the example in the text had involved an affiliated, nonconsolidated group, P would not have adjusted its bases in the S1 or S2 stock, and S1 would have essentially made a nontaxable, carryover basis transfer of the S3 stock to S2.

[67] Later legislation (*e.g.*, Code Sec. 358(h) or Code Sec. 362(e)) also should be considered to further the repeal.

[68] Act Sec. 54 of the Deficit Reduction Act of 1984, P.L. 98-369, 98 Stat. 568-69.

[69] H.R. (Conf.) Rep. No. 98-861, at 821 (1984).

[70] Note that in the 1986 Act, Congress also rejected a form of surrogate taxation when it strengthened Code Sec. 382 to limit loss trafficking by corporations. Act Sec. 621 of the 1986 Act, 100 Stat. 2254-2269 (amending Code Secs. 382 and 383). *See also* General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., at 294-95 (1987) (noting that the purpose of the amendments was to prevent tax biases in favor of retaining or selling loss corporations).

[71] *See supra* note 49 (explaining why the better view is that pre-1987 law was consistent with the 1987 amendment, so that the amendment merely clarified the law).

[72] George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 575, 623 (1987) (suggesting this rationale).

[73] *See id.* (suggesting that rationale but criticizing it because all assets are distributed). Note that the liquidating corporation can still choose (or select) to distribute loss assets to the minority shareholder, thereby raising a concern with loss selectivity.

[74] In a Code Sec. 332 liquidation, the liquidating corporation recognizes no gain or loss on its distribution of property to the controlling parent with respect to its stock. Code Sec. 337(a). Without a provision like Code Sec. 337(b)(1), however, the liquidating corporation would recognize gain or loss on its use of property to satisfy the parent's debt. Code Sec. 1001. Thus, it could essentially elect to recognize loss (or gain) simply by identifying the property used to satisfy the parent's debt. *See also supra* note 14 (for a further discussion).

[75] *See* Yin, *supra* note 72, at 620-625 (stating the non-*pro rata* rule of Code Secs. 336(d)(1) and 267 have the same underlying theory and that the "disqualified property" rule targets loss duplication). As Code Sec. 311 does, Code Sec. 336(d)(1) also mitigates the risk that a corporation and controlling shareholder would undervalue distributed property, although Code Sec. 336(d)(1) may not apply in the most problematic case—when the corporation has a single shareholder—because property will be distributed *pro rata.*

[76] Code Sec. 267(b)(2) (providing that an individual is related to a corporation if the individual owns, actually and constructively, more than 50 percent of the corporation's stock, by value). *See also id.*, at (b)(3) (treating members of the same controlled group as related persons); *id.*, at (f) (providing that "controlled group" has the meaning given in Code Sec. 1563(a), except, among other things, that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in Code Sec. 1563(a)).

[77] Perhaps in lieu of adding Code Sec. 336(d)(1), Congress could have modified the second sentence of Code Sec. 267(a)(1) to provide that Code Sec. 267(a)(1) applied to disallow a corporation's loss on any liquidating distributions to a related person. That modification would have differed from Code Sec. 336(d)(1) in two ways, however. First, the modification would have applied to loss property distributed *pro rata*, to the extent distributed to a related person. Second, it would have afforded the transferee shareholder a possible basis benefit. *Cf.* Code Sec. 267(d) (providing that if the transferor later sells the acquired property at a gain, the gain is recognized only to the extent that it exceeds the disallowed loss). Congress may have chosen to add Code Sec. 336(d)(1), rather than amend Code Sec. 267 because the loss disallowance rule of Code Sec. 267(a)(1) does not apply in one critical case—when the liquidating corporation and shareholder are members of a controlled group. *See* Code Sec. 267(f). Instead of the loss being disallowed, it is deferred and taken into account under the principles of the consolidated return regulations (*e.g.*, immediately before the shareholder leaves the controlled group). *See* Code Sec. 267(f)(2); Reg. §1.267(f)-1(c)(1) (applying the principles of the matching and acceleration rules for intercompany transactions under Reg. §1.1502-13).

[78] Accordingly, a liquidating distribution of loss property to a shareholder who directly or indirectly owns more than 50 percent of the liquidating corporation's stock may fall under this loss prevention rule.

[79] Code Sec. 336(b)(1)(B).

[80] *See* Yin, *supra* note 72, at 628.

[81] Code Sec. 336(d)(2)(B)(i).

[82] Code Sec. 336(d)(2)(B)(ii).

[83] *See Yin*, supra note 72, at 686 (suggesting that this approach would be a "more precise mechanism" than was employed under Code Sec. 1374).

[84] Code Sec. 355(d) was adopted in 1990. *See* Act Sec. 11321(a) of the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, 104 Stat. 1388-461.
Code Sec. 362(d) also targets gain elimination by limiting a possible duplicate use of basis. *See* Sen. Rep. No. 106-2, at 75 (1999). That provision was enacted in Act Sec. 3001(b)(2) of the Miscellaneous Trade and Technical Corrections Act of 1999, P.L. 106-36, 113 Stat. 182.

[85] Code Sec. 355(d)(1) and (2). Disqualified stock includes (i) stock of the distributing or controlled corporation acquired by purchase within five years of the distribution, and (ii) stock of the controlled corporation received in the distribution and attributable to stock or securities of the distributing corporation acquired by purchase within five years of the distribution. *Id., at* (d)(3). *See also id.,* at (d)(5) (defining purchase to include taxable acquisitions and certain non-taxable acquisitions); *id., at* (d)(7) (treating as one person all persons related under Code Secs. 267(b) or 707(b)(1)); *id.*, at (d)(8) (for ownership attribution rules).

[86] H.R. Rep. No. 101-881, at 340-41 (recognition prevented distributing corporations from "dispos[ing] of subsidiaries in transactions that resemble sales or to obtain a fair market value stepped-up basis for any future disposition, without incurring a corporate-level tax").

[87] Code Sec. 358(h) was adopted in 2000 and Code Sec. 362(e) was adopted in 2004. *See* Act Sec. 309(a) of the Community Renewal Tax Relief Act of 2000, P.L. 106-554, 114 Stat. 2763A-638; Act Sec. 836(a) of the American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1594.

[88] *See* Code Sec. 358(a).

[89] *But see Coltec Industries, Inc.*, CA-FC,

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2006-2 USTC ¶50,389, 454 F3d 1340 (finding that a similar transaction lacked economic substance); *Thrifty Oil Co. & Subsidiaries*, 139 TC No. 6, Dec. 59,179 (2012) (denying the duplicate loss as a double deduction, citing *Ilfeld Co. v. Hernandez*, SCt, 4 USTC ¶1261, 292 US 62, 54 SCt 596.

90 More precisely, Code Sec. 362(e)(2) applies if the transferee's aggregate basis in the applicable property received from a transferor under Code Sec. 362(a) would exceed the property's aggregate value. Code Sec. 362(e)(2)(A). Note that Code Sec. 362(e)(2) disregards any transferred property to which Code Sec. 362(e)(1) applies.

Code Sec. 362(e)(1) applies, for example, to an inbound transfer of property described in Code Sec. 361(e)(1)(B) if that property would otherwise take a net built-in loss basis under Code Sec. 362(a) or (b). Property is described in Code Sec. 362(e)(1)(B) if it is not subject to federal income tax in the transferor's hands immediately before the transfer but is subject to such tax in the transferee's hands immediately after the transfer. If Code Sec. 361(e)(1) applies to property, the property takes a basis equal to its fair market value immediately after the transaction. Code Sec. 361(e)(1)(A). Thus, Code Sec. 361(e)(1) targets the importation of built-in loss.

91 Code Sec. 362(e)(2)(A) (for the general rule eliminating the net built-in loss at the corporate level); *id.,* at (e)(2)(C) (for the election to instead eliminate the net built-in loss at the shareholder level). Note that if the election is made and the corporation liquidates, the corporation's loss may be disallowed under Code Sec. 336(d)(1) or (2). Thus, the election and liquidation may have the sad effect of eliminating the loss in its entirety.

92 *See* Code Sec. 1059(c) (defining an extraordinary dividend as a dividend that exceeds five percent (for preferred stock) or 10 percent (for other stock) of the stock's basis over an 85-day period or 20 percent over a year). *See also id.,* at (e) (for special rules for redemptions and certain other distributions); H.R. Rep. No. 105-48, at 459-60 (1997) (describing a rule added to Code Sec. 1059(e) to deal with a redemption treated as a dividend when the redeemed shareholder received options, noting a transaction involving Seagrams and DuPont).

93 Code Sec. 1059(a)(1). Code Sec. 1059 was enacted in 1984. *See* Act Sec. 53(a) of the Deficit Reduction Act of 1984, P.L. 105-34, 98 Stat. 565. H.R. Rep. No. 98-432, Pt. II, at 1185 (1984) (justifying Code Sec. 1059 to prevent the creation of a loss that may effectively convert taxable income into tax-exempt income).

94 Code Sec. 1059(a)(2). Until 1997, that excess created negative basis, which was taken into account when the stock was sold. Congress changed Code Sec. 1059 to require immediate recognition because it concluded that the gain deferral was "inappropriate." *See* Act Sec. 1011(b) of the Taxpayer Relief Act of 1997, P.L. 105-34, 111 Stat. 912 (making the change); H.R. Rep. No. 105-48, at 460 (1997) (calling the deferral inappropriate); General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, H.R. 4170, at 138 (noting that Code Sec. 1059 targeted "tax motivated transactions such as 'dividend stripping,'" where a corporation could "obtain a dividends received deduction without bearing the economic risk of holding the dividend paying stock").

95 Code Sec. 243(a)(1) and (c) (providing an 80-percent dividends received deduction for a corporate shareholder for dividends received from a domestic corporation in which the corporate shareholder owns at least 20 percent of the stock, disregarding Code Sec. 1504(a)(4) stock). *Cf.* Code Sec. 243(a)(3) (providing a 100-percent dividends received deduction for qualifying dividends); *id.,* at (b)(1)(B) (providing that a qualifying dividend must be paid out of earnings and profits for a tax year on each day of which the distributee and distributing corporations were affiliated); Code Sec. 246(c) (providing a minimum holding period to qualify for the dividends received deduction).

96 That overall benefit equals the $1,400,000 benefit from the loss minus the $280,000 tax on the dividend.

97 X paid $10,000,000 for the stock and receives $10,000,000 of proceeds for the stock ($4,000,000 as a dividend plus $6,000,000 in sales proceeds).

98 Thus, its basis in the T stock would be reduced from $10,000,000 to $6,800,000. Note that the $4,000,000 dividend would be an "extraordinary dividend," because P would not own the T stock for more than two years before the dividend announcement date and the dividend would equal 40 percent of P's adjusted basis in the T stock.

99 The seller could avoid the gain if T instead paid the dividend to the seller and the seller then sold the T stock to P. That dividend should not be treated as part of the sales price, at least if T declared the dividend before P and the seller negotiated the T stock sale. *See* Rev. Rul. 75-493, 1975-2 CB 108 (respecting as a separate step a distribution of unwanted cash to a seller before a binding sales contract was executed where the buyer did not indirectly fund the distribution, refusing to follow *J.E. Casner*, CA-5, 71-2 USTC ¶9651, 450 F2d 379). *Compare Waterman Steamship Corp.*, CA-5, 70-2 USTC ¶9514, 430 F2d 1185, *cert. denied*, 401 US 939 (1971) (concluding that a dividend of a note from a target corporation to a selling target shareholder was part of the consideration for target stock where the buyer paid off the note) *with Litton Industries, Inc.*, 89 TC 1086, Dec. 44,357 (1987), *acq. in result* (pre-sale distribution respected as a dividend; distribution announced before sales negotiations began).

100 Stated differently, P should not take the loss into account as a surrogate for the seller because its tax benefit from the loss would exceed the seller's tax cost for the gain.

101 For example, Code Sec. 332 may allow the elimination of a corporate shareholder's gain. *See also* Code Secs. 1032; 1014; *Cf.* Code Sec. 243.

102 This rule should be more than just an anti-abuse rule. Gain recognition cannot be avoided merely because the taxpayer has a strong nontax business purpose for a transaction that triggers gain.

103 *See* Code Sec. 337(d) (providing a broad grant of regulatory authority to "carry out the purposes of" the repeal); H.R. (Conf.) Rep. No. 99-841, at II-204 (1986) (reflecting that broad grant, including that the regulations may deal with tax-free reorganizations).

104 Moreover, enforcement is more likely to be uneven, so that similarly situated taxpayers are more likely to be treated differently.

105 Code Sec. 1031(a)(1). Although P is also transferring the P stock for T assets, P should be treated as exchanging the land for T's land under the priority scheme established in Reg. §1.1031(j)-1(a)(2). Under that scheme, to the extent possible, like-kind property is treated as exchanged for like-kind property. *See also* Reg. §1.1060-1(b)(8) (describing the priority scheme for payment of boot when Code Secs. 1031 and 1060 both apply to an asset sale).

106 Code Sec. 1001(a).

107 *See* Rev. Rul. 77-337, 1997-2 CB 305 (providing that Code Sec. 1031 does not apply to a taxpayer who acquired property following a Code Sec. 333 liquidation and immediately exchanged the property); Rev. Rul. 77-297, 1977-2 CB 304 (providing that Code Sec. 1031 does not apply to a taxpayer who acquires property solely to make the like-kind exchange); Rev. Rul. 75-292, 1975-2 CB 333 (concluding that Code Sec. 1031 did not apply to a taxpayer who exchanged like-kind property and transferred the property received to a newly formed, wholly owned corporation in a Code Sec. 351 transfer because the taxpayer did not plan to hold the property

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received for a qualified purpose). *Cf. J.R. Bolker*, CA-9, 85-1 USTC ¶9400, 760 F2d 1039 (concluding that property received in a Code Sec. 333 liquidation in which the shareholder took a transferred basis could be considered held for investment when it was held for three months and later exchanged in an exchange planned at the time of the liquidation); *B.B. Maloney*, 93 TC 89, Dec. 45,863 (1989) (concluding that a corporation made a Code Sec. 1031 exchange when it exchanged like-kind property and 26 days later liquidated in a Code Sec. 333 liquidation because the shareholder took a transferred basis in the property and intended to retain it; the court distinguished a liquidation in which gain or loss was recognized because the transferred property in the latter liquidation was "cashed out").

[108] In no case would that corporation recognize loss on the receipt of the boot. Code Sec. 361(b)(2).

[109] Code Sec. 361(c)(2)(A).

[110] Code Sec. 361(c)(2)(B). Stock, stock rights, or obligations of a party to the reorganization (other than the distributing corporation) are nonqualifying property unless received by the target in the reorganization exchange.

[111] Code Sec. 358(a). *See* Code Sec. 362(b) (second sentence).

[112] Code Sec. 358(a)(1) and (2). *See also id.*, at (f) (providing that although the boot is received without gain recognition, it is not treated as nonrecognition property for purposes of Code Sec. 358(a)(1)).

[113] Stated differently, the nonrecognition rules of Code Sec. 361 and the basis rule of Code Sec. 362(b) are each integral parts of the same regime. Note that although P preserves a $25,000 gain in the land transferred from T, that gain is properly traced to P's realized gain in its surrendered land, not the land transferred by T.

[114] Under the boot relaxation rule of Code Sec. 368(a)(2)(B), a transaction may be a C reorganization even if the acquiring corporation uses boot, if that corporation acquires at least 80 percent of the target assets for its voting stock. Because X acquires 90 percent of the S1 assets for its voting stock, the boot relaxation rule applies and the transaction may be a C reorganization.

[115] Code Sec. 368(b).

[116] Code Sec. 361(b)(1) (providing that no gain is recognized if a party to a reorganization exchanges property for boot and stock of another party to the reorganization if it distributes the boot pursuant to the plan of reorganization); *id.*, at (b)(2) (providing no loss is recognized); *id.*, at (b)(3) (providing that transfers of boot by a target corporation to its creditors in connection with the reorganization are treated as distributions pursuant to the plan of reorganization).

[117] Code Sec. 361(c)(1) (providing generally that the target recognizes no gain or loss on distributions of property to shareholders pursuant to the plan of reorganization); *id.*, at (c)(2)(A) (providing an exception for distributions of appreciated property other than qualified property); *id.*, at (c)(2)(B)(ii) (providing that qualified property includes stock of a party to the reorganization received by the distributing corporation in the exchange).

[118] S1's basis in the GainCo stock is determined under Code Sec. 358(a)(2) and therefore equals its fair market value when received. *See also* Code Sec. 358(f) (providing that for purposes of Code Sec. 358, property permitted to be received under Code Sec. 361 without the recognition of gain or loss includes only stock or securities of another party to the reorganization). Code Sec. 358 applies because S1 received the stock as part of a Code Sec. 361 exchange. *See* Code Sec. 358(a).

[119] Code Sec. 1032(a).

[120] Code Sec. 1001(c).

[121] Code Sec. 362(b).

[122] Code Sec. 368(c) (defining "control").

[123] That section applies to a corporation that acquires property in connection with a reorganization, but only if the corporation acquired that property, in whole or in part, in exchange for its stock or securities or stock or securities of its controlling parent.

[124] Note that if S1 had a basis in the GainCo stock less than its value, it would recognize that difference as gain on the distribution; Code Sec. 361(c) does not protect S1 from gain recognition because the GainCo stock is not qualified property. *Cf.* Code Sec. 361(c)(3) (treating a transfer of qualified property by a corporation to its creditor in connection with a reorganization as a distribution to its shareholders pursuant to a plan of reorganization).

[125] Code Sec. 1001(c).

[126] *Id.*

[127] Note that the duplicated loss may also be attacked as a "double deduction." Reg. §1.1016-6(a) (providing that "[a]djustments must always be made to eliminate double deductions or their equivalent"). *See also Ilfeld Co., Chas. v. Hernandez*, SCt, 4 USTC ¶1261, 292 US 62, 54 SCt 596 (denying a double deduction to a consolidated group); *Thrifty Oil Co. & Subsidiaries*, 139 TC No. 6, Dec. 59,179 (2012) (citing *Ilfeld* to deny a double deduction to a consolidated group). *Cf. Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357, *reh'g denied,* 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001) (refusing to find a prohibited "double deduction" when one deduction was taken by a consolidated group on its sale of subsidiary stock and another was preserved in the subsidiary attributes).

[128] *See* Code Sec. 354(a)(2)(C)(i) (treating nonqualified preferred stock as boot for these purposes).

[129] *Cf.* Rev. Rul. 74-515, 1975-2 CB 118 (concluding that shareholders who received solely boot in a merger treated as an acquisitive reorganization took the boot into account under Code Sec. 302(a)).

[130] The preceding example illustrates a concern that would arise even in the absence of Code Sec. 362(e)(2). A similar example that illustrates a shortcoming of Code Sec. 362(e)(2) is discussed below. *See supra* "III. Implementing the Repeal—E. Possible Legislative Targets."

[131] *But cf.* Code Sec. 338(h)(10); Reg. §1.338(h)(10)-1(d)(5)(iii) (under which a shareholder may recognize no gain or loss on its sale of target stock (but may recognize gain or loss on the target's deemed liquidation).

[132] Code Sec. 332(a).

[133] *See* H.R. (Conf.) Rep. No. 99-841, at II-199-200 (1986) (providing that gain or loss is generally recognized on a liquidating sale or distribution of assets); *id.,* at II-204 (noting that Code Sec. 338(h)(10) may provide relief from the multiple taxation of the same economic gain that may otherwise occur when appreciated corporate stock is sold); General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., at 348 (1987) (stating that "Congress believed that it was appropriate ... to require recognition when appreciated property, including stock of a subsidiary, is transferred to a corporate or individual recipient outside the economic unit of the selling or distributing group"); Paul, *supra* note 53, at 603.

[134] For example, assume that P owned all S stock with a $60 basis and $100 value and S owned assets also with a $60 basis and $100 value. P could sell the S stock to X for $100, recognizing a $40 gain. S could then sell its assets for $100, also recognizing a $40 gain. If P liquidated and the liquidation was described in Code Sec. 331, P's shareholders might also recognize gain. A tax could be imposed on each of the three gains, a result that would be the same before or after the repeal. Of course, the repeal makes it more difficult to avoid extra levels of tax because following the repeal a liquidating corporation generally recognizes any realized gain (or loss) on its distributions in liquidation. Code Sec. 336(a).

[135] Code Sec. 332(a). Note that this discussion assumes that the parent and subsidiary are domestic corporations.

[136] Code Sec. 243(a)(3) and (b) (describing the 100-percent dividends received de-

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duction (DRD) for qualifying dividends); Reg. §1.1502-13(f)(2)(ii) (for distributions between consolidated group members). *But see* Code Sec. 243(b)(1)(B) (providing that a qualifying dividend must be paid out of earnings and profits of a tax year after 1963, on each day of which the distributing and shareholder corporations were members of the same affiliated group; thus, the 100-percent DRD may not apply to earnings and profits attributable to a target acquired in a Code Sec. 368 reorganization).

[137] Rev. Rul. 75-521, 1975-2 CB 120 (noting that the plan adoption occurred immediately after the purchase). *Cf. G.L. Riggs, Inc.*, 64 TC 474, Dec. 33,283 (1975) (concluding that Code Sec. 332 applied to the liquidation of a corporation that adopted a formal plan of liquidation after it redeemed stock of minority shareholders when a parent corporation became affiliated with the subsidiary because of the redemption). *But cf.* Rev. Rul. 70-106, 1970-1 CB 70 (concluding on essentially the same facts that the subsidiary adopted an informal plan of liquidation before it redeemed the stock held by minority shareholders).

[138] H.R. (Conf.) Rep. No. 99-841, at II-202 (also referring to an affiliated group as an "economic unit").

[139] Act Sec. 631(b) of the 1986 Act, 100 Stat. 2272. *See also* H.R. (Conf.) Rep. No. 99-841, at II-204 (1986) (describing the purpose of Code Sec. 338(h)(10) to "offer[] taxpayers relief from a potential multiple taxation of the same economic gain").

[140] Reg. §1.338(h)(10)-1T(a) (1987).

[141] Act Secs. 13 and 14 of the Revenue Act of 1936 (the "1936 Act"), P.L. 74-740, 49 Stat. 1655-57 (providing graduated rates for the corporate normal tax and surtax); *id.,* at §1, 49 Stat. 1652 (providing that this amendment applied to tax years beginning after December 31, 1935). *See also* Act Sec. 102(a) of the Revenue Act of 1935 (the "1935 Act"), 49 Stat. 1015 (providing graduated corporate tax rates; this provision was superseded by the 1936 Act). By 1938, Congress had limited the benefit of graduated rates primarily to corporations with annual net income less than $25,000. Act Secs. 13 and 14, Revenue Act of 1938, P.L. 75-554, 52 Stat. 447, 455-57.

[142] H.R. Rep. No. 74-1681, at 3 (1935) (quoting the President's message to Congress dated June 19, 1935; the President also asserted that "smaller corporations should not carry burdens beyond their powers"); S. Rep. No. 74-1240, at 3 (quoting the same message).

[143] *Cf.* Act Sec. 128(a) of the Revenue Act of 1943, P.L. 78-235, 58 Stat. 47-48 (introducing Code Sec. 129, the predecessor to current Code Sec. 269, which, among other things, allowed the IRS to make appropriate adjustments if a person or persons acquired control of a corporation with "the principal purpose" to evade or avoid federal income tax). *But cf.* Act Sec. 102 of the Revenue Act of 1934 Act, 48 Stat. 702-03 (imposing an additional surtax (*i.e.*, an accumulated earnings tax) on a corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders" by accumulating, rather than distributing, gains or profits).

[144] Act Sec. 26(b) of the 1936 Act, 49 Stat. 1664 (providing for an 85-percent DRD); *id.,* Act Sec. 1, 49 Stat. 1652 (providing that this amendment applied to tax years beginning after December 31, 1935). *See* Act Sec. 102(h) of the 1935 Act, 49 Stat. 1016 (providing for a 90-percent DRD; this provision was superseded by the 1936 Act). *See also* H.R. Rep. No. 74-1681, at 3 (1935) (quoting the President's message to Congress dated June 19, 1935, which stated that "[p]rovision should be made to prevent the avoidance of such graduated tax on corporate income through the device of numerous subsidiaries" and that "[t]he most effective method of preventing such evasions would be through a tax on dividends received by corporations"); 1948 Study of the Division of Tax Research of the U.S. Treasury Department, *Consolidated Returns and Intercorporate Dividends, reprinted in* 124 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS 2 (Bernard D. Reams, Jr. ed. 1979) (stating that although the reduction in the DRD could be "explained in large part by increasing hostility toward concentration in business ownership characteristic of that decade, the precipitating factor was the introduction of rate graduation in the tax on corporate net income").

As a more direct and complete response, Congress could have required related corporations to share one set of graduated rates. It finally adopted that strategy in 1964 when it enacted Code Sec. 1561. *See* Act Sec. 235(a) of the Revenue Act of 1964, P.L. 88-272, 78 Stat. 116-17 (the "1964 Act").

[145] *Cf.* Code Sec. 1059.

[146] Code Sec. 331(a) (for the loss on liquidation). In other words, just as the parent can move from nonaffiliated to affiliated status with a subsidiary, it can do the reverse.

[147] *Granite Trust Co.*, CA-1, 57-1 USTC ¶9201, 238 F2d 670 (citing to Sen Rep. No. 83-255 (1954)). It also noted that if Congress had opposed the result reached in an earlier "well-known" case that supported electivity, *Day & Zimmermann, Inc.*, CA-3, 45-2 USTC ¶9403, 151 F2d 517, it would have made appropriate changes when it enacted Code Sec. 332. *Id., at* 675-76 (suggesting that if Congress had not intended to follow *Day & Zimmerman*, it would have incorporated an "end-result" provision in Code Sec. 332).

[148] *Id., at* 676-77.

[149] *See supra* note 139.

[150] Note that duplicate loss is limited if a parent disaffiliates a consolidated subsidiary. *See* Reg. §1.1502-36. A similar rule does not apply to the disaffiliation of a nonconsolidated subsidiary, but the case for such a rule is weaker because the nonconsolidated parent and subsidiary do not combine tax items and are therefore less like a single entity.

[151] *See, e.g.,* Code Sec. 381(a).

[152] *See supra* notes 141 to 144 (and accompanying text).

[153] *See* Code Sec. 336(a). *But see id.,* at (d).

[154] *See* Paul, *supra* note 53, at 576-81 and 584-89 (for a discussion of upstream and downstream transactions).

[155] *Cf.* Rev. Rul. 78-47, 1978-1 CB 113 (considering a downstream reorganization under Code Sec. 368(a)(1)(C)); Paul, *supra* note 53, at 585-86 (also discussing the Petrie Stores transaction).

[156] Note that if the upstream transfer occurs by merger, all assets and liabilities (including contingent liabilities) of the merged corporation become assets and liabilities of the survivor, perhaps providing a substantive difference from a liquidation alternative.

[157] *See* Paul, *supra* note 53, at 585 (calling the difference between the liquidation and reorganization in this case "ephemeral").

[158] For articles that discuss some basis-shifting concerns, *see* Thomas F. Wessell, Joseph M. Pari, and Richard D'Avino, *Corporate Distributions Under Section 355*, 15 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 2011 201-54-201-57 (Practicing Law Institute 2011) (discussing how an excess loss account can be avoided through basis shifting that occurs in an internal Code Sec. 355 distribution that precedes a Code Sec. 355 distribution outside the group); Don Leatherman, *Liquidating into Multiple Distributee Members*, 24 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 2005 849 (Practicing Law Institute 2005); Don Leatherman, *Notice 2001-45 and Consolidated Groups*, 15 J. OF TAXATION FINANCIAL INSTITUTIONS 9 (Mar./Apr. 2002); Don Leatherman, *Shifting of Member Stock Basis under §1.302-2(c)*, 13 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS,

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[159] *See* Reg. §1.1502-20(a) (2001). As a corollary, the group reduced its basis in subsidiary stock on the subsidiary's deconsolidation to the extent that basis exceeded value. *See id.,* at (b).

[160] *See id.,* at (a)(4).

[161] *See id.,* at (c).

[162] Under Reg. §1.1502-20, the Treasury's "general approach" was "to phase out separate return treatment as the group and the subsidiary enjoy[ed] the benefits of consolidation." CO-93-90, 1990-2 CB 696, 700. Thus, the Treasury treated subsidiary stock as an indirect interest in subsidiary assets. It adopted a single-entity approach, the likely effect of which was to eliminate the group's loss on its disposition of the stock of a long-standing subsidiary but not its loss on a disposition of the subsidiary's assets.

[163] *Rite Aid Corp.*, CA-FC, 255 F3d 1359 (2001). The Federal Circuit reversed the United States Court of Federal Claims, which found the regulation a proper exercise of regulatory authority. *See Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357.

[164] *Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357, 1358. Code Sec. 1502 provides that Treasury may prescribe regulations as "deem[ed] necessary ... clearly to reflect the income tax liability [of a consolidated group] ... and in order to prevent avoidance of such liability."

[165] *Id., at* 505 (emphasis added). *Cf. Woods Investment Co.*, 85 TC 274, Dec. 42,315 (1985), *acq.* 1986-2 CB 1 (not adopting a single-entity approach when regulations expressly required a different result).

[166] *Rite Aid Corp.* , 46 FedCl 505 (also pointing out that a deemed or actual asset sale could avoid duplicated gain but that without Reg. §1.1502-20 a "regular" stock sale could preserve duplicated loss).

[167] *Id.*

[168] *Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357, 1360.

[169] *Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357, 1360 (also stating that Rite Aid's stock loss "does not stem from the filing of a consolidated return, and the denial of the deduction imposes a tax on income that would not otherwise be taxed"). The court therefore accepted Rite Aid's argument that Code Sec. 1502, though a broad regulatory grant, "does not include discretion to deny the Code's benefits without furthering the purpose of that section." *Rite Aid Corp.*, 46 FedCl 500, 504 (2000) (setting out this argument).

[170] *Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357, 1359 (citing S. Rep. No. 70-960, at 15 (1928), which stated that "[m]any difficult and complicated problems, however, have arisen in the administration of the provisions permitting the filing of consolidated returns"). In the 1928 legislation, Congress granted Treasury the authority to issue consolidated return regulations "clearly to reflect" income and "prevent avoidance of tax liability." Act Sec. 141(b) of the Revenue Act of 1928, P.L. 70-562, 45 Stat. (pt. 1) 791, 831.

[171] *Id.,* at 1359-60.

[172] *Id.*

[173] *See* Don Leatherman, *Why Rite Aid is Wrong*, 52 AMERICAN UNIVERSITY LAW REVIEW 811 (2003) (for a more extended discussion of *Rite Aid*).

[174] Although Rite Aid's stock loss was reduced because of the added compensation, the Rite Aid group still enjoyed an additional benefit from the inside subsidiary loss, equal to at least that added compensation minus the tax on its last dollars of taxable income equal to that compensation.

[175] The Federal Circuit in *Rite Aid* never acknowledged the tension created by the *General Utilities* repeal between treating subsidiary stock as a separate asset or as an indirect interest in subsidiary assets, essentially concluding without analysis that the stock had to be treated as a separate asset. It makes sense, however, to treat a consolidated parent's subsidiary stock as an indirect interest in the subsidiary's assets. Even more than a nonconsolidated parent and subsidiary, the consolidated parent and subsidiary should be treated as part of an economic unit. *See supra* notes 135-140 and accompanying text (for a general discussion of the "economic unit" theory). Not only would Code Sec. 332 apply to a liquidation of the consolidated subsidiary but the investment adjustments rules closely tie the parent's subsidiary stock to the subsidiary's assets.

[176] Act Sec. 844(a) of the American Jobs Creation Act of 2004 (the "2004 Act"), P.L. 108-357, 118 Stat. 1600. *See also id.,* at 844(c) (providing that the change applies to all tax years, including those before the enactment of the 2004 Act).

[177] H.R. (Conf.) Rep. 755, 108th Cong., 2d Sess. 640 (2004). *Cf. Rite Aid Corp.*, CA-FC, 2001-2 USTC ¶50,516, 255 F3d 1357, 1360, *reh'g denied,* 2001 U.S. App. LEXIS 23207 (Oct. 3, 2001) (justifying its invalidation of the "duplicated loss" piece of Reg. §1.1502-20 because it did not deal with a "consolidated" problem).

[178] Act Sec. 844(b) of the 2004 Act, P.L. 108-357, 118 Stat. 1600 (stating that notwithstanding the amendment, "the Internal Revenue Code of 1986 shall be construed by treating Treasury Reg. §1.1502-20(c)(1)(iii) (as in effect on January 1, 2001) as being inapplicable to the factual situation in [*Rite Aid*]"). *See* H.R. (Conf.) Rep. 755, 108th Cong., 2d Sess. 640 (2004) (stating that the amendment "nevertheless allows the result of the Rite Aid case to stand with respect to the type of factual situation presented in the case").

[179] *See* H.R. (Conf.) Rep. 755, 108th Cong., 2d Sess. 640, note 595 (2004) (also stating 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").

[180] *Id., at* 640 (providing that the Treasury may issue regulations providing "that inside attributes [may be] adjusted when a subsidiary leaves a group"). *Cf.* Act Sec. 836(a) of the 2004 Act, P.L. 108-357, 118 Stat. 1594-95 (adding Code Sec. 362(e)(2), which generally limits loss duplication in a Code Sec. 351 exchange by reducing the controlled corporation's attributes).

[181] *See* Andrew J. Dubroff, Jerred G. Blanchard, Jr., Marc A. Countryman, and Steven B. Teplinsky, FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS, Ch. 73A (Matthew Bender 2012) (for an exhaustive discussion of the regulation). *See also* Don Leatherman, *A Survey of §1.1502-36*, 24 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS AND RESTRUCTURINGS 2009 1027 (Practicing Law Institute 2009) (for a discussion of the regulation and more examples that illustrate concerns with the regulation).

[182] For either group, the description will likely serve as an effective sleep aid.

[183] Reg. §1.1502-36(b)(1)(i).

[184] *Id.*

[185] *Id.,* at (b)(2) (introductory language).

[186] *Id.,* at (f)(10)(i).

[187] *Id.,* at (f)(10)(i)(A). *See also id.,* at (e)(3) (for a special rule that applies to an intercompany sale of an S loss share).

[188] *Id.,* at (f)(10)(i)(B). For this purpose, "group" refers to a consolidated group, not merely an affiliated group. *See, e.g.,* Reg. §1.1502-36(b)(3), *Ex.* 3(i). *Cf.* Reg. §1.1502-1(a) (providing that, except as the context requires, references to a group are to a consolidated group). Thus, M and S must be members of the same consolidated group, not just the same affiliated group.

[189] *Id.,* at (f)(10)(ii)(A) (providing that this rule applies to Code Sec. 332 intercompany liquidation only if M is the only member that owns S shares).

[190] *Id.,* at (f)(10)(ii)(B).

[191] In other words, each share of common stock owned by a member has the same

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ratio of basis to value. Common and preferred stock have the same meanings as under Reg. §1.1502-32(d)(2) and (3). Reg. §1.1502-36(f)(8). *See* Reg. §1.1502-32(d)(2) (defining preferred stock generally as "stock that is limited and preferred as to dividends and has a liquidation preference"); *id.*, at (d)(3) (defining common stock as stock that is not preferred stock).

[192] Reg. §1.1502-36(b)(1)(ii)(A). Note that this exception does not apply if the members' preferred stock has built-in gain or loss merely because of a fluctuation in market rates.

[193] *Id.*, at (b)(1)(ii)(B) (also applying if, in one fully taxable transaction, either the stock becomes worthless under Code Sec. 165 and Reg. §1.1502-80(c) or the stock is in part sold to nonmembers and in remaining part becomes worthless). *See* 73 FR 53938 (Sept. 17, 2008) (stating that, because of this exception, the basis-redetermination rule should apply to only a small number of cases). Note that a transaction "includes all the steps taken pursuant to the same plan or arrangement." Reg. §1.1502-36(f)(9). Thus, as this exception makes clear, a transaction can include dispositions of shares to more than one person.

[194] Reg. §1.1502-36(b)(1)(ii)(B). *See also id.*, at (e)(5)(i) and (ii) (for the mechanics of the election). The election may make sense if it increases the income of a member with losses limited under Reg. §1.1502-21(c) (*i.e.*, separate return limitation year (SRLY) losses) or minimizes disallowed stock loss in a higher-tier subsidiary (because of a tier-up). *See* 73 FR 53938 (Sept. 17, 2008) (stating that "taxpayers might choose to apply the basis redetermination rule in such cases in order to reduce gain or avoid the Unified Loss Rule with respect to upper tier shares").

[195] Reg. §1.1502-36(b)(2)(i). The amounts reallocated are the *net* positive or negative adjustments for a year. *See id.*, at (b)(3), *Ex. 4*. For this purpose, investment adjustments include adjustments for taxable income or loss, tax-exempt income and nondeductible, noncapitalizable items but exclude adjustments for distributions. *Id., at* (b)(1)(iii). *See also* Reg. §1.1502-32(c)(1)(iii). *See also* Reg. §1.1502-36(b)(3), *Ex. 4* (illustrating that adjustments for distributions are not taken into account); *id.*, at (c)(8), *Ex. 1(iv)(C)* (to the same effect); *id.*, at (c)(8), *Ex. 6(C)* (to the same effect). They also include amounts reflected in the basis of the share (whether or not under Reg. §1.1502-32) and adjustments previously reallocated to (but not adjustments previously reallocated away from) the share under the basis-redetermination rule. *Id.* (also noting that they include adjustments reflected in the exchanged basis of a share, such as under Code Sec. 358 following a Code Sec. 355 transaction). Finally, they include amounts specially allocated under Reg. §1.1502-32(c)(1)(ii)(B) (accounting for the "prior use" limitation). *Id.*, at (b)(1)(iii).

Note, however, that if a member distributes loss property to another member, the distribution may ultimately trigger two types of negative adjustments, one for the distribution itself and one to account for the built-in loss in the distributed property. *See* Reg. §1.1502-32(b)(2)(iv) (for distributions); *id.*, at (b)(3)(iii) (providing that loss not recognized under Code Sec. 311(a) is a noncapital, nondeductible expense). *See also* Reg. §1.1502-13(f)(2)(iii) (providing that the principles of Code Sec. 311(b) apply to a subsidiary's loss, as well as gain, from an intercompany distribution of property). Although any negative adjustment for a distribution should be not be taken into account, a negative adjustment for the built-in loss should be a reallocable adjustment under the basis-redetermination rule.

[196] *Id.*, at (b)(2)(i)(A). These amounts are reallocated in the third step below.

[197] *Id.*, at (b)(2)(i)(B). To the extent a negative adjustment is reallocated from a share, the group increases its basis in that share. *See* Reg. §1.1502-32(b)(2).

[198] *Id.*, at (b)(2)(i)(B).

[199] *Id.*, at (b)(2)(ii)(A). The order of these reallocations helps minimize basis disparity, giving flexibility to allocate negative adjustments to (and positive adjustments away from) shares with built-in loss. *Cf. id.*, at (b)(2)(iii)(A) (providing that the overall allocation must reduce basis disparity to the greatest extent possible, implicitly adopting that ordering rule).

[200] *Id.*, at (b)(2)(ii)(B) (also providing that this amount is reallocated without regard to whether the common stock is a loss share or a transferred share and without regard to the share's value). *But see id.*, at (b)(2)(iii) (discussed in the text that follows, providing how the reallocation takes value into account in determining the allocation among shares).

[201] *Id., at* (b)(2)(iii)(A) (providing that the overall allocation must reduce basis disparities). *See also id.*, at (b)(2)(i)(B); *id.*, at (b)(2)(ii)(A); *id.*, at (b)(2)(ii)(B) (providing that the allocations in each step must be "made in a manner that, to the greatest extent possible, reduces the disparity among" members' basis in S common or preferred shares, as appropriate). 73 FR 53939 (Sept. 17, 2008) (stating that the reallocation may be made using "any reasonable method or formula that is consistent with the basis redetermination rule and furthers the purposes of the Unified Loss Rule," adding that the regulations "contemplate that more than one result may be reasonable in any specific case").

[202] Reg. §1.1502-36(b)(2)(iii)(A).

[203] Thus, under Reg. §1.1502-32, at least $100 of positive adjustments are allocated each S3 share, but because of the distributions, each share still retains a $100 basis. *See* Reg. §1.1502-32(b)(2)(i) and (iv).

[204] Share 1's value equals $5, which is $100, its beginning value, plus five percent of the built-in gain on Asset 3 ($5), minus 100 percent of the built-in loss on Asset 1 ($100). Share 2's value equals $105, which is $100, its beginning value, plus five percent of the built-in gain on Asset 3 ($5). Share 3's value equals $190, which is $100, its beginning value, plus 90 percent of the built-in gain on Asset 3 ($90).

[205] S3 remains in the P group because the retained S3 interests constitute 100 percent of the voting power of the S3 stock and over 98.33 percent of its value. *See* Code Sec. 1504(a)(2) (for the affiliation definition). Thus, neither P nor S2's S3 interest is considered to be transferred because of S1's sale.

[206] Reg. §1.1502-36(b)(2)(i)(A) (providing for the reallocation of positive adjustments from transferred loss shares to other shares); *id.*, at (b)(2)(iii) (providing that the reallocations are made to reduce basis disparity to the greatest extent possible).

[207] Allocations of adjustments between classes of common stock take into account the terms of each class and other relevant facts. Reg. §1.1502-32(c)(2) (providing that within each class of stock, each share is allocated the same proportion of any adjustment but that allocations among classes are made by considering the terms of each class and other relevant facts relating to the overall economic arrangement). Broadly speaking, common stock is stock that is not limited and preferred as to dividends. *See id.*, at (d)(2) and (3). Further, shares of stock constitute a class if they have the same material terms. *Id.*, at (d)(1).

All of the S3 interests should be common stock because none of the interests is limited and preferred as to dividends. Further, because Share 1 bore the entire built-in loss in Asset 1, it is a different class of stock than the other S3 shares. Because Share 1 bore that burden, under Reg. §1.1502-32(c)(2)(ii), that share should be allocated the entire investment adjustment related to the corresponding loss.

[208] Perhaps, $95 of the loss could be denied as a double deduction, although that result is not certain because it appears that the regulation, which is greatly detailed and highly technical, specifically allows the deduction. *See Woods Investment Co.*, 85 TC 274, Dec. 42,315 (1985) (allowing a

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double deduction when a specific regulation allowed the deduction); *Thrifty Oil Co. & Subsidiaries*, 139 TC No. 6, Dec. 59,179 (2012) (citing *Woods Inv.* with favor). *See also supra* note 127 (for a further discussion of double deductions).

[209] Reg. §1.1502-36(c)(1) (stating that the basis reduction is limited "to the net unrealized appreciation reflected in the share's basis as of the transfer").

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

[211] Reg. §1.1502-36(c)(3).

[212] *Id.,* at (c)(3)(ii). *See supra* note 195 (for a more complete description of these adjustments).

[213] Reg. §1.1502-36(c)(3)(ii). *See also* Reg. §1.1502-32(c)(1)(ii)(A) (describing the adjustment).

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

[215] Reg. §1.1502-36(c)(5) (providing that, except as provided in Reg. §1.1502-36, that determination is made by taking into account all other applicable rules, even if the adjustments required by those rules are not deemed effective until after the transfer, such as under Reg. §1.1502-28).

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

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

[218] *Id.* A liability generally means a liability that has been incurred within meaning of Code Sec. 461(h). *Id.,* at (f)(5).

[219] Reg. §1.1502-36(c)(5) (also providing that the share's basis is adjusted for any other related or resulting adjustments to the share's basis).

[220] *Id.,* at (c)(6).

[221] *Cf.* Reg. §1.337(d)-2(a)(4) (allowing the netting of gain and loss on stock with the same materials terms sold as part of the same plan or arrangement).

[222] Reg. §1.1502-36(c)(7).

[223] *Id.*

[224] *See supra* note 210 and accompanying text (for a description of that rule).

[225] Reg. §1.1502-32(b)(2)(i) and (b)(3)(i).

[226] Reg. §1.1502-36(b)(1)(ii)(B).

[227] That amount equals the $30 positive adjustment for the income recognized on the inventory sale. *Id.,* at (c)(3).

[228] The disconformity amount equals the excess of P's $100 S stock basis over the $100 of net inside attributes (*i.e.,* the $70 asset basis plus the $30 cash). *Id., at* (c)(4).

[229] *See id.,* at (d)(2) and (3).

[230] Note that even if the land could not be sold, the Y group may have recognized a loss on the land if it had sold the S stock and joined with the purchaser in making a Code Sec. 338(h)(10) election.

[231] *Id.,* at (d)(3)(i).

[232] *Id.*

[233] *Id.,* at (d)(2)(ii) (providing that the common parent may elect to not have this *de minimis* rule apply). The group may elect to apply the attribute-reduction rule, for example, so that it can reattribute the attributes of S (or a lower-tier subsidiary). *See* 73 FR 53941 (Sept. 17, 2008) (preamble to the final regulations) (making this suggestion).

[234] *Id.,* at (d)(2) and (3)(ii).

[235] *Id., at* (d)(3)(ii)(A); *id.,* at (d)(2)(i) (applying the attribute-reduction rule after taking into account the basis-redetermination and basis-reduction rules and all other applicable rules of law).

[236] *Id., at* (d)(3)(iii)(A). Thus, this factor takes into account the full aggregate inside loss, rather than just the portion attributable to the transferred shares. The preamble to the proposed regulation states that the full amount is taken into account because the basis of the transferred shares, in some cases, may reflect a disproportionate amount of the duplicate inside loss. REG-157711-02, 72 FR 2980 (Jan. 23, 2007) (the preamble). *See also* Reg. §1.1502-36(d)(8), *Ex. 9(v)* (for an example where transferred stock reflected a disproportionate amount of the duplicate inside loss).

[237] *Id.,* at (d)(3)(iii)(B) (generally defining those amounts for the basis reduction and attribute reduction rules in the same way); *id.,* at (c)(5). *See also supra* notes 216 to 218 and accompanying text (for further information on S's net inside attribute amount). Note that for purposes of the attribute-reduction rule, loss carryovers do not include any losses waived under Reg. §1.1502-32(b)(4). *Id.,* at (f)(6) (defining loss carryovers). That exclusion makes sense because the waiver eliminates any chance that the waived loss could provide a duplicate benefit.

[238] *Id. See infra* notes 263 to 265 and accompanying text (for a discussion of deemed basis).

[239] *Id.,* at (d)(4)(i). This fourth category of assets is more precisely all assets other than those described in Reg. §1.338-6(b)(1). The assets described in that regulatory provision are cash and general deposit accounts, other than certificates of deposit. Reg. §1.338-6(b)(1).

[240] Reg. §1.1502-36(d)(4)(iii). *See generally* Reg. §1.1502-36(d)(8), *Ex. 1–4* (illustrating these rules). Thus, the reductions do not affect the stock basis of S's upper-tier subsidiaries. *Cf.* Reg. §1.1502-32(b)(2)(iii) (providing that noncapital, nondeductible expenses are negative adjustments).

[241] *Id.,* at (d)(4)(ii)(A)(*1*) (providing that the election to specify the allocation is made as provided in Reg. §1.1502-36(e)(5)). For each subsidiary for which the election is made, a statement must specify which of the subsidiary's losses or deferred deductions are being reduced (or, alternatively, not reduced). *Id.,* at (e)(5)(iv).

[242] *Id.,* at (d)(4)(ii)(A).

[243] *Id.,* at (d)(4)(ii)(A)(*1*). *Cf.* Reg. §1.172-4(a)(3) (providing that loss carryovers are absorbed in the order of the taxable years from which the losses are carried). Note that loss carryovers are available for reduction even if their use is limited (or barred) by Code Sec. 382 or by a SRLY limitation.

[244] Reg. §1.1502-36(d)(4)(ii)(A)(*1*).

[245] *Id.*

[246] *Id.*

[247] *Id.,* at (d)(4)(ii)(B)(*1*). That allocation, and other special rules relating to lower-tier subsidiary stock are described beginning at section III.C.2.c.iii of this article.

[248] *Id.,* at (d)(4)(ii)(B)(*2*).

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[249] *Id.* (also providing that Classes II-VII are defined in Reg. §1.338-6(b)). *See also* 73 FR 53942 (Sept. 17, 2008) (concluding that this approach makes sense because it is administrable and "duplicated loss is generally more likely to be reflected in the basis of" goodwill and going concern value, so that "the elimination of the basis in those assets first seems particularly appropriate"). Note that in this allocation, no amount is allocated to lower-tier subsidiary stock.

Class II assets are certificates of deposit, foreign currency, U.S. government securities, publicly traded stock, and any other actively traded personal property (as defined in Code Sec. 1092(d)(1) without regard to Code Sec. 1092(d)(3)); Class III assets are accounts receivables and the like; Class IV assets are inventory and the like; Class VI assets are Code Sec. 197 intangibles other than goodwill and going concern value; and Class VII assets are goodwill and going concern value; Class V assets are any other noncash assets. Reg. §1.338-6(b)(2)(ii)-(vii).

[250] Reg. §1.1502-36(d)(4)(ii)(B)(*2*).

[251] *Id.,* at (d)(4)(ii)(C)(*1*) and (*2*). For this purpose, a liability is "any liability or obligation the satisfaction of which would be required to be capitalized as an assumed liability by a person that purchased all of S's assets and assumed all of S's liabilities in a single transaction." *Id.* Thus, this definition prominently may include "contingent" liabilities. *See id.,* at (d)(8), *Ex. 4* (for an example with "unaccounted for" liabilities).

[252] *Id.,* at (d)(4)(ii)(C)(*1*) (emphasis added).

[253] Because P still owns 80 percent of only class of S stock, S is still a member of the P consolidated group. *See* Code Sec. 1504(a)(2).

[254] The basis-redetermination rule does not apply because each share of S's only class of stock has the same ratio of basis to value. Reg. §1.1502-36(b)(1)(ii)(A). The basis-reduction rule does not apply because the transferred share has a $0 disconformity amount (*i.e.*, its $200 basis equals its allocable share of S's asset basis ($200 or one-fifth of $1,000). *Id.,* at (c)(2)(i) and (4).

[255] The net stock loss equals $100, the excess of (A) $200, the aggregate basis of the transferred S share, over (B) $100, its aggregate value. *Id.,* at (d)(2) and (3)(ii).

[256] S's aggregate inside loss equals the excess, if any, of (A) its net inside attribute amount (NIAA) over (B) the value of the S share. *Id.,* at (d)(3)(iii)(A). Because S has no lower-tier subsidiary stock, its NIAA equals $1,000, its basis in its asset. *See id.* Thus, S's aggregate inside loss equals $500, the excess of its $1,000 NIAA over the $500 S stock value.

[257] *Id.,* at (d)(4)(ii)(B)(*2*).

[258] Reg. §1.1502-32(b)(2)(i) and (b)(3)(i). *See also id.,* at (c)(1)(iv) (providing that the portion of an adjustment allocated to a nonmember has no effect on the basis of the share). *Cf. id.,* at (c)(1)(ii)(A) (special allocation to account for elective reattribution under Reg. §1.1502-36(d)); *id.,* at (c)(1)(ii)(B) (special allocation to account for investment adjustments subject to a prior use limitation).

[259] Under the facts of the example, the basis-redetermination rule would not apply because each share of S's only class of stock has the same ratio of basis to value. *Id.,* at (b)(ii)(A). The basis-reduction rule would not apply because each transferred S share had a $0 net positive adjustment. *Id.,* at (c)(2)(i).

[260] The $80 noneconomic loss is attributable to the portion of the $400 asset loss allocated to the S share no longer owned by the group. *See* Reg. §1.1502-32(c)(1)(iv).

[261] *See supra* note 208 (for reasons why the noneconomic loss should not be disallowed as a double deduction).

[262] *See* Reg. §1.1502-36(d)(8), *Ex. 5–9* (illustrating rules relating to lower-tier subsidiaries). The article includes this description of the lower-tier subsidiary stock rules, among other reasons, to illustrate their complexity.

[263] *Id.,* at (d)(5)(i)(A) and (B).

[264] *Id.,* at (d)(5)(i)(B). *See also id.,* at (f)(1) (providing that "allocable portion" has the same meaning as in Reg. §1.1502-32(b)(4)(iii)(B)); Reg. §1.1502-32(b)(4)(iii)(B) (providing that within each class of stock, each share has the same allocable portion of the relevant amount and allocations among classes are made by considering the terms of each class and other relevant facts relating to the overall economic arrangement).

[265] Reg. §1.1502-36(d)(5)(i)(C).

[266] *Id.,* at (d)(4)(ii)(B).

[267] *See id.,* at (d)(5)(ii).

[268] *Id.,* at (d)(5)(ii)(B) (providing that liabilities include those described in Reg. §1.1502-36(d)(4)(ii)(C)(*1*) (*e.g.,* contingent liabilities)). Note that this computation is made separately for each lower-tier subsidiary, the stock of which S holds. *Id.,* at (d)(5) (introductory language).

[269] *Id.,* at (d)(5)(ii)(B) (providing that liabilities include those described in Reg. §1.1502-36(d)(4)(ii)(C)(*1*)). Among other things, these modifications of deemed basis eliminate the value of lower-tier assets that S would not take into account if it owned them directly.

[270] *Id.,* at (d)(5)(iii)(A). *See* REG-157711-02, 72 FR 2981 (Jan. 23, 2007) (stating in the preamble to the proposed regulations that the recognition establishes that the share's basis no longer reflects noneconomic loss).

[271] Reg. §1.1502-36(d)(5)(iii)(A)-(D).

[272] *Id.,* at (d)(5)(iv) (adding that such portion is *not* treated as a noncapital, nondeductible amount for purposes of Reg. §1.1502-32 and does not result in gain or loss to S).

[273] *Id.,* at (d)(5)(v).

[274] *Id.* Thus, a portion of the amount allocated to any of L's G shares will be taken into account by G under the special lower-tier subsidiary rules, and a portion of G's allotment may be allocated to G's lower-tier subsidiary shares and taken into account by those lower-tier subsidiaries under those special rules, and so on.

[275] *See, e.g., id.,* at (d)(8), *Ex. 5–7* (illustrating these rules). *See* REG-157711-02, 72 FR 2981 (Jan. 23, 2007) (stating in the preamble to the proposed regulations that those rules are intended to eliminate the "full duplication potential ... without creating a noneconomic gain in the corresponding attribute").

[276] Reg. §1.1502-36(d)(5)(v)(B)(*1*).

[277] *Id.,* at (d)(5)(v)(B)(*2*).

[278] *Id.,* at (d)(5)(v)(B)(*3*) (adding that the aggregate basis for those shares is first determined after taking into account any reduction under Reg. §1.1502-36(d)).

[279] *Id., at* (d)(5)(v)(B)(*4*) (adding that the aggregate basis for those shares is first determined after taking into account any reduction under Reg. §1.1502-36, including under Reg. §1.1502-36(d)). Thus, this rule may limit L's attribute reduction when L has pre-acquisition, unrecognized built-in gain.

[280] *Id.,* at (d)(5)(vi)(A) (adding that L's NIAA is computed after taking into account any reductions under Reg. §1.1502-36(d)).

[281] *Id.,* at (d)(3)(B) (also providing that computation is made by taking Reg. §1.1502-36(d)(5) into account but without regard to Reg. §1.1502-36(c)(6)). *See supra* notes 216 to 218 and accompanying text (for the definition of NIAA under Reg. §1.1502-36(c)(5)).

[282] *Id.,* at (d)(vi)(A). *See id.,* at (d)(4)(ii)(A)(*1*) (for the suspension rule).

[283] *Id.,* at (d)(5)(vi)(A).

[284] *See id.,* at (d)(5)(v)(B) (election not to restore L attributes); *id.,* at (d)(5)(vi)(B) (election not to restore L stock basis). *See also id.,* at (e)(5)(v) and (vi) (for the form of these elections).

[285] However, it may be advantageous to elect not to restore an L loss carryover that is likely to expire unused because the expiration could otherwise cause a reduction in stock basis. *See* Reg. §1.1502-32(b)(3)(iii) (treating an expired loss carryover as a nondeductible, noncapital expenditure); *id.,* at (b)(2)(iii) (treating a nondeductible, noncapital expenditure as a negative adjustment). *See also id.,* at (b)(4) (providing for a waiver of loss carryovers of an acquired subsidiary, which may result in a stock basis reduction).

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[286] *Id.,* at (d)(6). *See id.,* at (d)(8), *Ex. 8* (illustrating those elections).

[287] *Id.,* at (d)(6)(i)(A) (also providing that it may reduce any amount in excess of a stated amount).

[288] *Id.,* at (d)(6)(i)(B); *id.,* at (d)(6)(iv)(A).

[289] *Id.,* at (6)(iv)(A).

[290] Note that the approach in Reg. §1.1502-20 could be modified to make it less harsh (*e.g.,* by considering *net* positive adjustments, rather than positive adjustments, as a disallowance factor).

[291] *See supra* note 178 and accompanying text (for why legislative may be needed).

[292] *See Glenshaw Glass Co.*, SCt, 55-1 USTC ¶9308, 348 US 426, 75 SCt 473.

[293] *Cf.* Rev. Rul. 99-57, 1999-2 CB 678. That increase prevents P from indirectly recognizing that excluded dividend amount on a sale of its PX interest.

[294] Code Sec. 1032; Rev. Rul. 99-57, 1999-2 CB 678.

[295] *See id.* Again that increase prevents P from indirectly recognizing that gain on a sale of its PX interest.

[296] Reg. §1.704-3(a)(7).

[297] Reg. §1.705-2(b)(1).

[298] *See* Proposed Reg. §1.337(d)-3(d) (for the deemed redemption rule); *id.,* at (e) (for the distribution rule).

[299] *Id.,* at Reg. §1.337(d)-3(d)(1).

[300] *Id.,* at (d)(2).

[301] *Id.,* at Reg. §1.337(d)-3(h), *Ex. 1.*

[302] This conclusion assumes that the P stock is not publicly traded. *Cf.* Code Sec. 731(c) (treating marketable securities as cash in certain cases).

[303] NYSBA Tax Section, "Report on the Impact of Legislative Changes to Subchapter K on the Proposed 'May Company' Regulations under section 337(d) and Technical Recommendations Regarding Affiliate Stock" (Aug. 15, 2012), *reprinted in* 2012 TNT 159-9 ("NYSBA report"). *See also* NYSBA Tax Section, "Report on Proposed Regulations Implementing Notice 89-37" (Mar. 3, 1993), *reprinted in* 93 TNT 57-27; NYSBA Tax Section, "Report on Notice 89-37" (Nov. 14, 1989), *reprinted in* 89 TNT 240-5.

[304] NYSBA report, *supra* note 303, at *16.

[305] *Id.*

[306] *Id.* Note, however, that if P is solvent, the P stock held by the partnership has value, value that a rational creditor may exploit to help satisfy its claim against P. Note as well that the corporate contraction theory flows from the following incontrovertible point: If the partnership were to liquidate, to the extent that P received its stock, its pool of assets would shrink. Perhaps, however, that point better supports applying a deemed redemption rule when the liquidation occurs.

[307] *Id.,* at *16-*17 (noting that "[s]ection 721 is intended to provide nonrecognition on the view that people are mixing their assets for a non-tax purpose. ... [P] stock cannot be used for operations and would seem to be a peculiar type of investment asset to contribute to a partnership. In general, there seems to be little reason for [P] stock to go into a partnership other than to effect an economic redemption of the stock").

In a sense, the deemed redemption rule automatically applies the deemed sales rule of Code Sec. 707(a)(2)(B), an automatic application that may be justified by the absence of a nontax business purpose. Nevertheless, in limited cases, there may be nontax business reasons for P stock to be contributed or acquired by a partnership in which P is a partner. For example, if P is a small partner in an investment partnership, the partnership may acquire P stock as part of its portfolio of investments. Further, a partner (other than P) may contribute P stock to the partnership to facilitate borrowing. *But see id.,* at *17 (discounting the latter purpose). Exceptions to the deemed redemption rule could be provided in those limited cases, at least if there was adequate assurance that the P stock would not be distributed to P.

[308] *Id.*

[309] Monte A. Jackel and Audrey Ellis, *Perpetually Proposed: The May Company Regulations*, 2012 TNT 63-12, at *3-*4 (noting, among other things, that since the regulations were proposed, the following changes were made: Code Secs. 704(c)(1)(B) and 737 apply for seven, not just five years, after contribution, Code Sec. 731(c) was added to the Code, Code Sec. 732(c) was revised to make it harder to shift basis away from P stock, and Code Sec. 734(d) makes it harder to distribute low-basis property to a high-basis partner but keep the high basis of partnership property intact); Monte A. Jackel, *Aggregate View of Partnerships in May Company Proposed Regs*, 137 TAX NOTES 679, 680 (Nov. 5, 2012) ("Jackel article") (adding that Code Sec. 707(a)(2), as illustrated by Reg. §1.707-3(f), *Ex. 8*, may also provide a backstop); NYSBA report, *supra* note 303, at *15 and *17 (pointing to Code Sec. 755(c) and Code Sec. 7701(o)).

[310] Under Code Sec. 311(a), a corporation cannot recognize loss when it uses built-in loss property to redeem its stock.

[311] *Cf.* Proposed Reg. §1.337(d)-3(d)(1).

[312] *See* Code Sec. 704(c).

[313] In appropriate cases, Code Sec. 707(a)(2) may treat P's transfer of the loss property as a redemption.

[314] Assume that the other assets maintain their value. Thus, P's interest is worth $80.20, $79.20 related to the P stock (99 percent of $80) and $1 related to the other assets (0.5 percent of $200).

[315] Note that this change could benefit P if the P stock had appreciated in value.

[316] Proposed Reg. §1.337(d)-3(c) (defining a corporate partner and another corporation as affiliates if they are members of the same affiliated group, as defined in Code Sec. 1504(a) without regard to the exceptions in Code Sec. 1504(b)). Notice 93-2, 1993-1 CB 292 (providing that affiliation is determined immediately before the relevant transaction). Note that for this purpose, stock also includes options, warrants, and similar interests. Proposed Reg. §1.337(d)-3(c). The concerns raised in the text for stock also generally apply to options, warrants, and similar interests.

[317] *Cf.* Code Sec. 1032(a) (applying to a corporation's sale or exchange of its stock). *See also* Reg. §1.1502-13(f)(2)(ii) (excluding an *intercompany distribution* from gross income but only if the distributee has corresponding negative adjustment in the stock of the distributing corporation); *id.,* at (f)(6) (providing that a member recognizes no loss on common parent stock).

[318] NYSBA report, *supra* note 303, at *18. *See also id.,* at *25 (proposing that the amount of the stock deemed redeemed be reduced if the affiliate owns less than a 100-percent direct and indirect interest in P).

[319] *Id.,* at *20-*22.

[320] *Id.,* at *22-*23 (more precisely recommending that the rule apply if the combination is a Code Sec. 332 liquidation or Code Sec. 368 reorganization).

[321] *Id.,* at *23.

[322] *Id.,* at *24.

[323] *Id.* (describing this example).

[324] *Id.* The report also considers internal transactions involving affiliated groups. Among other cases, it considers the following: P owns all S1 and S2 stock. P and S1 form a partnership, with P contributing the S2 stock and S1 contributing an appreciated asset. The report sensibly concludes that the deemed redemption rule should not apply to this case because any concern that arises (*i.e.,* a mixing bowl concern) does not depend on P's contributed asset being stock of an affiliate. *Id.,* at *26. The report notes that if the P group is a consolidated group, in an appropriate case, the anti-avoidance rule under Reg. §1.1502-13(h) may apply. *Id.,* at *27.

[325] Note that in at least one respect, the affiliate rule may be too narrow because it may allow a corporate partner to avoid the application of Code Secs. 304 and 311(b). If a corporation directly acquires stock for appreciated property in a transaction described in Code Sec. 304, the corporation must recognize gain under Code Sec.

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311(b). The acquired stock, however, may not be stock of an affiliated group member. *See* Code Sec. 304(a) and (c) (requiring that the persons or persons transferring the stock control the target and acquiring corporations; control broadly requires only 50-percent ownership). Subject to an anti-abuse rule, a corporate partner might avoid Code Sec. 311(b) by having the partnership acquire the target stock. *Cf.* Reg. §1.368-1(e)(5) (in measuring continuity of interest, treating an acquisition by a partnership as a proportionate acquisition by a partner).

[326] Reg. §1.337(d)-3(e).

[327] NYSBA report, *supra* note 303, at *27-*28. Note that if the distribution rule is eliminated, the deemed redemption rule may still apply to a distribution.

If, however, the deemed redemption rule is not retained, the distribution rule will be needed to help prevent the avoidance of the *General Utilities* repeal. *See* Jackel article, *supra* note 309, at 683 (adding that deemed redemption rule is fundamentally inconsistent with the disguised sale rules and Code Sec. 704(c) because it applies the aggregate approach). Note that eliminating the deemed redemption rule and keeping the distribution rule would be administratively simpler but would fail to fully implement the repeal. *See supra* notes 304-312 and accompanying text (for a fuller discussion).

[328] Proposed Reg. §1.337(d)-3(h), *Ex. 1*.

[329] *Id.*

[330] Code Sec. 731(a).

[331] Code Sec. 732(b) (providing that a partner's basis in noncash property distributed in liquidation of a partner's partnership interest equals the partner's basis in that interest minus any distributed cash).

[332] Proposed Reg. §1.337(d)-3(h), *Ex. 1*.

[333] *Id.*

[334] Code Sec. 705(a)(2). One more refinement would be required. The examples in the text all involve P stock that had a fair market value basis when P acquired its indirect interest in that stock through the partnership. P's adjustment should more precisely reflect the difference between the stock's fair market value at that time and the stock's value when distributed. *Cf.* Reg. §1.704-2(b)(iv)(*f*) (describing "reverse Code Sec. 704(c) allocations); Reg. §1.705-2 (basis adjustments coordinating Code Secs. 705 and 1032).

[335] Code Sec. 731(a). If P had been allocated a loss and reduced the basis of its partnership interest, P would recognize gain on the distribution, an appropriate result since the reduced basis would be attributable to P's indirect interest in its stock.

[336] Code Sec. 732(b) (providing that a partner's basis in noncash property distributed in liquidation of a partner's partnership interest equals the partner's basis in that interest minus any distributed cash).

[337] Code Secs. 351(a); 358(a).

[338] Code Sec. 362(a).

[339] For Code Sec. 351 to apply to the incorporation, the partnership must hold the entity's stock "immediately after" the exchange. It is not clear to what extent the distribution may affect that "immediately after" requirement, but the partnership may be treated as holding the "stock" for as long as it held the interests in the disregarded entity. Note that in applying Code Sec. 269, it appears that if there was a good business reason to form (or acquire) the disregarded entity, Code Sec. 269 should not apply to the "check the box" election.

[340] Notice 93-2, 1993-1 CB 292.

[341] As originally proposed, the distribution rule measured affiliation immediately after the transaction. Reg. §1.337(d)-3(c). Notice 93-2, 1993-1 CB 292, required that affiliation be measured immediately before the transaction.

[342] The legislative history makes clear that Code Sec. 732(f) is concerned not with the avoidance of the *General Utilities* repeal but instead with avoiding a low basis assigned under Code Sec. 732. S. Rep. No. 106-201, at 50 (1999). It applies only to the extent that the basis that the corporate partner takes in affiliate stock is less than the partnership's basis in that stock immediately before the distribution. Congress may have been particularly concerned with transactions in which a partnership formed a corporation primarily with cash and distributed the corporation's stock to a corporate partner that had a basis in its partnership interest less than the cash. *Cf.* Code Sec. 269.

[343] Code Sec. 732(f)(1).

[344] *Id.*; Code Sec. 732(f)(3)(A).

[345] Code Sec. 732(f)(4).

[346] Note that if P had directly acquired the S assets for $20 plus the assumption of the S liabilities, S would have recognized no gain or loss and P would have taken a $130 basis in the acquired assets. Code Secs. 1001; 1012.

[347] Code Sec. 362(e)(2)(A).

[348] Code Secs. 721; 722; 723.

[349] Code Sec. 732(f)(1). If S, instead, had a $0 inside asset basis, before the sequence of steps, there would be $200 of corporate-level gain, $100 for P and $100 for S. Code Sec. 732(f) would still apply to the distribution, but S would not reduce its asset basis because its asset basis before any reduction would be $0. Code Sec. 732(f)(2) (for the limitation on any basis reduction). Instead, P would recognize a $100 gain. *Id., at* (f)(4) (providing for gain recognition to the extent that basis is not reduced). After that gain recognition, however, S's assets would still have a $0 basis, preserving the $100 of corporate-level gain as yet unrecognized.

[350] Code Secs. 336; 331.

[351] Code Secs. 721; 722; 723.

[352] *See* Code Secs. 334(a); 332(a).

[353] *Cf.* Code Secs. 311(b); 336(a). Note that the *General Utilities* repeal is aimed at corporate-level, not shareholder-level, recognition. Even though X's basis in the land preserves a $100 built-in gain, the sequence of steps has eliminated $100 of corporate-level gain. In effect, without recognizing gain, P has transferred an asset with a $0 basis, acquiring an asset with a $100 basis. These steps therefore thwart the purposes of the repeal—to assure that corporate-level gain does not escape tax.

[354] Even if the aggregate basis of S's assets was less than $100, the sequence of steps would eliminate $100 of corporate-level gain (*i.e.*, P's pre-sequence gain reflected in the land), although any built-in gain in the S assets would be preserved in the transaction.

[355] More precisely, it would be required to reduce its basis by the partnership's basis in the S stock, but that basis would equal X's basis in the S stock before the partnership was formed. Code Sec. 722. On the partnership's liquidation, P would take a basis in the S stock under Code Sec. 732(a) of $0. Code Sec. 732(f) would therefore apply because P would receive a distribution of the S stock, be affiliated with S immediately after the distribution, but the partnership's basis in that stock immediately before the distribution would exceed P's basis in that stock under Code Sec. 732(a). Under Code Sec. 732(f)(1), S would be required to reduce its asset basis by the excess. Note that if X had a loss basis in the S stock, the Code Sec. 732(f) penalty would create additional corporate-level gain, a result certainly not mandated by the *General Utilities* repeal.

[356] Code Secs. 721; 722; 723.

[357] Under the distribution rule before its modification, P would also recognize no gain because its basis in its partnership interest would equal the value of the C stock.

[358] To avoid an arguably comparable deferral, Code Sec. 351 requires gain in contributed assets to be duplicated at both the shareholder and corporate level. If it was preserved only at the shareholder level, the corporation could sell the contributed asset without gain, while if it was preserved only at the corporate level, the shareholder could sell the stock received without gain. Thus, with gain preserved at only one level, Code Sec. 351 could be easily used to avoid gain. The example in the text would not allow such facile avoidance, however, because, among other things, assets subject

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to unpredictable shifts in value would have to remain in partnership solution for at least seven years.

[359] Note that in certain cases the other partners may be indifferent about any reduction in their outside bases.

[360] Assume that the control requirement under Code Sec. 351 is met.

[361] Under the distribution rule, as originally proposed, P would recognize a $10 gain.

[362] Reg. §1.358-2(a)(2).

[363] Code Sec. 334(b)(1).

[364] *See* Code Secs. 332; 337; 355(a) and (c).

[365] *See* Code Sec. 355(b)(1)(B).

[366] Code Sec. 361(c)(4) (providing that Code Sec. 311 and subpart B of part II of subchapter C (*i.e.*, Code Secs. 336 and 337) do not apply to the distribution).

[367] *Cf.* Rev. Rul. 69-6, 1969-1 CB 104 (providing that if a target merges into a corporation in a taxable transaction, the target is treated as selling all assets and distributing the sales proceeds to its shareholders in liquidation). Note, however, that because Code Sec. 356 is the more "specific" provision, it arguably should apply.

[368] Under Code Sec. 358, P's basis in the X stock would be a negative $60, equal to $0 (the basis of its transferred assets) minus $60 (the value of the boot received). However, because P and X do not join in filing a consolidated return, the X stock basis cannot be less than $0.

[369] Assuming that the liquidation qualified under Code Secs. 332 and 337, neither P nor S1 would recognize gain or loss, and P would take a transferred $0 basis in the S1 assets. Code Sec. 334(b)(1). On its taxable transfer of those assets, therefore, P would recognize a $100 gain.

[370] Note that if Code Sec. 332 did not apply in the reorganization transaction, the transaction resulted in a $160 gain, $100 of which was deferred and $60 of which was recognized.

[371] Code Sec. 1012.

[372] Code Sec. 1059(a)(1); *id.*, at (b) (defining the non-taxed portion); *id.*, at (c) (generally defining extraordinary dividends).

[373] *Id.*, at (e)(2)(A). *Cf. id.*, at (c)(2)(B) (for an exception if the dividend is paid out of earnings and profits earned or accrued by a corporation when it was not affiliated with the distributee shareholder).

[374] Code Sec. 243(b)(1) (defining qualifying dividends).

[375] *Cf.* Code Sec. 246(c)(1).

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