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Proposed Intercompany Transaction Regulations: Side-by-Side Comparisons

Andrew J. Dubroff
PROPOSED INTERCOMPANY TRANSACTION REGULATIONS:
SIDE-BY-SIDE COMPARISONS

Andrew J. Dubroff

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ASSETS AND SERVICES OF MEMBERS

Introduction

The consolidated return regulations provide detailed accounting rules for transactions between members of a group. Most of the current rules for transactions involving the sale or exchange of property or services are under §§1.1502-13 and 1.1502-13T. Section 267(f) adopts a parallel system for losses and deductions from sales or exchanges between controlled group members (some or all of which also may be consolidated group members). Related rules under §§1.1502-14 and 1.1502-14T are discussed below and apply to transactions with respect to member stock and obligations. In general, the timing of items from intercompany transactions is determined under the current rules as if the members were a single entity, while the amount, location, character, and source of the items are generally determined on a separate entity basis.

In addition to these basic rules, additional significant consolidated return rules for intercompany transactions are provided in §§1.1502-17 (accounting methods), 1.1502-18 (special inventory adjustments), and 1.1502-80 (nonapplicability of certain Code provisions). Further rules are provided throughout the Code and the consolidated return regulations. See, e.g., Code sections 469(j)(11) (passive activities), 904(i) (foreign tax credit), and 1092(d)(4) (straddles); and regulation §§1.168(d)-1(b)(5) (ix) (depreciation conventions), 1.1502-12(a) (separate taxable income), 1.1502-20(a)(4) (netting of gain and loss for LDR), 1.1502-32(b) (stock basis adjustments) and 1.1502-33(c) (E&P adjustments).

The current intercompany transaction rules were modified by temporary regulations filed in March 1990. To address the possible application of the basic rules in specific circumstances perceived by the government to be abusive, the modifications significantly expanded the reliance of intercompany accounting on single entity principles. Because the temporary regulations were only intended to eliminate specific abuses, they did not reflect a comprehensive reconsideration of the basic intercompany accounting system. The temporary regulations were finalized on March 9, 1993 without substantial modification.

Proposed regulations filed in April 1994 would revise all of the significant consolidated return regulations applicable to intercompany transactions (including transactions with respect to the stock and obligations of members). See CO-11-91, 1994-18 I.R.B. 40, and Notice 94-49, 1994-18 I.R.B. 8. The basic policy decision reflected in the proposed regulations is that preserving the location of items from intercompany


transactions is compelled by the Code (including the repeal of the General Utilities doctrine) and various consolidated return rules that depend on the location of items within a group (e.g., the stock basis and E&P adjustment systems under §§1.1502-32 and 1.1502-33). Consequently, the proposed regulations retain the deferred sale approach of the current regulations rather than returning to the more administrable pre-1966 intercompany transaction system of nonrecognition and carryover basis. However, the proposed regulations also reflect the policy underlying the recent temporary regulations, that enhanced single entity treatment is also necessary to clearly reflect consolidated taxable income.

The proposed regulations replace the detailed, mechanical approach of the current regulations with uniform rules. Under these rules, S is the member transferring property or providing services and has intercompany items, while B is the member paying for the property or services and has corresponding items. Unlike the current regulations, which generally limit single entity treatment to timing and restore S's items based on specified events (e.g., B's redispotion outside the group), the uniform rules take into account the intercompany and corresponding items by generally treating S and B as divisions of a single corporation. The principal features of the current and proposed rules are as follows:

<table>
<thead>
<tr>
<th>Current rules</th>
<th>Proposed rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount.</td>
<td>Separate entity</td>
</tr>
<tr>
<td>Location.</td>
<td>Separate entity</td>
</tr>
<tr>
<td>Timing.</td>
<td>Single entity</td>
</tr>
<tr>
<td>Character.</td>
<td>Separate entity (generally)</td>
</tr>
<tr>
<td>Source.</td>
<td>Separate entity</td>
</tr>
<tr>
<td>Other attributes.</td>
<td>Separate entity</td>
</tr>
<tr>
<td>Holding periods.</td>
<td>Separate entity</td>
</tr>
</tbody>
</table>
Commentators generally agree that more uniform rules and enhanced single entity treatment is appropriate for intercompany transactions. It is the failure of the current regulations to adequately achieve single entity treatment that has lead to taxpayer requests for revisions. The government also believes that some taxpayers have relied on a mechanical reading of the current rules to reach a favorable result for certain applications, but relied on the single entity principles underlying the regulations to reach a favorable result in other applications.

The matching rule is the principal source of single entity treatment under the proposed regulations and its timing aspects are an accounting method. The matching rule conforms the timing and character of intercompany and corresponding items to prevent an intercompany transaction from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). The acceleration rule operates as a backstop to the matching rule, taking intercompany items into account immediately to the extent that they cannot be taken into account under the matching rule to produce the effect of treating the members as divisions of a single corporation (e.g., when S or B leaves the group).

The uniform rules of the proposed regulations combine the various separate operating provisions of the current regulations, but do not provide detailed guidance for any particular transaction. Nevertheless, the proper application of the proposed rules will be clear in most cases because they are based on single entity principles that should be relatively clear. As with uniform rules in other recent regulations (consolidated and otherwise), the application of the rules to particular fact patterns will develop through interpretation, and anti-abuse rules are included to prevent "creative" applications that might otherwise undermine the purposes of the regulations.

Because of the range of transactions that can be intercompany transactions, the intercompany rules must be flexible enough to adapt a broad range of accounting systems under the Code to single entity treatment. To enhance guidance, the proposed regulations provide numerous examples illustrating application of the rules in the most common circumstances (e.g., the sale of property or provision of services), and additional examples are provided for more difficult cases (e.g., the application of sections 382 and 475). Moreover, the rules for inventory transactions, perhaps the most common intercompany transactions, are dramatically simplified to permit any reasonable method of accounting. However, it is not possible to illustrate all of the possible transactions and affected Code rules.
The side-by-side chart below shows that, despite criticisms as unduly vague, the proposed regulations provide at least the guidance provided by the current regulations. The uncertainty identified by commentators may be unavoidable under any system that adapts complex policies underlying a range of Code provisions to expanded single entity treatment for intercompany transactions. While some aspects of the Code require even greater single entity treatment of members, the more expansive treatment results in complexity and some areas actually require separate entity accounting. Compare proposed §1.263A(f)-2(f)(5) (single entity approach to interest capitalization) with proposed §§1.446-4(e)(9) and 1.1221-2(d) (elective separate entity treatment for related-party hedge accounting). Final evaluation of the proposed regulations will require comparisons with comparable accounting systems elsewhere under the Code. See, e.g., §§1.446-4(b) (the timing of items from a hedging transaction must be "reasonably matched" with the items being hedged) and 1.704-3T(d) (remedial allocation method for allocating partnership items from contributed property).

The proposed regulations generally apply to transactions occurring in taxable years beginning after the issuance of final regulations. Thus, for prior period intercompany transactions involving land, stock, or other nonamortizable property, the current rules may continue to apply for a substantial period. The general effective date is subject to an anti-abuse rule providing that the final regulations apply to transactions occurring after the proposed regulations are issued, if the transaction is engaged in or structured with a principal purpose to avoid the final regulations.
Current regulations

I. PURPOSES.

-13(a)(1). The purpose of intercompany accounting is to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

Proposed regulations

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II. DEFINITIONS.

1. Transactions.

-13(a)(1). An intercompany transaction (IT) is a transaction between corporations that are members immediately after the transaction.

-13(a)(2). A deferred intercompany transaction (DIT) is an IT that is also a sale or exchange, performance of capitalized

Proposed regulations

-13(b)(1). The distinction between ITs and DITs is eliminated. All transactions between corporations that are members immediately after the transaction are ITs subject to uniform rules. S is the provider of property or services, and B is the payor for property or services.

Significant effects

Identifying the purposes promotes consistent interpretation and discourages "creative" applications. See, e.g., Rev. Rul. 89-85 (so-called corporate CPR transactions) and -14(g) (so-called bump-and-strip transactions).

By eliminating the distinctions between ITs and DITs, the results for comparable transactions are unified. In general, the proposed regulations apply the DIT rules (rather than the IT rules) to determine the timing of S's restoration.
Current regulations

services, or incurrence of other capitalized expenditure.

Different restoration rules apply, depending on whether a transaction is an IT or DIT. Only transactions directly between members are ITs or DITs.

An IT or DIT cannot be retroactively rescinded (e.g., by merging S and B, or B retransferring the property back to S).

The definitions are largely by example. No guidance is provided for transactions straddling consolidated and separate returns or the treatment of related transactions.

2. S’s items and B’s items.

-13(b)(2). For ITs, S’s items are coordinated with B’s “corresponding items,” but the items are not

Proposed regulations

-13(h). Uniform rules apply, and anti-abuse rules (discussed below) prevent circumvention of the IT rules (e.g., through indirect transactions).

The same approach applies.

The same approach applies, although authority is provided for appropriate adjustments, and certain issues related to stock and debt are addressed.

Additional straddling problems are addressed in -76(b) (part of the investment adjustment regulations).

Significant effects

The IT system is a mandatory accounting system for intercompany transactions, and the anti-abuse rules prevent avoidance.

The treatment of certain basis adjustments as items (and certain items as not being items) is consistent
Current regulations

defined.

-13(c)(1) and (2). For DITs, S's deferred gain or loss is loosely defined, but includes: (i) amounts that S would not otherwise recognize under its method of accounting until a later year, and (ii) direct and indirect costs which are properly includible. The definition is largely by example.

III. INTERCOMPANY TRANSACTIONS.

1. Timing.

-13(b)(1). S's gain or loss is not deferred or eliminated.

-13(b)(2). If S or B takes into account its item before the other takes into account the corresponding item, the later item generally controls the earlier item.

Proposed regulations

are provided. S's items from intercompany transactions are always intercompany items and B's items are always corresponding items. In addition, certain basis adjustments are treated like items (and certain items are treated as not being items). [See the description below of the matching rule for B's recomputed corresponding items.]

Significant effects

with the treatment of "basis pops" under the investment adjustment regulations.

Current law is unclear regarding whether S defers its separate costs as well as its income from ITs, and how S is to compute the deferral (or acceleration) of intercompany profit or loss not yet recognized. Significant ambiguities remain unsettled.

The alternative of generally following the IT approach (i.e., later items control earlier items, rather than the DIT approach of B's items controlling S's items) would be possible for matching, but would raise additional issues.
Current regulations

If S or B has a separate return year, there appears to be no acceleration of either member's items.

2. Attributes.

No special rules are provided for attributes.

IV. DEFERRED INTERCOMPANY TRANSACTIONS.

1. Timing.

-13(c). S's deferred gain or loss is taken into account only when a specified restoration event occurs.

-13(d). S's restoration based on B's depreciation, amortization, or depletion of property purchased from S. For example, if S sells depreciable property to B, and B depreciates 10% of the property's total depreciable basis, S restores 10% of its deferred gain or loss.

-13(e). S's restoration

Proposed regulations

-13(c). The matching rule. B's corresponding items are taken into account under its accounting method, and S's intercompany items are taken into account to reflect the difference between: (i) B's corresponding items taken into account, and (ii) the corresponding items B would have taken into account if S and B were divisions of a single corporation (B's recomputed corresponding items). For example: if S sells $70 basis depreciable property to B for $100, and B has $10 of depreciation

Significant effects

regarding the treatment of acceleration events.

The matching rule is similar to the DIT timing rules. The numerous separate, mechanical DIT rules are replaced with the matching rule, which reflects the principles underlying the DIT rules. The matching rule is the principal source of single entity treatment for the timing and attributes of intercompany and corresponding items.

S and B are treated as divisions of a single corporation (and the IT as
**Current regulations**

Based on payments reported by B under the installment method from B's sale to a nonmember. If S sells an existing nonmember installment note to B, S's deferred gain is taken into account based on payments received by B.

-13(c)(7) (formerly -31(a)). B's basis in property is determined as if separate returns filed.

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**Proposed regulations**

(under section 168(i)(7), $4 with respect to the original $70 of basis, and $6 with respect to the new $30 of basis), S takes into account $6 of its $30 intercompany gain, to reflect the $6 difference between the $10 of depreciation B takes into account and the recomputed $4 of depreciation B would take into account if B had succeeded to S's $70 basis in an interdivisional transfer within a single corporation. Although B retains its own cost basis and accounting methods, a redetermination of B's character under the matching rule may affect B's timing under its accounting method. For example, if S's dealer activities with respect to property sold to B causes B's gain from reselling the property to be ordinary, B cannot report its gain on the installment method. See section 453(b)(2).

Numerous examples are provided.

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**Significant effects**

A transfer between divisions) only to the extent necessary to take the intercompany and corresponding items into account. The activities of both S and B are taken into account, rather than only S (as if the IT had not occurred) or B (as if the IT occurred with a carryover basis), but the activities of other members are not taken into account.

Although matching is different from the DIT rules, matching generally will not change the timing of most items under the DIT rules. However, there will be some timing affects, such as: (i) B's nonrecognition disposition outside the group does not restore S's gain, if B receives successor property and no nonmember reflects B's cost basis (e.g., a section 1031 exchange, but not a section 351 transfer), (ii) possible restoration...
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>No significant rules are provided for IT inventory transactions. Substantial ambiguity exists as to the application of the rules to these transactions.</td>
<td>13(e)(1). Simplifying rules are provided if S or B uses a dollar-value LIFO accounting method. For example, if B has an inventory increment for the year, S may assume that its sales to B for the year make up a pro rata portion of the increment (and if B has a decrement, a pro rata portion of the decrement). Alternatively, another method can be used (e.g., GAAP computations) if no unreasonable deferral results. S may compute its intercompany income or loss under any reasonable method.</td>
<td>if B's basis in the property is eliminated (e.g., an intragroup section 355 distribution, or attribute reduction under section 108(b)), (iii) no restoration from B's depreciation that is capitalized, and (iv) the benefit of S's percentage depletion in excess of basis is preserved. The simplified rules conform to the common practices under the current regulations, and reflect the inability to separately analyze each inventory transaction under dollar-value LIFO, as required by the DIT rules.</td>
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Current regulations

-13(f)(1). S's restoration based on the earliest of: (i) disposition of property outside the group (or abandonment), (ii) S or B ceases to be a member, (iii) for nonmember installment obligations, write-off satisfaction or disposition, (iv) for inventory, S's or B's separate return year or a write-down to market, (v) for nonmember obligations, satisfaction or worthlessness, (vi) for stock, a redemption or worthlessness, or (vii) if consolidated for less than 3 consecutive years, the common parent's separate return year.

Proposed regulations

-13(d). The acceleration rule. S's intercompany items are taken into account immediately, to the extent they cannot be taken into account under the matching rule in the group's consolidated taxable income to produce the effect of treating S and B as divisions of a single corporation.

Numerous examples are provided.

Significant effects

The acceleration rule is most analogous to current -13(f) because the most common acceleration events will be: (i) S or B becoming a nonmember, and (ii) B's nonrecognition disposition outside the group where the nonmember reflects B's cost basis (e.g., a section 351 or 721 transfer). This is because either: (i) intercompany or corresponding items will not be reflected in the group's consolidated taxable income, or (ii) because a single entity could not have affected the basis that the nonmember succeeds to (under section 362 or 723).

Although acceleration is different from the DIT rules, acceleration generally will not change the timing of most items under the DIT rules. However, there will be some timing affects, such as: (i) S's intercompany
<table>
<thead>
<tr>
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<th>Proposed regulations</th>
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</thead>
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<td>-13(f)(2). Exceptions to restoration for: (i) acquisition of entire group by another consolidated group, and (ii) liquidation of all remaining members into the common parent.</td>
<td>-13(j). The same approach applies. However, if the group is acquired; only the common parent and the parties to the IT must become members of the acquiring group.</td>
<td>item is restored at the time of the IT (even though nothing leaves the group) if the item is greater than B's possible corresponding items (e.g., if B buys property from S pursuant to section 1033 and its basis does not reflect S's gain, S's gain must be accelerated to the extent it exceeds any additional basis), (ii) restoration is required if S or B has a separate return year but remains an affiliate, regardless of how long consolidated returns have been filed, and (iii) ITs that are not DITs might not be restored under current law if S or B becomes a nonmember.</td>
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Continuing to require the common parent to be acquired effectively rejects the subgroup approach of only requiring S and B to be acquired. If S is deferring gain, accelerating restoration of the gain may be beneficial because of the...
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>-13(i).</strong> S's restoration based on increased or decreased deductions or basis recovery. There is substantial overlap between -13(1) and -13(d) (and perhaps -13(f)), but the relationship is not addressed. A &quot;basis recovery&quot; is not defined.</td>
<td><strong>No special rule needed.</strong></td>
<td><strong>resulting stock basis increase under §1.1502-32.</strong></td>
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<tr>
<td><strong>-13(o).</strong> Special bump-and-strip rules.</td>
<td><strong>No special rule needed.</strong></td>
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<tr>
<td><strong>1.267(f)-1T and -2T.</strong> Parallel rules applicable to losses or deductions from sales or exchanges between controlled group members. These rules may override the consolidated return rules. [Discussed below.]</td>
<td><strong>[Section 267(f), discussed below, remains an override on IT sales or exchanges at a loss.]</strong></td>
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<td><strong>2. Attributes.</strong></td>
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<td><strong>-13(c)(4)(i).</strong> The character and source of S's items and B's items are generally determined as if separate returns were filed. No</td>
<td><strong>-13(c) and (d). In addition to timing, the matching and acceleration rules generally conform the character and all other attributes of</strong></td>
<td><strong>By determining both timing and character on a single entity basis, the potential conflicts</strong></td>
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</table>
Current regulations

rules are provided for other attributes.

-13(c)(4)(ii). Gain or loss restored under -13(d) from depreciation (or under -13(f) from abandonment) is treated as ordinary income or loss.

-13(d)(3). If more than one kind of income or gain is deferred, the first gain restored under -13(d) is any deferred ordinary income.

-13(e)(3). The first gain restored under -13(e) is any deferred ordinary income.

-13(m)(1). If B disposes of the property outside the group, S’s deferred gain or loss is restored as if S had disposed of the property at the same time and manner as B. The relationship between -13(c)(4), -13(f), and -13(m)(1) is not addressed.

-13(m)(2). If B’s disposition outside the group is a nonrecognition transaction, -13(e) and (f)

Proposed regulations

intercompany items and corresponding items as if S and B were divisions of a single corporation. For example, if S sells investment property to B, but B holds the property as a dealer, whether the items of S and B are capital or ordinary depends on their character if S and B had been divisions of a single corporation.

Significant effects

between timing and character are eliminated and there is no need for an expanded list of special character rules similar to the DIT rules. Timing and character are sometimes interdependent. For example, holding securities as a dealer may result in mark-to-market accounting under section 475. Other times, whether a provision affects timing or character is unclear. For example, section 469 may be viewed as a timing rule for some purposes and a character rule for other purposes.

Only the activities of S and B are taken into account in determining the attributes of intercompany and corresponding items. Thus, attributes will generally not be an issue unless: (i) S or B is a dealer, but the other is not, (ii) characteristics other than ordinary-capital are relevant (e.g., built-ins under
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>apply rather than (-13(m)(1)).</td>
<td>(-13(c)(3)). Conforming the attributes of S’s and B’s items includes treating S’s items as noncapital, nondeductible amounts or excluded from gross income (if necessary). However, S’s income or gain generally can be excluded from gross income only to the extent B’s corresponding item is a deduction or loss that, in the taxable year taken into account, is permanently disallowed directly under a provision of the Code or regulations (or under section 311 from B’s distribution to a nonmember).</td>
<td>section 382(h)), (iii) B capitalizes its corresponding item, or (iv) B’s item is disallowed (e.g., under section 265) or otherwise eliminated (e.g., under section 332). The &quot;governor&quot; on the recharacterization of S’s income-gain, but not S’s losses-deductions, reflects concern with possible manipulation and &quot;mirror&quot; transactions, but may produce harsh results.</td>
</tr>
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Section 1239. The extent to which section 1239 applies to DITs is unclear. | Section 1239 does not apply to S’s intercompany income or gain taken into account under the matching
3. **Holding periods.**

-3(c)(1). The holding periods of S and B with respect to property transferred in an IT are aggregated.

4. **Effective dates.**

-3(l). The proposed rules generally apply to transactions occurring in taxable years beginning on or after the final regulations are filed.

An anti-abuse rule prevents transactions engaged in or structured on or after the filing of the proposed regulations from avoiding the final regulations, if there is a prohibited principal purpose.

**Significant effects**

rule, unless B's subsequent transaction is subject to section 1239. Section 1239 will apply under the acceleration rule.

The switch to aggregate holding periods conforms to the determination of attributes on a single entity basis.

Current law generally continues to apply to prior period DITs. Certain DITs, such as those involving land, stock, and other nonamortizing assets, may effectively lock-in the DIT rules in perpetuity.
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
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<tbody>
<tr>
<td>V. EXCEPTIONS TO -13.</td>
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<td>-13(c)(3). Permission may be requested to not defer gain or loss on DITs with respect to all or any classes of property. (The election does not apply for purposes of section 267(f).)</td>
<td>-13(e)(3). The same approach applies.</td>
<td>Because the election does not apply for section 267(f), it is generally not requested (unless, perhaps, if one member is subject to separate regulation and cannot benefit from single entity treatment). No generally applicable de minimis, ordinary course exception is provided other than simplifying inventory rules.</td>
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<td>-13(n). The DIT rules do not apply to the extent S's gain or loss is attributable to: (i) S's long-term contract with B, and (ii) arises from B's long-term contract with a nonmember.</td>
<td>-13(k). The same approach applies.</td>
<td>The continuing need for this exception may be studied as part of a section 460 project.</td>
</tr>
<tr>
<td>Proposed §1.263A(f)-2(f)(5). The -13 rules are overridden if S's interest income is from funds borrowed from a nonmember.</td>
<td>-13(k). The same approach applies.</td>
<td>The continuing need for this exception may be studied as part of the section 263A project.</td>
</tr>
<tr>
<td>-13(e)(2). Simplifying exceptions for reserve</td>
<td></td>
<td>The IT rules continue to apply to: (1) reserves</td>
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<td>Accounting. S’s change in a reserve for bad debts that is maintained under section 585 or 593 is generally taken into account on a separate entity basis (but see the special rules for bad debts with respect to intercompany obligations). If S’s accounting for providing insurance to B requires changing a reserve or similar item under section 805, 807, or 832, the IT is taken into account on a separate entity basis.</td>
<td>-13(j). The same approach applies.</td>
<td>with respect to intercompany obligations (discussed below), and (ii) reinsurance ITs.</td>
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VI. MISCELLANEOUS OPERATING RULES.

-13(c)(5). Adequate books and records must be kept.

-13(c)(6) and -13T(c). Successor rule for deferred amount. Deferred amounts are inherited by the member acquiring the greatest portion of S’s assets (by value). No generally applicable successor rule for property (although -13(1) and -13(m)(1) adopt successor property rules for

-13(j). More general successor rules are provided for items and property. | The expanded successor rules prevent "mirror" transactions, but create uncertainty where more than one member may be a successor. |
The regulations do not identify whether -13 and -14 are an accounting method. Private rulings have been inconsistent, but generally indicate that they may only be a method of keeping books and reporting. But see 9429001.

-13(a). The proposed rules state that they are an accounting method to the extent they affect the timing of items. Items taken into account may therefore be deferred or eliminated under other Code provisions.

-13(h). If a transaction is engaged in or structured with a principal purpose to avoid treatment as an IT, or to avoid the single and separate entity treatment that is the purpose of -13, adjustments must be made to carry out the purposes of -13.

Changes in application of the rules require consent of the Commissioner, and may require a section 481 adjustment.

Comparable anti-abuse rules have been included in most of the recent consolidated return projects.

Examples of avoidance include: (i) transacting with a partnership controlled by members, (ii) recognition transactions having a carryover basis effect, and (iii) transitory status as a member. An example of nonavoidance is a sale and leaseback with an unrelated nonmember. It is unclear whether nonrecognition ITs (e.g., under section 351) are ever an avoidance, or
### VII. Section 267(f).

Section 267(f) defers a loss or deduction from the sale or exchange of property between members of a controlled group (rather than disallowance under section 267(a)). In general, the rules conform to the IT principles, but they apply to controlled groups under section 1563, using 50% common ownership. These rules may override the consolidated return rules.

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<td>1. §1.267(f)-1T (controlled group members filing separate returns).</td>
<td>The basic approach of the current rules is retained, but simplified by more generally incorporating the IT rules and combining all of the rules under §1.267(f)-1.</td>
<td>The change will not affect most transactions. Section 267(f) only defers losses-deductions and has no affect on attributes. The ambiguities under the current rules are generally not resolved (e.g., if S and B are members of a controlled group, and B and B1 are members of a different controlled group, should S's sale to B1 be treated the same as back-to-back transactions between S, B, and B1).</td>
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<td>-1T(c)(1). The DIT rules generally apply.</td>
<td>-1(a), (b), and (c). The same approach applies.</td>
<td>transacting with a nonmember corporation (e.g., a 76% subsidiary) may be treated as an IT.</td>
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<tr>
<td>-1T(c)(2). The -13(c)(3) election out does not apply.</td>
<td>-1(a)(2). The same approach applies.</td>
<td>This is the most significant change to the section 267(f) rules. The current regulations transform S's disallowed loss into B's increased basis in the property, and this shift produces anomalies. The section 267(f) rules reflect: (i) concerns with the amount of the loss, and (ii) &quot;cherry picking&quot; of losses. No abuse exists under the proposed regulations if the stock basis adjustment from S's loss or deduction causes a corresponding increase in P's gain (or reduced loss) from its disposition of</td>
</tr>
<tr>
<td>-1T(c)(4), (5), and (9). Continued deferral, provided S and B remain in a controlled group relationship with each other (regardless of separate returns, or remaining members of a particular controlled group).</td>
<td>-1(b)(3). The same approach applies.</td>
<td></td>
</tr>
<tr>
<td>-1T(c)(6) and (7). If S ceases to be a member, the loss is never restored to S. Instead, B's basis in the property is increased to reflect the amount of S's disallowed loss.</td>
<td>-1(g). The loss is taken into account unless the transaction violates the anti-abuse rule (discussed below). If the rule is violated, the loss is disallowed (rather than being shifted to B).</td>
<td></td>
</tr>
<tr>
<td>Current regulations</td>
<td>Proposed regulations</td>
<td>Significant effects</td>
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<tr>
<td>-----------------------------------------------------------------------------------</td>
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</tr>
<tr>
<td><strong>-1T(c)(8).</strong> No restoration on sale to a section 267(b) (but not section 267(f)) related person.</td>
<td><strong>-1(c)(2).</strong> The same approach applies.</td>
<td>the S stock.</td>
</tr>
<tr>
<td><strong>-1T(d).</strong> Adjustments for restoration from depreciation.</td>
<td><strong>-1(f).</strong> The same approach applies.</td>
<td></td>
</tr>
<tr>
<td><strong>-1T(e).</strong> Special rule for receivables.</td>
<td><strong>-1(d) and (e).</strong> The same approach applies.</td>
<td></td>
</tr>
<tr>
<td><strong>-1T(f) and (g), and -1 (h). Foreign provisions.</strong></td>
<td><strong>-1(d) and (e).</strong> The same approach applies.</td>
<td></td>
</tr>
<tr>
<td>2. §1.267(f)-2T (controlled group members filing consolidated returns).</td>
<td></td>
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</tr>
<tr>
<td><strong>-2T(c).</strong> The -13(c) (3) election out does not apply.</td>
<td>No special rule needed.</td>
<td></td>
</tr>
<tr>
<td><strong>-2T(d).</strong> Adjustments if S or B ceases to be a consolidated group member, but remains a controlled group member.</td>
<td>No special rule needed.</td>
<td></td>
</tr>
<tr>
<td><strong>-2T(e).</strong> Adjustments if the property is disposed of outside the consolidated</td>
<td>No special rule needed.</td>
<td></td>
</tr>
<tr>
<td>Current regulations</td>
<td>Proposed regulations</td>
<td>Significant effects</td>
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<tr>
<td>group, but not the controlled group.</td>
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<tr>
<td>-2T(f). No restoration on sale to a section 267(b) (but not section 267(f)) related person.</td>
<td>No special rule needed.</td>
<td></td>
</tr>
<tr>
<td>-2T(g). Adjustments for restoration from depreciation after S or B ceases to be a consolidated group member, but remains a controlled group member.</td>
<td>No special rule needed.</td>
<td></td>
</tr>
<tr>
<td>-2T(h). Adjustments for restoration from depreciation after property is disposed of outside the consolidated group, but not the controlled group.</td>
<td>No special rule needed.</td>
<td></td>
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<tr>
<td>-2T(j). Special rule for receivables after deconsolidation.</td>
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<tr>
<td>-1(g). If a transaction is engaged in or structured with a principal purpose to avoid the application of section 267(f), or to affect the timing of deductions or losses (or tax liability) under section 267(f),</td>
<td></td>
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</tr>
</tbody>
</table>
VIII. ACCOUNTING METHODS.

$1.1502-17 (a). Each member is generally permitted to determine its own method of accounting as if separate returns were filed.

IX. SPECIAL INVENTORY ADJUSTMENT.

$1.1502-18. A special adjustment to reflect separate return year intercompany profit from inventory transactions, but

Current regulations

Proposed regulations

adjustments must be made to carry out the purposes of section 267(f).

-17(c). Although each member generally determines its own method of accounting, if B directly or indirectly acquires an activity of S or undertakes S's activity, with the principal purpose to avail the group of an accounting method that would be unavailable without securing consent from the Commissioner had S and B been divisions of a single corporation, B must use S's accounting method or secure consent from the Commissioner for a different method.

Significant effects

The proposed rule prevents ITs (including those under section 351) from circumventing section 446(e).

The special inventory adjustment is eliminated. Any remaining unrecovered deduction under the rules is recovered in the first

The adjustment appears to reflect concern for Federal revenue loss from a group's initial filing of a consolidated return.
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>only if the members had been</td>
<td>consolidated return year</td>
<td>Few affiliates appear to file separate</td>
</tr>
<tr>
<td>affiliates filing separate returns</td>
<td>beginning on or after the date final</td>
<td>returns or to comply with the adjustment.</td>
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<tr>
<td>and then elected to file</td>
<td>regulations are filed.</td>
<td>Thus, no significant revenue appears to</td>
</tr>
<tr>
<td>consolidated returns</td>
<td></td>
<td>actually be in issue.</td>
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<td>X. §1.1502-80.</td>
<td></td>
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<tr>
<td></td>
<td>-80(g). Section 1031 does not apply</td>
<td>Although section 1031(f) eliminates some</td>
</tr>
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<td></td>
<td>to any IT subject to the new rules.</td>
<td>concerns, remaining basis shifting</td>
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<td>opportunities prompted complete</td>
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<td></td>
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<td>elimination.</td>
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</table>
Stock of Members

Introduction

In addition to the basic rules for ITs and DITs, special rules are provided under current §§1.1502-14 and 1.1502-14T for distributions with respect to member stock. For example, the basic DIT rules apply to S’s gain or loss from its sale of the stock of a lower-tier member to B. The special rules apply, however, if the lower-tier member distributes a dividend to S or liquidates. The special rules treat the members more like a single entity (e.g., to eliminate S’s section 301(c) income from the lower-tier member’s distribution without regard to the dividends received deduction, as well as S’s gain or loss from the liquidation of a lower-tier member). See also §§1.1502-32 and 1.1502-33 (stock basis and E&P adjustments), 1.1502-80(b) (non-applicability of section 304 to intercompany transactions), 1.1502-80(c) (deferral of section 165(g) stock loss), and 1.1502-80(d) (non-applicability of section 357(c) to intercompany transactions).

The proposed regulations generally unify the basic rules for all intercompany transactions. Thus, many of the distinctions drawn by the current regulations between ITs, DITs, and stock transactions are eliminated. For example, if S sells the stock of a lower-tier member to B, S’s stock gain or loss is taken into account under the matching and acceleration rules applicable to all IT sales. The basic rules are no longer divided between §1.1502-13 and §1.1502-14, and section 267(f) applies more uniformly to stock transactions.

Nevertheless, the proposed regulations also provide special rules for stock of members. The rules under proposed §1.1502-13(f) are necessary to reduce the conflicts between preserving the location of income arising within a group and treating the members as a single entity. The proposed deferred sale system reflects the need to preserve the location of items from intercompany transactions. Thus, S’s gain or loss from transactions with respect to the stock of lower-tier members must be identified and allocated to S. However, the lower-tier member’s stock generally has no value independent of its underlying assets, and the treatment of stock as a separate asset is generally inconsistent with the treatment of members as a single entity because any gain or loss with respect to the stock is not reflected in the basis of the lower-tier member’s assets.

Some commentators have argued that simplification and a clearer reflection of
consolidated taxable income would result if the separate existence of member stock were disregarded. However, the general need to preserve the location of items within a group, and the problems resulting from more expansive single entity treatment of stock transactions (e.g., adapting the distribution and reorganization rules of Subchapter C of the Code), may actually result in greater complexity. See, e.g., Notice 94-49, 1994-18 I.R.B. 8. Many of the conflicts ultimately may be addressed in a future regulation project that might treat intercompany transactions involving member stock as transactions involving the underlying assets. See, e.g., section 336(e). Again, this approach may spawn complexity because the members inevitably will have numerous separate gain and loss assets and lower-tier subsidiaries, and traditional government concerns (e.g., the liquidation-reincorporation doctrine and the scope of "D" reorganizations) will have to be addressed.

The special stock rules under the proposed regulations address the aspects of stock transactions that reach perhaps the most inconsistent results with single entity treatment. Most of the problems with intercompany stock transactions arise if a taxable intercompany transaction (e.g., S’s sale of lower-tier member stock to B) is followed by a nonrecognition intercompany transaction involving the same stock and in which the stock is eliminated or its basis is redetermined (e.g., the lower-tier member’s liquidation subject to section 332, or B’s distribution of the stock to a higher-tier member subject to section 355). Similar problems are presented if a member acquires its own stock in an intercompany transaction because the stock is thereafter subject to nonrecognition under section 1032. These transactions are problematic for intercompany accounting because of the inability to continue matching S’s gain with subsequent stock basis recovery.

Because the effective date of the proposed regulations is generally for transactions occurring in taxable years beginning after the issuance of final regulations, the proposed regulations will apply to existing member stock that is involved in subsequent transactions. Thus, any relief from double taxation under the proposed rules will only apply prospectively. The general effective date is subject to an anti-abuse rule that applies the final regulations to transactions occurring after the proposed regulations, if the transaction is engaged in or structured with a principal purpose to avoid the final regulations. Consider, for example, the treatment under the final regulations of a 1994 distribution by S to another member of that member’s stock (in order to apply the analysis of G.C.M. 39,608).
### Current regulations

#### I. NONLIQUIDATING DISTRIBUTIONS.

1. **Amount.**

   -14(a)(3). Former section 301(b)(1)(B) (repealed 1988) determines the amount of S's property distribution to P as the lesser of basis or fair market value.

### Proposed regulations

- **No special rule needed.**

- Under section 301(b), the amount of P's dividend from S is the fair market value of property received.

### Significant effects

- The special Code rules for intercorporate dividends have been repealed. Fair market value conforms to the results in the separate return context, preserves the location of items, and conforms the treatment of IT distributions and IT sales. Because of the repeal of section 301(b)(1)(B), the impact of current -14(a)(3) is unclear.

2. **Basis.**

   -14(a)(4) (formerly -31(b)(1)). Former section 301(d)(2)(B) (repealed in 1988) determines P's basis in property received from S as equal to S's adjusted basis increased by the amount of any section 311(b)

- **No special rule needed.**

- Under section 301(d), P's basis in property received from S is the property's fair market value.

- A fair market value basis conforms to the results in the separate return context, preserves the location of items, and conforms the treatment of IT distributions and IT sales. Because of the
**Current regulations**

Gain recognized. But see -14(g)(2), Ex.2 (fair market value basis if gain property).

3. **Timing, attributes, and holding period.**

-14(a)(5). Under an "entitlement rule," a distribution from S is taken into account for all Federal income tax purposes when P becomes entitled to it (generally on the record date), or earlier if required under the Code (e.g., under section 305).

-14(e). For in-kind distributions, no special attribute or holding period rules are provided.

**Proposed regulations**

-13(f)(2)(iv). The same approach applies.

-13(c)(1) and (d). Under the general matching and acceleration rules, all attributes and holding periods are determined by treating the distributor and distributee as divisions of a single corporation.

**Significant effects**

Repeal of section 301(d)(2)(B), the impact of current -14(a)(4) is unclear.

The proposed regulations conform to recent amendments introduced by revisions to the investment adjustment rules. The entitlement rule expands the approach of former -32(k). No special rules may be needed for ITs.

Under the current regulations, only the holding period for distributed loss property tacks under section 1223 (because of the carryover basis). Under the proposed regulations, holding periods tack for all intercompany transactions.
Current regulations

4. Distributee.
   a. Dividend.

-14(a)(1). P "eliminates" the portion of the distribution from S which is a dividend under section 301(c)(1).

   b. Nondividend.

-14(a)(2). P has no gain from the portion of the distribution for S that is described in section 301(c)(2) or (3). Instead,

Proposed regulations

-13(f)(2)(ii). S's distributions to P are "not included in P's gross income." If S is a subsidiary, P can exclude the distribution only if it reduces its basis in the S stock under -32 by a corresponding amount. No similar requirement applies if the distribution is from the common parent to a subsidiary (i.e., circular ownership).

Significant effects

The change from "elimination" to "not included in gross income" conforms to more general Code terminology. The requirement of a negative stock basis adjustment prevents future dividend straddle opportunities. It is difficult to reconcile either approach to dividends with special case applications in rulings. See, e.g., Rev. Rul. 72-230 (the effect of dividend elimination on sourcing for purposes of section 861(a)(2)), and Rev. Rul. 79-60 (the effect of dividend elimination on personal holding company status).

The same "exclusion from gross income" applies to both the dividend and nondividend portions of a distribution.
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>P reduces its S stock basis by the amount of the distribution, and any reduction in excess of basis becomes (or increases) an excess loss account.</td>
<td>-13(f)(2)(iii). Section 311(b) is expanded to cover IT losses as well as IT gains. S's gain or loss from the distribution is taken into account under the matching and acceleration rules. For example, if S distributes property to P at a loss, and P subsequently resells the property, S's loss is taken into account. However, if P distributes it to a nonmember at a further loss, S's loss is treated as a nondeductible, noncapital amount (because, as a single entity, the group's distribution of loss property to a nonmember remains subject to section 311(b)).</td>
<td>By expanding the application of section 311(b) to cover IT losses, the location of the loss is preserved in S. This conforms the treatment of S's distribution to P, with S's sale of property to P followed by S's distribution of the proceeds to P.</td>
</tr>
</tbody>
</table>

5. **Distributor.**

-14(c)(1) and -14T(a). Any gain recognized on S's distribution to P is deferred. S is treated as the selling member and P as the purchasing member with the distribution being treated as a DIT. Because the distributions are subject to section 311(a), no loss is recognized. However, -14(a)(4) (formerly -31(b)) preserves the loss by having P succeed to S's basis in the distributed property.
### Current regulations

#### II. REDEMPTIONS.

The rules for redemptions generally are similar to the rules for section 301 distributions.

1. **Shareholder.**

- **-14(b).** Generally no gain or loss is recognized by P from S’s redemption of its stock. If gain or loss is recognized by P (e.g., because S distributes only cash), it is deferred and taken into account by analogy to the excess loss account rules. (The basis rules formerly under -31(b)(2) are now under -14(b)(4).)

- **-13(f)(1)(vi).** If gain or loss previously recognized and deferred on the stock, it is taken into account on the redemption.

- **-14(e)(1).** The character of deferred gain or loss is generally determined as if separate returns were filed.

### Proposed regulations

- **-13(c)(1) and (d).** Under the matching and acceleration rules, all attributes and holding periods are determined by

### Significant effects

Because of the section 318 attribution rules, most redemptions within a group will be treated under section 302(d) as distributions to which section 301 applies. Thus, the redemption rules rarely apply. The one likely exception to section 301 treatment is if S owns common parent stock that is redeemed (e.g., the redemption could be a complete termination under section 302(b)(3)). Deferral of any shareholder gain is not possible under the proposed rules (conforming the treatment of redemptions and distributions of stock).
<table>
<thead>
<tr>
<th><strong>Current regulations</strong></th>
<th><strong>Proposed regulations</strong></th>
<th><strong>Significant effects</strong></th>
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</table>

<table>
<thead>
<tr>
<th><strong>2. Issuer.</strong></th>
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<tbody>
<tr>
<td>-14(c)(1) and -14T(a). The rules that apply to the distributor for dividends apply in the same manner for redemptions. Thus, S is treated as the selling member and P is treated as the purchasing member, and the redemption is treated as a DIT resulting in potential section 311(b) gain that is deferred.</td>
</tr>
<tr>
<td>-14(c)(1) and -14T(a). The rules that apply to the distributor for dividends apply in the same manner for redemptions. Thus, S is treated as the selling member and P is treated as the purchasing member, and the redemption is treated as a DIT resulting in potential section 311(b) gain that is deferred.</td>
</tr>
<tr>
<td>No special rules are provided. S's gain (or loss under expanded section 311(b)) from the distribution of property is taken into account under the matching and acceleration rules.</td>
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</table>

<table>
<thead>
<tr>
<th><strong>III. LIQUIDATING DISTRIBUTIONS.</strong></th>
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<tbody>
<tr>
<td><strong>1. Distributee.</strong></td>
</tr>
<tr>
<td>-14(b). Generally no gain or loss is recognized by P on its S stock. If gain or loss is recognized by P (because S distributes only cash) in a liquidation to which section 331 applies, it is not deferred.</td>
</tr>
<tr>
<td>No special rules are needed for liquidating distributions. The Code provisions apply, and gain or loss is taken into account under the matching and acceleration rules. If gain or loss is recognized on the liquidating</td>
</tr>
</tbody>
</table>

33
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>-14(b)(4) (formerly -31(b)(2)). To the extent gain or loss is not recognized by P in a liquidation to which section 331 applies, the gain or loss inherent in P's S stock is preserved by P applying its basis in the former S stock to the distributed property (rather than section 334 applying.)</td>
<td>distribution, it is not deferred, and any stock loss is treated as a noncapital, nondeductible amount.</td>
<td>No longer any nonrecognition of gain or loss, so no special basis rules are needed.</td>
</tr>
<tr>
<td>-14(e)(1). The character of deferred gain or loss is generally determined as if separate returns were filed.</td>
<td>-13(c)(1) and (d). Under the matching and acceleration rules, all attributes and holding periods are determined by treating S and P as divisions of a single corporation.</td>
<td>The same approach applies.</td>
</tr>
<tr>
<td>-34. Special aggregation rules for determining the applicability of section 332 to P (but not the applicability of section 337 to S).</td>
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</tbody>
</table>
Current regulations

2. Distributor.

-14(c)(2) and -14T(a). If gain or loss is recognized by S under section 336, it is deferred and taken into account as if it were recognized in a DIT.

-14(e)(2), -14T(a), and -13T(c). The member acquiring the greatest portion of S's assets (by fair market value) inherits the deferred gain or loss.

Section 337(c) prevents -34 from applying to determine the applicability of section 337.

Proposed regulations

No special rules are needed. Gain or loss recognized under section 336 is taken into account under the matching and acceleration rules.

-13(j). The generally applicable successor rules apply.

The same approach applies.

Significant effects

-13(f)(4). If a member acquires its own stock in an IT, its basis in that stock is treated as eliminated, causing the transferor's gain or loss from the transfer to be taken into account.

The modified approach is intended to prevent "mirror" transactions.

GCM 39,608 offers effectively indefinite deferral of gain if S distributes P stock to P. However, if S has a loss
Current regulations

shares received (or when P or S ceases to be a member).

Proposed regulations

-13(f)(3). Boot in an IT reorganization is treated as received in a separate distribution to which section 301 applies, rather than subject to section 356. An IT reorganization does not include a reorganization in which a corporation becomes a nonmember (or ceases to be a member).

Significant effects

in the stock, S can sell it to a nonmember and recognize the loss. Under the proposed regulations, S’s gain or loss is not deferred (and any loss is treated under the general rules as a noncapital, nondeductible amount because of the subsequent application of section 1032).

The application of current -14 to section 356 dividends is unclear. See, e.g., Rev. Rul. 72-498. By applying section 301: (i) the results are clarified and distributions before, during, and after reorganizations are treated similarly, (ii) all section 301(c) income is "excluded from gross income" with a corresponding negative stock basis adjustment under -32, and (iii) the loss disallowance rules of
VI. INTERCOMPANY TRANSFER OF MEMBER STOCK FOLLOWED BY NONRECOGNITION IT.

1. S sells or distributes T stock to B, and T is then liquidated.

-13(f)(1)(i) and (vi). S’s gain or loss is taken into account when T liquidates.

-13(c) and (d). S’s gain or loss is taken into account because matching S’s gain with T’s stock is no longer possible.

-13(f)(5)(ii). If section 332 applies to T’s liquidation and B retransfers T’s assets to a new member (new T), subject to certain limitations, the reincorporation is likely to be treated as pursuant to the same plan or arrangement as the liquidation so that S’s gain will not be taken into account. Instead, S’s

Significant effects

sections 361(c) and 355(c) are replaced with the IT rules expanding the application of section 311(b) to loss.

These ITs have received significant attention, and the scope of the issue was expanded by -80(b) (non-applicability of section 304 to ITs of T stock). If T’s assets reflect the same gain or loss taken into account with respect to the T stock, gain or loss is duplicated. Single entity treatment should eliminate S’s gain or loss, or coordinate the stock gain or loss with the corresponding T asset gain or loss. The proposed regulations
S's gain or loss is also taken into account if the liquidation is deemed to occur under section 338(h)(10) as a result of a qualified stock purchase of the T stock by a nonmember.

Current regulations

Proposed regulations

gain is taken into account by reference to the stock of new T. New T must be formed and the relief elected by the group within specified time periods. (Comparable rules apply if B merges downstream into T.)

-13(f)(5)(iii). Different relief is provided if the liquidation is deemed to occur as a result of a section 338(h)(10) transaction. S takes its intercompany income or gain into account under the general rules. Subject to certain limitations, B is also treated as recognizing any loss or deduction if it would recognize if section 331 applied to the deemed liquidation of T (determined after adjusting the T stock basis under § 1.1502-32 for its asset gain).

Significant effects

provide limited, administrable relief from the potential for gain duplication. (Any net stock loss will be recharacterized as a noncapital, nondeductible amount under the general rules, but LDR is likely to have applied in any event.)

S's stock gain may be offset by B's stock loss in determining consolidated taxable income, because -20(a)(4) permits netting of the gain and loss from T stock. The positive -32 adjustment for T's asset gain will also be offset by B's stock loss. In general, the relief requires the group to recognize the greater of S's stock gain or T's asset gain. Additional relief eventually may be provided in a separate project under section 336(e).
Current regulations

2. S sells or distributes T stock to B, and B then distributes the T stock to P in an IT to which section 355 applies.

-13(f), -14(c) (1), and -14T. S's gain or loss is not taken into account as a result of B's distribution because the T stock remains within the group.

Proposed regulations

-13(c) and (d). S's gain or loss might be taken into account because the adjustments to the T stock's basis under section 358 may result in an inability to match the stock basis with S's gain.

-13(f) (5) (iv). The group may avoid any immediate restoration by electing to treat B's distribution as subject to section 301 and 311 rather than section 355.

Significant effects

Because the matching and acceleration rules permit deferral only to the extent that matching remains possible, a section 355 IT may result in immediate gain.

The inability to match following a section 355 transaction is analogous to the problem with a section 332 liquidation. The election facilitates further matching with S, by converting the section 355 IT into a recognition IT that permits further matching, but additional gain or loss will be recognized by B.
OBLIGATIONS OF MEMBERS

Introduction

In addition to the basic rules for ITs and DITs, special rules are provided under current §1.1502-14(d) for transactions with respect to member obligations. For example, the basic IT rules apply to S's interest income and B's interest deductions on an intercompany debt. The special rules apply, however, if S sells the debt to a nonmember. The special rules enhance the treatment of S and B as a single entity by generally deferring S's gain or loss and taking it into account over the remaining term of the debt. In effect, the deferred amount is reflected in consolidated taxable income in a manner similar to the original issue discount or amortizable bond premium rules that existed under the Code when §1.1502-14(d) was adopted. (If S had sold the debt to another member, the gain or loss generally would be deferred and not taken into account until the debt is cancelled or redeemed.) Related-party obligations are often subject to enhanced single entity treatment under the Code. See, e.g., section 108(e)(4) (a single entity approach for related-party acquisition of debt), 163(j)(6)(C) (single entity treatment for earnings stripping rules), and 7701(f) (related-party financing arrangements). Single entity treatment has also been adopted under regulations in particular areas. See, e.g., proposed §1.263A(f)-2(f)(5) (single entity treatment to determine interest capitalization).

The proposed regulations apply the basic matching and acceleration rules to obligations of members. For example, S's interest income and B's interest deductions are taken into account under the matching rule. The basic rules are no longer divided between §1.1502-13 and §1.1502-14(d). In addition, however, the proposed regulations provide special rules for member obligations. The rules of proposed §1.1502-13(g) are necessary because member obligations generally have no value independent of the issuer's underlying assets. Moreover, members have a virtually unlimited capacity to create obligations between each other and thereby potentially affect consolidated taxable income. Consequently, even greater single entity treatment is necessary for member obligations than for other assets or for member stock.

Proposed §1.1502-13(g) provides special rules for two categories of transactions: (i) transactions in which an intercompany obligation becomes a nonintercompany obligation (or remains an intercompany obligation but gain or loss is realized with respect to it), and
(ii) transactions in which a nonintercompany obligation becomes an intercompany obligation. In both cases, the obligation generally is deemed to be satisfied and, if it remains outstanding, to be reissued. There are, however, differences as to how the transactions are deemed to occur.

The effect on consolidated taxable income of transactions in the first category is analogous to the effect under current §1.1502-14(d). The net gain or loss is reflected in consolidated taxable income in a manner consistent with time value of money principles. However, rather than deferring S’s gain or loss from the sale of B’s debt to a nonmember, the proposed regulations immediately take into account the gain or loss, and also cause B to take into account an offsetting loss or gain as if B had redeemed the debt immediately before S’s sale. The special rules require the offsetting gains and losses to match in character. Thereafter, the debt is deemed to be reissued by B directly to the nonmember at an equivalent premium or discount that is taken into account under the Code in accordance with time value of money principles (e.g., as original issue discount). The nonmember must also treat B’s debt as a newly issued obligation with premium or discount.

The approach of the proposed regulations more accurately adjusts the stock basis of S and B each year under §1.1502-32, and is closer to the results under common law principles for debtors and creditors in a parent-subsidiary relationship. See also §§1.61-12 and 1.301-1(m). The approach in many respects treats B’s debt as first existing only after it is sold by S to the nonmember (rather than as an existing debt that the nonmember holds subject to market discount or premium).

The effect on consolidated taxable income of transactions in the second category is similar in many respects to the treatment of B under section 108(e)(4). B is deemed to retire its obligation immediately after the obligations becomes an intercompany obligation. Because section 108(e)(4) is an anti-abuse rule, however, it does not provide adequate single entity treatment of members. Consequently, the proposed regulations apply to cases beyond the scope of section 108(e)(4) (e.g., the acquisition of debt at a premium, and any case in which a related, nonmember corporation holding B’s debt becomes a member). The deemed satisfaction and reissuance under the proposed rules applies to both the issuer and the holder, and the character of their respective items under the Code is not modified. Consequently, the corresponding amounts of gain and loss may not match in character in this category of deemed transactions. The amount at which an obligation is deemed to be satisfied is determined under §1.108-2.
The proposed regulations provide for exceptions to the deemed satisfaction and reissuance treatment in both categories. For example, the treatment will not apply to certain securities dealer transactions, or to cases where the treatment has no significant effect on any person's Federal income tax liability for any year.

The single entity treatment of obligations under the proposed regulations may not reflect the policies underlying particular Code provisions. For example, proposed §§1.446-4(e)(9) and 1.1221-2(d) permit an election to apply separate entity treatment for certain intercompany hedging transactions. Because hedge accounting may coordinate an intercompany item with an item from a transaction with a nonmember, hedge accounting may conflict with intercompany accounting and separate entity treatment may more clearly reflect income in certain cases. On the other hand, even greater single entity treatment is required under proposed §1.263A(f)-2(f)(5) to properly identify the amount of interest to be capitalized in connection with related-party transactions. In general, however, the single entity treatment of the proposed regulations addresses most of the issues and eliminates the need for certain Code provisions. For example, proposed §1.1502-80(f) provides that the section 163(e)(5) "applicable high yield discount obligation" (or AHYDO) rules are not applicable to intercompany transactions. Additional areas must continue to be studied on a case-by-case basis.

Because the effective date of the proposed regulations is generally for transactions occurring in taxable years beginning after the issuance of final regulations, the proposed regulations will apply to existing member obligations that are involved in subsequent transactions. The general effective date is subject to an anti-abuse rule that applies the final regulations to transactions occurring after the proposed regulations, if the transaction is engaged in or structured with a principal purpose to avoid the final regulations. Consider, for example, the treatment under the final regulations of a 1994 acquisition by the group of the stock of a nonmember, related party that is a creditor of B (in order to avoid the expansion of section 108(e)(4) principles).
## Current regulations

### I. DEFINITIONS.

-14(d) applies to "obligations" of another member. No definitions are provided.

### II. INTEREST, DISCOUNT, AND PREMIUM.

-13(a)(1) and -14(d)(5). Currently deducted amounts are taken into account under the IT rules.

-13(a)(2) and -14(d)(5). Capitalized amounts are taken into account under the DIT rules.

## Proposed regulations

-13(g)(2). An intercompany obligation to which the special rules apply is any (i) instrument constituting indebtedness under general Federal income tax principles, (ii) security defined in section 475(c)(2)(D) or (E), and (iii) comparable security with respect to commodities.

Interest and premium are taken into account under the basic matching and acceleration rules.

## Significant effects

The current regulations appear to have been written with only conventional debt instruments in mind. The expanded proposed definition does not include ordinary course executory arrangements, such as supply and employment contracts.
### Current regulations

III. TRANSACTIONS INVOLVING INTERCOMPANY OBLIGATIONS.

1. Timing.
   
a. Realization of gain or loss from an intercompany obligation.

-14(d)(1). A creditor member's recognized gain or loss (including bad debt deductions and additions to reserves) is deferred. See, e.g., Rev. Rul. 76-430 (deferral of bad debt reserve deduction).

-14(d)(2) and (3). The deferred amount is taken into account when the debt leaves the group or, if earlier, by analogy to the excess loss account rules.

-14(f). Debt does not leave the group solely by reason of the group's termination from the acquisition of the common parent's stock or assets.

### Proposed regulations

-13(g)(3). Both the debtor and creditor members treat the intercompany obligation as satisfied and reissued for all Federal income tax purposes if either party realizes gain or loss (including bad debt deductions). The satisfaction and reissuance occur immediately before the realization event, at an amount reflecting the realized gain or loss. For example, if S sells B's $100 debt for $90, the satisfaction is for $90, and the new debt is issued for $90 with a $100 stated redemption price. The timing and character of S's $10 loss and B's $10 gain must conform. Sections 354

### Significant effects

Gain or loss is immediately reflected in stock basis and E&P, rather than deferred. This better reflects the economics of the obligation. (If S and B are in a parent-subsidiary relationship, this stock basis effect may already be the common law.) The proposed rule applies equally to all intercompany obligations, to both debtor and creditor realization events, and to both realized and recognized gain/loss. The deemed reissuance results in OID or premium that is taken into account under the applicable Code rules.
Current regulations

Proposed regulations

and 1091 do no apply to the satisfaction and reissue.

Exceptions to satisfaction and reissue: (i) if the obligation became an intercompany obligation subject to an exception to -13(g)(4) (e.g., S is a securities dealer), (ii) if loss is taken into account from a section 585 or 593 reserve, and (iii) if there will be no significant effect on the Federal income tax liability of any person for any year.

Significant effects

If a member is subject to section 475, the proposed rules may result in complexity because of annual OID/premium computations. See also proposed §§1.446-4(e)(9) and 1.1221-2(d) for elective relief for hedging transactions.

The "no significant effect" exception is likely to apply only if both the debtor and creditor are simultaneously transferred between consolidated groups.

b. An intercompany obligation becomes a nonintercompany obligation.

-14(d)(2). An Obligation leaving the group does not, alone, have any effect. S's deferred gain or loss from the sale of B's debt to a nonmember (or its prior sale to a member that later becomes a nonmember or that resells to a nonmember) is

-13(g)(3). An intercompany obligation is deemed to be satisfied and reissued if it becomes a nonintercompany obligation. If no gain or loss is realized when it becomes a nonintercompany obligation (e.g., if S or B becomes a nonmember), the

Because the deemed reissue results in OID or premium (rather than market discount) under the Code, the obligation is effectively treated as first existing once it is outside the group. Thus, while the current rules

45
<table>
<thead>
<tr>
<th><strong>Current regulations</strong></th>
<th><strong>Proposed regulations</strong></th>
<th><strong>Significant effects</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>taken into account ratably over the debt's remaining life once it leaves the group.</td>
<td>satisfaction and reissuance are at fair market value.</td>
<td>only apply if there was prior recognized gain or loss, the proposed rules apply in all cases of an intercompany obligation becoming a nonintercompany obligation. Potential problems include fungibility of B's debt held by S with B's other debts, etc.</td>
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</table>

**c. Other restoration events.**

-14(d)(3). Complete restoration of any remaining deferred gain or loss on the earliest of: (i) S leaving the group, (ii) B's stock being treated as disposed of under the excess loss account rules (e.g., if the group ceases filing consolidated returns or B becomes worthless), and (iii) the debt being redeemed or cancelled.

| | No special rules are provided. (The deemed satisfaction and reissuance equally address the additional cases). |
| | |
| | -13(g)(5). Unlike the general proposed rules, amounts attributable to reserve deductions on |
| | |

Deferral of the creditor's reserve loss conforms to the current rules. The creditor's special reserve
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
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<tbody>
<tr>
<td></td>
<td><strong>d. Special rule for tax-free acquisitions.</strong></td>
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<tr>
<td>-14(d)(4). Special restoration rules for deferred gain or loss from redemption or cancellation of intercompany debt acquired in an &quot;exchanged basis&quot; transaction (e.g., the treatment of securities under section 351 before 1989).</td>
<td>intercompany debt are deferred and taken into account when the debt is charged off.</td>
<td>accounting does not reflect the value of any particular debt and should not affect the income of the other members.</td>
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<td></td>
<td>No special rules are provided.</td>
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<tr>
<td>2. Attributes.</td>
<td></td>
<td>Code amendments have generally eliminated these transactions.</td>
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<tr>
<td>-14(e)(1). Character and source are determined at the time of the transaction as if separate returns were filed.</td>
<td>-13(g)(3). The attributes of the gain and loss of the parties from the deemed satisfaction must conform under the basic matching rule.</td>
<td>Conformity of attributes prevents whipsaw. The effect of the deemed satisfaction is to reflect the economics of the obligation in stock basis and E&amp;P (and its initial existence as a nonintercompany obligation), but no net amount is reflected in the group's income. The</td>
</tr>
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</table>
satisfaction and reinsurance. 1091 do no apply to the
all cases, sections 354 and
reinsurance is required.
Satisfaction and reinsurance may be
an intercompany obligation.
Immedately after it becomes
immediate satisfaction. 1091 does not apply to
and reissued for all Federal
the obligation as satisfied
and reinsurance members treat
-13(9)(4). Both the debtor

satisfaction and reinsurance.

satisfaction does not apply to terms excluding from gross income
recognizing income as
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### Current regulations

price of S's deemed new debt. An exception is made if B is a securities dealer or the debt is retired within one year.

### Proposed regulations

- **13(g)(4).** Section 108(e)(4) is used to measure the amount at which the deemed satisfaction and reissuance occur.

  Exceptions to satisfaction and reissuance: (i) an event described in §1.108-2(e) (e.g., B is a securities dealer) and (ii) if there will be no significant effect on the Federal income tax liability of any person for any year.

- **13(h).** One anti-abuse example indicates that transient status as an intercompany obligation will be disregarded if a principal purpose of the status is to mark an obligation to market despite limitations under the Code.

### Significant effects

- **Deemed satisfaction and reissuance apply equally to all intercompany obligations, to both the**

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b. **Unrelated debtor or creditor becomes member.**

**§ 1.108-2.** The deemed satisfaction and reissuance occurs only if (i) the creditor acquired debt "in
<table>
<thead>
<tr>
<th>Current regulations</th>
<th>Proposed regulations</th>
<th>Significant effects</th>
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<tbody>
<tr>
<td>anticipation&quot; of becoming related to debtor, and (ii) satisfaction would produce COD income to debtor.</td>
<td>nonintercompany obligations become intercompany obligations.</td>
<td>debtor and creditor, and to both COD and premium cases. They also apply to all indirect acquisitions, not just &quot;avoidance&quot; transactions.</td>
</tr>
<tr>
<td>The deemed satisfaction and reissuance are at cost, if the creditor acquired the debt within 6 months of becoming related. Otherwise at fair market value.</td>
<td>-13(g)(4). The same cost/value measure is used for the deemed satisfaction and reissuance.</td>
<td>There may be a character whipsaw because the creditor’s gain or loss may not conform to its OID income or to the debtor’s COD income. However, the results of the proposed regulations may conform to the results under current law of a merger of a solvent debtor and creditor (regardless of whether the debtor or creditor survives). See, e.g., §1.332-7 (liquidation of debtor into creditor), Rev. Rul. 72-464 (merger of debtor into creditor), Rev. Rul. 74-54 (liquidation of creditor into debtor), Rev. Rul. 93-7</td>
</tr>
<tr>
<td>Although no gain or loss to the creditor, the creditor treats any excess of basis over issue price on reissuance as acquisition premium amortizable over the debt’s remaining life. The premium offsets its OID income because of the correspondence in timing and character. It also corresponds in character (but not timing) to the debtor’s COD income.</td>
<td>-13(g)(4). Both the creditor and the holder must account for the deemed satisfaction and reissuance. Thus, the creditor may have capital gain or loss from the satisfaction. The character of the debtor and creditor items is not conformed under the general matching and acceleration rules.</td>
<td></td>
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<tr>
<td>Current regulations</td>
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<td>Significant effects</td>
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<tr>
<td>2. Related-party nonintercompany obligation becomes intercompany obligation...</td>
<td>-13(g)(4). Deemed satisfaction and reissuance are required in all cases if an obligation becomes an intercompany obligation.</td>
<td>(distribution of debt to debtor partner), CO-90-90, and Notice 91-15 (future guidance on nonrecognition transactions).</td>
</tr>
<tr>
<td>No special rules apply.</td>
<td></td>
<td>Unlike the section 108(e)(4) concern with related parties being used to avoid COD, the proposed regulations reflect uniform single entity treatment of members.</td>
</tr>
<tr>
<td>V. § 1.1502-80.</td>
<td>-80(f). The AHYDO rules (section 163(e)(5)) do not apply to newly issued intercompany obligations.</td>
<td>The concerns reflected in the AHYDO rules do not apply to intercompany debt, and the Code provides only a partial recast for the dividend equivalent portion of the disqualified portion of the original issue discount.</td>
</tr>
</tbody>
</table>
VI. ATTRIBUTE REDUCTION.

Current regulations

Proposed regulations

§ 1.108-3. S's deferred losses and deductions from the intercompany sale of property are treated as additional basis that S has retained in the property, and are available for attribute reduction under section 108(b).

Significant effects

Groups cannot avoid section 108(b) through intercompany sales. There is no inference, however, as to single entity treatment for other application of section 108 to consolidated groups (e.g., attribute reduction generally on a single entity basis).