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Final Consolidated Return Regulations Modifying the Calculation of Stock Basis and Other Items

Kevin A. Duvall

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Final Consolidated Return Regulations
Modifying the Calculation of Stock Basis and Other Items

Detailed Outline

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Final Consolidated Return Regulations
Modifying the Calculation of Stock Basis and Other Items

I. INTRODUCTION.

On August 12, 1994, the Internal Revenue Service (the Service) issued final regulations which significantly modify much of the current consolidated return regulations. These new rules revise the current investment adjustment system in calculating stock basis, including the rules for earnings and profits and excess loss accounts. Rules are also promulgated which modify the allocation of income and deductions of a subsidiary in the year it joins or leaves a consolidated group. In addition, several elections under the consolidated return rules, e.g., the deemed dividend election and the "thirty day rules," are eliminated under the new regulations. These new provisions may drastically affect corporations filing consolidated returns and are discussed in greater detail below.

II. INVESTMENT ADJUSTMENTS TO STOCK BASIS OF A CONSOLIDATED SUBSIDIARY.

A. Background.

1. Historically, an owning member (P) has been required to reduce its basis in the stock of a subsidiary (S) upon the use of S’s net operating losses in a consolidated return if these losses were used to offset the income of members of the group. See Ilfeld Co. v. Hernandez, 292 U.S. 62, 4 USTC ¶1261, 13 AFTR 881 (1934), Regs. §1.1016-6(a) and Regs. §1.1502-34A (effective for taxable years beginning before 1966).

2. In 1966, the Service promulgated regulations which embody concepts of the equity method of accounting for investments in subsidiaries. The purpose of these adjustments is to prevent the double deduction of loss or the double taxation of a subsidiary’s earnings. The quantity chosen for the annual adjustment was S’s undistributed current earnings and profits (E&P) or deficit therein. The Service felt that E&P represented a better measure of economic gain or loss and therefore was preferable to taxable income as the yardstick for adjusting stock basis.

3. While E&P generally took into account the economic increase or decrease in wealth of a subsidiary, the system of creating parallel adjustments to basis and E&P created anomalies. For example, “phantom” E&P is created under the current system for unused net operating losses.

4. After the enactment of Section 312(k) in the Tax Reform Act of 1969, a further anomaly was created by the use of E&P instead of taxable income in calculating investment adjustments. Section 312(k) required the use of straight-line depreciation for taxable years beginning after June 30, 1972.
while accelerated depreciation could be used in determining taxable income. Thus, S’s E&P was not reduced by the excess of accelerated depreciation over the straight-line amount. Correspondingly, P’s basis in the S stock was reduced by a lesser amount even though a tax deduction for the full accelerated depreciation had been obtained. Therefore, on disposition of S’s stock, P could realize a tax advantage in the form of less gain (or more loss) if the excess depreciation was not taken into account in calculating P’s basis in the S stock. Despite challenge by the Service, the Tax Court affirmed this application of the rules in Woods Investment Company, 85 TC 274 (1985).

5. In 1987, the Congress enacted Section 1503(e)(1)(A) to overrule the decision in Woods Investment and to reverse the effects of Section 312(k) and other special adjustments under Section 312(n) (other than Section 312(n)(7)) on the stock basis adjustments. Under Section 1503(e)(1)(A), stock basis adjustments must generally be determined without regard to Section 312(k) and (n) for purposes of determining gain or loss on dispositions of subsidiary stock after December 15, 1987. However, Section 1503(e)(1)(A) is not otherwise applicable for purposes of computing and tiering up S’s E&P. As a result, a separate accounting system is required under the current regulations in determining P’s E&P with respect to S’s earnings or losses.

6. On November 10, 1992, the Service issued proposed regulations which would substantially change much of the current consolidated return regulations. These regulations were issued in final form on August 12, 1994.

B. In General.

1. The changes made by the new regulations represent a comprehensive revision of the consolidated investment adjustment system. In adopting a simplified approach to these rules, the Service has mandated that consolidated groups adopt principles similar to the rules for adjusting the basis of partnership interests under Section 705 and stock in S corporations under Section 1367.

2. Because the new rules conform the consolidated investment adjustment system to take into account Section 1503(e), the new rules should not materially alter the investment adjustments of most subsidiaries under the current regulations. However, because of the effective dates, simplifying rules, and the correction of anomalies, consolidated groups may be favorably or adversely affected by the new rules.

3. P’s basis in the S stock is increased by positive adjustments and decreased by negative adjustments. Regs. §1.1502-32(a)(3)(i).
4. If net negative adjustments exceeds P’s basis in the S stock, the excess is referred to as an “excess loss account.” Regs. §1.1502-32(a)(3)(ii).

5. Subsequent negative adjustments increase P’s excess loss account. Subsequent positive adjustments first eliminate the excess loss account, and any remaining amount increases P’s basis in the S stock. Id.

6. Temp. Regs. §1.1502-32T(a) (basis reduction account) and Regs. §1.1502-32(g) (reversal of excess net positive adjustments) are eliminated by the final regulations.

C. Timing of Adjustment.

1. Basis adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine a tax liability of any person. For example, adjustments are made as of P’s sale of S’s stock, in order to measure P’s income, gain, or loss from the sale. Regs. §1.1502-32(b)(1)(i).

2. A current adjustment may be necessary even if tax liability is not affected until a later time. Thus, if P sells only 50 percent of S’s stock and S becomes a nonmember, adjustments must be made for the retained stock as of the disposition (whether or not P has an excess loss account in that stock).

3. Similarly, if S liquidates during a consolidated return year, adjustments must be made as of the liquidation (even if the liquidation is tax-free under Section 332). Id. This rule would eliminate another anomaly under the current regulations in which a Section 332 liquidation of a subsidiary during a consolidated return year (as opposed to year end) would not be treated as a “disposition,” which is necessary to cause basis adjustments to be made. As a result, the higher-tier member’s basis in the P stock is not increased under the current regulations.

4. If Regs. §1.1502-76(b) applies to S for purposes of an adjustment before the close of the group’s consolidated return year, the amount of the adjustment is determined under that provision. If Regs. §1.1502-76(b) does not apply to the interim adjustment, the adjustment is determined under the applicable principles of Regs. §1.1502-76(b), and ratable application under the principles of Regs. §1.1502-76(b)(2) may be used without filing an election under that provision. Regs. §1.1502-32(b)(1)(ii).
D. Amount of Adjustment.

1. The adjustment to P's basis in the S stock is the net amount (treating income and gain items as increases and losses, deductions, and distributions as decreases) of S's—
   a. Taxable income or loss;
   b. Tax-exempt income;
   c. Noncapital, nondeductible expenses; and
   d. Distributions with respect to S's stock. Regs. §1.1502-32(b)(2).

2. Taxable Income or Loss.
   a. S's taxable income or loss is consolidated taxable income determined by taking into account only S's items of income, gain, deduction and loss. By referring to consolidated taxable income, the rules take into account such provisions as the deferral of intercompany items under Regs. §1.1502-13 and the elimination of intercompany dividends under Regs. §1.1502-14. Regs. §1.1502-32(b)(3)(i).

   Example (1): During Year 1, the P group has $100 of consolidated taxable income when determined by taking into account only S's items of income, gain, deduction, and loss. P has a $100 positive adjustment with respect to S's stock for Year 1 which increases P's basis in S's stock by $100 as of the close of Year 1.

   The facts are the same as above except that, during Year 1, S sells property to P and recognizes a $25 gain, which is deferred under Regs. §1.1502-13 and taken into account in Year 3 when P resells the property. The deferred gain is not additional taxable income for Year 1 because it is not taken into account in determining the P group's consolidated taxable income for that year. Thus, the deferred gain does not result in a basis adjustment until Year 3, when it is taken into account in determining the P group's consolidated taxable income.

   Assume instead that P sells S's stock on December 31 of Year 2. Under Regs. §1.1502-13, S takes the $25 deferred gain into account immediately before the sale. Thus, P increases its basis in S's stock by the $25 immediately before the stock sale.
   b. In determining consolidated taxable income (or loss), S's deductions and losses are taken into account to the extent that they are absorbed by S or any other member. Id.
(1) To the extent that S's deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under Sections 172, 465, or 1212), the deduction or loss is taken into account in the year in which it is absorbed. Regs. §1.1502-32(b)(3)(i)(A).

(2) To the extent that S's deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the loss is treated as tax loss for purposes of these rules in the year in which it arises and not in the year in which it is absorbed. Regs. §1.1502-32(b)(3)(i)(B).

(3) Query: What if S has a loss in a subsequent separate return year of the same group which is carried back and absorbed in a prior consolidated return year? Although neither the current nor new regulations would require a negative basis adjustment for the absorbed loss, L.R. 8827001 (Mar. 31, 1988) does. See also Example (15) infra.

Example (2): During Year 2, the P group has a $50 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. S's loss is absorbed by the P group in Year 2, offsetting P's income for that year. Because S's loss is absorbed in the year it arises, the loss is treated as a $50 tax loss for Year 2, and P has a $50 negative adjustment with respect to S's stock. This negative adjustment decreases P's basis in S's stock by $50.

Assume instead that P has no income or loss for Year 2, the $50 consolidated net operating loss determined by taking into account only S's items is carried back and absorbed by the P group in Year 1 (offsetting the income of P or S), and the P group receives a $17 tax refund that P pays to S. Because the loss is carried back and absorbed in Year 1, the loss is treated as a $50 tax loss for Year 2 (the year in which it arises). Under Regs. §1.1502-32(b)(3)(iv), the refund is treated as tax-exempt income of S for Year 2 (when the loss is taken into account). Thus, P decreases its basis in S's stock by $33 as of the close of Year 2 (the $50 tax loss less the $17 tax refund).

Assume instead that P has no income or loss for Year 2 and S's tax loss is carried forward and absorbed by the P group in Year 3 (offsetting the income of P or S). The loss is not treated as a tax loss until Year 3.
c. Items which are deferred by a statutory provision should not be taken into account until included in S's taxable income. Thus, deductions suspended under Sections 465, 469, and 1630 should not reduce P's basis in S until S is allowed a tax deduction for such items.

3. Tax-exempt income.

a. S's tax-exempt income is its income and gain that is taken into account but is permanently excluded from S's gross income under applicable law and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's dividend income to which Regs. §1.1502-14(a) applies and interest excluded from gross income under Section 103 are tax-exempt income, while income realized but not recognized under Section 1031 is not. Regs. §1.1502-32(b)(3)(ii)(A). This prevents S’s tax-exempt income from being indirectly taxed as gain on P’s disposition of the S stock.

b. An item of income or gain is also treated as tax-exempt income for purposes of P’s stock basis adjustments if it is permanently offset by a deduction or loss and the offsetting item does not reduce, directly or indirectly, the basis of S’s assets (or an equivalent amount). Regs. §1.1502-32(b)(3)(ii)(B).

Example (3): S receives a $100 dividend with respect to which a $70 dividends-received deduction is allowed under Section 243. Both the $100 dividend and the $70 deduction are taken into account in computing taxable income. In addition, $70 of the dividend is treated as tax-exempt income (assuming that no corresponding stock basis reduction is required under Section 1059 or otherwise). As a result, P’s basis in S’s stock increases by $100, $30 because of S’s taxable income and $70 because of its tax-exempt income.

c. Similarly, income from mineral properties is treated as tax-exempt income to the extent it is offset by deductions for depletion in excess of the basis of the property. Id.

d. In contrast, income offset by an asset’s accelerated depreciation deductions is not tax-exempt because the deductions represent a recovery of S’s basis in the asset.
Discharge of S's indebtedness that is excluded from gross income under Section 108(a) is treated as tax-exempt income to the extent the discharged amount is applied to reduce tax attributes (e.g., Sections 108(b) or 1017) and the attribute reduction is taken into account as a noncapital, nondeductible expense under Regs. §1.1502-32(b)(3)(iii).

(1) Discharge of S's indebtedness that is excluded from gross income but is not applied to reduce tax attributes is not treated as tax-exempt income. Regs. §1.1502-32(b)(3)(ii)(C)(1).

(2) The final regulations treat expired loss carryovers as continuing to exist for purposes of determining whether a positive adjustment is permitted for cancellation of indebtedness income. A basis increase is permitted for the discharge income to the extent the expiration of the loss was treated as a noncapital, nondeductible expense under Regs. §1.1502-32(b)(3)(iii), and the loss carryover would have been reduced had it not expired. Regs. §1.1502-32(b)(3)(ii)(C)(2).

Example (4): P forms S on January 1 of Year 1 with a nominal capital contribution and S borrows $200. During Year 1, S's assets decline in value and the P group has a $100 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. None of the loss is absorbed in Year 1, and, at the close of Year 1, S is discharged from $100 of indebtedness. Under Section 108(a), S's $100 of discharge of indebtedness is excluded from the P group's gross income because of insolvency. Under Section 108(b), however, S's $100 net operating loss is reduced to zero.

All $100 of the discharge is treated as tax-exempt income because the discharge results in a $100 reduction to S's net operating loss. Consequently, the loss of the borrowed funds and the cancellation of the indebtedness result, in the aggregate, in no positive or negative adjustment to P's basis in S's stock for Year 1. If the basis of assets were reduced under Section 1017, rather than S's loss, the reduction would not occur until the beginning of Year 2 and the discharge would not be treated as tax-exempt income until that time.
Assume instead that $70 of S's net operating loss is absorbed in Year 1, offsetting P's income for that year, and the indebtedness is discharged at the beginning of Year 2. The $70 of S's loss absorbed in Year 1 reduces P's basis in S's stock by $70 as of the close of Year 1. Under Section 108(a), S's discharge of indebtedness in Year 2 is excluded from the P group's gross income because of insolvency. Under Section 108(b), the remaining $30 of S's net operating loss carryover from Year 1 is reduced to zero. No other attributes are reduced. Only $30 of the discharge is treated as tax-exempt income because only that amount is applied to reduce attributes. The $30 net operating loss permanently disallowed by Section 108(b) is treated as a noncapital, nondeductible expense under Regs. §1.1502-32(b)(3)(iii).

An increase in the basis of S's assets (or its equivalent, such as an increase in a loss carryover or a decrease in an excess loss account in stock owned by S) is treated as tax-exempt income to the extent that the increase—

1. Is not otherwise taken into account in determining stock basis;

2. Corresponds to a negative adjustment that is taken into account by the group under Regs. §1.1502-32(b) (or incurred by the common parent); and

3. Has the effect (viewing the group in the aggregate) of a permanent recovery of the reduction. Regs. §1.1502-32(b)(3)(ii)(D).

4. For example, a basis increase under Section 50(c)(2) is treated as tax-exempt income to the extent the preceding basis reduction under Section 50(c)(1) is reflected in the basis of a member's stock. Alternatively, if S increases the basis of an asset as the result of an accounting method change, and the related positive Section 481(a) adjustment is taken into account over time, the basis increase is not treated as tax-exempt income.

4. Noncapital, nondeductible expenses.

a. P's basis in the S stock is also decreased by the amount of S's noncapital, nondeductible expenses, to prevent the expenses from being indirectly recovered on the disposition of S's stock. A noncapital, nondeductible expense is a deduction or loss that is
taken into account but permanently disallowed or eliminated under applicable law in determining S's taxable income or loss and that decreases, directly or indirectly, the basis of its assets (or an equivalent amount). Regs. §1.1502-32(b)(3)(iii)(A).

(1) For example, federal taxes described in Section 275 and loss not recognized under Section 311(a) are noncapital, nondeductible expenses.

(2) Likewise, if a loss carryover (e.g., under Section 172 or 1212) attributable to S expires or is reduced under Section 108(b), it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried.

Example (5): P acquired all of the stock of S at the close of 1995 from an individual for $1 million in a taxable purchase transaction. At the time of acquisition, S had a $10 million NOL carryforward, which will expire in 2002 and which is subject to an annual Section 382 limitation of $60,000 (assumed long-term tax-exempt rate of 6% x $1,000,000).

Under the new regulations, P must reduce its basis in the S stock in 2002 by the amount of the NOL which expires unused. If S's entire NOL expires unused in 2002, and assuming no other adjustments, P would have an excess loss account in the S stock of $9,000,000 ($1,000,000 less $10,000,000). This result occurs even though the P group could never have used all of S's NOL due to the limitations imposed by Section 382.

(a) To mitigate the harsh results illustrated above, the final regulations permit the acquiring group to elect to treat all or any portion of a loss carryover of S which arose in a separate return limitation year as expiring for all federal income tax purposes immediately before S becomes a member of the group. If S was a member of another group immediately before it became a member of the acquiring group, the expiration is also treated as occurring immediately after it ceases to be a member of the prior group. Regs. §1.1502-32(b)(4).

(i) If S becomes a member of the consolidated group in a qualifying cost basis transaction, the noncapital, nondeductible expense
resulting from the deemed expiration of S’s loss carryover does not result in a negative stock basis adjustment. A qualifying cost basis transaction is the purchase (i.e., a transaction in which basis is determined under Section 1012) by members of the acquiring consolidated group (while they are members) in a 12-month period of an amount of S’s stock satisfying the requirements of Section 1504(a)(2). Cf. the definition of a qualified stock purchase under Section 338(d)(3).

(ii) If S becomes a member of the consolidated group other than in a qualifying cost basis transaction, the basis of its stock that is owned by members immediately after it becomes a member must be reduced to reflect the deemed expiration. The reduction occurs immediately before S becomes a member, but after it ceases to be a member of any prior group, and it therefore does not result in a corresponding stock basis adjustment for any higher-tier member of the transferring or acquiring consolidated group. This basis reduction is taken into account in making determinations of basis under the Code with respect to S’s stock [e.g., a determination under Section 362 because the stock is acquired in a Section 368(a)(1)(B) reorganization], but it does not result in corresponding stock basis adjustments for any higher-tier member. If the basis reduction exceeds the basis of S’s stock, the excess is treated as an excess loss account to which the members owning S’s stock succeed.

(iii) If S becomes a member of the consolidated group as a result, in whole or in part, of a higher-tier corporation becoming a member (whether or not in a qualifying cost basis transaction), additional adjustments are required. The highest-tier corporation (T) whose becoming a member resulted in S becoming a member, and T’s chain of
lower-tier corporations that includes $S$ are subject to the adjustment. The deemed expiration of $S$'s loss carryover that results in a negative adjustment for the first higher-tier corporation is treated as an expiring loss carryover of that higher-tier corporation. For example, if $P$ purchases all of the stock of $T$, $T$ owns all of the stock of $T_1$, $T_1$ owns all of the stock of $S$, $S$ becomes a member as a result of $T$ becoming a member, and the election to waive $S$ losses is made, the basis of the $S$ stock is reduced and the reduction tiers up to $T_1$, $T_1$ treats the negative adjustment to its basis in $S$'s stock as an expiring loss carryover of $S$, and $T$ then adjusts its basis in $T_1$'s stock. In addition, if $T$ becomes a member of the acquiring group in a transaction other than a qualifying cost basis transaction, the amount that tiers up to $T$ also reduces the basis of its stock (but the amount does not tier up to higher-tier members).

(iv) Basis reduced as a result of the election is restored before $S$ becomes a member (and before the basis of $S$'s stock is taken into account in determining basis under the Code) to the extent necessary to conform a share's basis to its allocable portion of net asset basis. In the case of higher-tier corporations, the restoration does not tier up but is instead applied separately to each higher-tier corporation. For purposes of determining each corporation's net asset basis (including the basis of stock in lower-tier corporations), the restoration is applied in the order of tiers, from the lowest to the highest. A member's net asset basis is the positive or negative difference between the adjusted basis of its assets (and the amount of any of its loss carryovers that are not deemed to expire) and its liabilities. Appropriate adjustments must be made, for example, to disregard liabilities that subsequently will give rise to deductions (e.g., liabilities to which Section 461(h)
applies). Note that this limitation on the amount by which stock basis is reduced does not apply if no election is made and the losses of the acquired subsidiary expire unused.

(v) A similar election is available for former common parents following a group structure change underRegs. §1.1502-31. See V.D.7., infra, for a further discussion.

(b) The election to waive losses must be made in a separate statement entitled “ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER §1.1502-32(b)(4).” The statement must be filed with the consolidated group’s return for the year S becomes a member, and it must be signed by the common parent and S. A separate statement must be made for each member whose loss carryover is deemed to expire. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire), the basis of any stock reduced as a result of the deemed expiration, and the computation of the basis reduction.

(3) On the other hand, if S sells and repurchases a security subject to Section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustment prevents the disallowance from being permanent.

b. A decrease in the basis of S’s assets (or its equivalent, such as a decrease in a loss carryover, a denial of basis for taxable income, or an increase in an excess loss account in stock owned by S) may be treated as a noncapital, nondeductible expense to the extent that the decrease is not otherwise taken into account in determining stock basis and is permanently disallowed in determining S’s taxable income or loss. Regs. §1.1502-32(b)(3)(iii)(B).

(1) For example, S has a noncapital, nondeductible expense if the basis of its assets is decreased under Section 50(c)(1), 1017, or 1059, or under Regs. §1.1502-20(b), or S’s losses are reattributed under Regs. §1.1502-20(g).
Likewise, a noncapital, nondeductible expense also includes the amount of any gross-up for taxes paid by another taxpayer that S is treated as having paid (e.g., income included under Section 78 or the portion of an undistributed capital gain dividend that is treated as tax deemed to have been paid by a shareholder under Section 852(b)(3)(D)(ii), whether or not any corresponding amount is claimed as a tax credit).

In contrast, a decrease generally is not a noncapital, nondeductible expense if it results because S's basis in assets received in a liquidation to which Section 332 applies is less than S's basis in the stock canceled or S distributes the stock of a subsidiary in a distribution to which Section 355 applies. Likewise, the repayment of debt is generally not a noncapital, nondeductible expense.

Example (6): During Year 1, the P group has $500 of consolidated taxable income. However, the P group has a $100 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. Also during Year 1, S has $80 of interest income that is permanently excluded from gross income under Section 103 and incurs a related $60 of expense for which a deduction is permanently disallowed under Section 265.

S has a $100 tax loss for Year 1. S also has $80 of tax-exempt income and $60 of noncapital, nondeductible expenses. Thus, P decreases its basis in S's stock as of the close of Year 1 by $80 (the $100 tax loss, less $80 of tax-exempt income, plus $60 of noncapital, nondeductible expenses).

Example (7): S is a life insurance company. During Year 1, the P group has $200 of consolidated taxable income, determined by taking into account only S's items of income, gain, deduction, and loss (including a $300 small company deduction under Section 806). In addition, S has $100 of tax-exempt interest income, $60 of which is S's "company share." The remaining $40 of tax-exempt income is the "policyholders' share" that reduces S's deduction for increase in reserves.

Thus, S has $200 of taxable income for Year 1. Also for Year 1, S has $100 of tax-exempt income and another $300 is treated as tax-exempt income because of the deduction under Section 806. S has $40 of noncapital, nondeductible expenses for Year 1 because S's deduction under Section 807 for its increase in reserves has been
permanently reduced by the $40 policyholders' share of the tax-exempt interest income. Thus, P increases its basis in S's stock by $560.

Assume instead that S is a property and casualty company and, during Year 1, S accrues $100 of estimated salvage recoverable under Section 832. Of this amount, $87 (87 percent of $100) is excluded from gross income because of the "fresh start" provisions of the Omnibus Budget Reconciliation Act of 1990. Thus, S has $87 of tax-exempt income that increases P's basis in S's stock for Year 1. (S also has $13 of taxable income over the period of inclusion under Section 481.) In Year 5, S determines that the $100 salvage recoverable was overestimated by $30 and deducts the $30 for the reduction of the salvage recoverable. However, S has $26.10 (87 percent of $30) of taxable income in Year 5 due to the partial recapture of its fresh start. Because S has no basis corresponding to this income, S is treated as having a $26.10 noncapital, nondeductible expense in Year 5. This treatment is necessary to reflect the elimination of the erroneous fresh start in S's stock basis and causes a decrease in P's basis in S's stock by $30 for Year 5 (a $3.90 taxable loss and a $26.10 special adjustment).

5. Distributions.

a. P's basis in the S stock is reduced by all of S's distributions to P to which Section 301 applies and to all other distributions treated as dividends [e.g., under Section 356(a)(2)], without regard to when the E&P was accumulated. Regs. §1.1502-32(b)(3)(v).

(1) Thus P must reduce its basis in the S stock upon a distribution of E&P accumulated in separate return affiliation years or in pre-1966 consolidated return years of the group.

(a) Due to the effective dates contained in the regulations, P will be permitted to increase its basis in the S stock retroactively for S's pre-1966 consolidated E&P. Thus, a negative adjustment upon a distribution is warranted.

(b) However, these new regulations represent a significant departure from the current rules with respect to E&P accumulated in years for which the group files separate returns. Although a basis
increase was not obtained when this E&P was accumulated, P must nevertheless reduce its basis in the S stock when this E&P is distributed. This change puts consolidated groups at a disadvantage vis-a-vis separate return filers, since groups filing separate returns could obtain a 100% dividends-received deduction under Section 243(b) and would not be required to reduce the basis of the stock of the distributing company (unless Section 1059 applied).

(c) Note that a deemed dividend election made for a consolidated return year ending before the new regulations are effective can achieve a step-up in the subsidiary’s stock basis for separate return affiliation year (non-SRLY) E&P. See c. below.

b. A distribution is taken into account as a negative adjustment when the shareholding member becomes entitled to the distribution (generally on the record date). Regs. §1.1502-14(a)(5)(i).

(1) For example, if P becomes entitled to the distribution before it is made, S is treated as distributing the amount to P at the time P becomes entitled to the distribution. For this purpose, stock is treated as entitled to a distribution no later than the time the distribution is taken into account under the Code (see, e.g., Section 305).

(2) If it is later established, based on all of the facts and circumstances, that the distribution will not be made, the initial adjustment is reversed as of the date it was made. Id.

(3) This entitlement rule eliminates the need for Regs. §1.1502-32(k), which currently treats certain distributions to P by S after S is no longer a member of the P group as occurring on the last day that S was a member of the P group.

Example (8): During Year 1, the P group has $120 of consolidated taxable income when determined by taking into account only S’s items of income, gain, deduction, and loss. On December 31 of Year 1, S declares and makes a $10 dividend distribution to P. Thus, P increases its basis in S’s stock as of the close of Year 1 by $110 ($120 of taxable income, less a $10 distribution).
Assume instead that, in December of Year 1, S declares (and P becomes entitled to) another $70 dividend distribution with respect to its stock, but P does not receive the distribution until after it sells all of S's stock on December 31 of Year 1. S is treated as making a $70 distribution to P at the time P becomes entitled to the distribution. Consequently, P increases its basis in S's stock as of the close of Year 1 by only $40 ($120 of taxable income, less two distributions totaling $80). Any further adjustments after S ceases to be a member and the $70 distribution is made would be duplicative, because the stock basis has already been adjusted for the distribution. Accordingly, the distribution will not result in further adjustments, even if the distribution is a payment to which Section 301(c)(2) or (3) applies.

c. The new regulations would also eliminate the deemed dividend election under Regs. §1.1502-32(f)(2).


The adjustments to S's stock are taken into account in determining adjustments to higher-tier stock. The adjustments are applied in the order of the tiers, from the lowest to the highest. Regs. §1.1502-32(a)(3)(iii). For example, if P is a subsidiary whose stock is owned by another member, P's adjustment to S's stock is taken into account in determining the adjustments to stock of P owned by other members.

Example (9): M owns all of P's stock, and P owns all of S's stock. During Year 1, the M group has $100 of consolidated taxable income when determined by taking into account only S's items of income, gain, deduction, and loss, and $50 of consolidated taxable income when determined by taking into account only P's items. P increases its basis in S's stock by $100. This $100 basis adjustment is taken into account in determining M's basis in P's stock. Thus, M increases its basis in P's stock by $150.

7. Tax Sharing Agreements.

a. Federal income taxes are taken into account by applying the principles of Section 1552 and the percentage method under Regs. §1.1502-33(d)(3) (and by assuming a 100 percent allocation of any decreased tax liability). Regs. §1.1502-32(b)(3)(iv)(D).

b. Rather than relying on the E&P rules, however, the basis rules treat a group as having a tax-sharing agreement in effect providing for a 100 percent allocation of any decreased tax liability.
c. The treatment of tax-sharing amounts allocated under the basis rules is analogous to the treatment of allocations under Regs. §1.1552-1(b)(2).

d. For example, if one member owes a payment for taxes to a second member, the first member is treated as indebted to the second member. If the indebtedness is not paid, the amount not paid is generally treated as a distribution, contribution, or both, depending on the relationship between the members.

e. A consolidated group may elect to synchronize the method in allocating taxes for stock basis and E&P purposes. For a further discussion, see III. E. 2., infra.

E. Allocation of Adjustments to Shares of Stock.

1. In General.

a. The negative adjustment for distributions is allocated to the shares of S's stock to which the distribution relates. Regs. §1.1502-32(c)(1). Thus, distributions may reduce the basis of common or preferred stock of a subsidiary owned by members of the group.

b. The remainder of the adjustment with respect to S's stock [the portion described in Regs. §1.1502-32(b)(2)(i) to (iii)] is allocated among the shares of S's stock, including shares owned by nonmembers. However, the allocation to nonmembers has no effect on their basis in the S stock. Id.

c. If the adjustment under Regs. §1.1502-32(b)(2) (without taking distributions into account) is positive, it is allocated first to any preferred stock to cover distributions and arrearages and then to common stock. If it is negative, it is allocated only to common stock. Id.

2. Common Stock.

a. The final regulations define "common stock" as stock that is not preferred stock. Regs. §1.1502-32(d)(3).

b. Adjustments allocable to a class of common stock are generally allocated equally to each share in the class. Regs. §1.1502-32(c)(2)(i).

(1) For this purpose, the shares of a member having the same material terms (without taking into account voting rights) are treated as a single class of stock. Regs. §1.1502-32(d)(1).
(2) Distributions and any adjustments or determinations under the Internal Revenue Code (e.g., basis increases resulting from capital contributions) are taken into account before the allocation is made. Regs. §1.1502-32(c)(2)(i).

(3) However, if P has an excess loss account in shares of a class of common stock, the portion of any positive adjustment allocable to P with respect to the class is allocated first to eliminate the excess loss account. Similarly, any negative adjustment is allocated first to reduce P's basis in shares of the class before creating or increasing P's excess loss account. Id.

c. If S has more than one class of common stock, the allocation of a stock basis adjustment is determined by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement. Regs. §1.1502-32(c)(2)(ii).

(1) The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. In determining the participation, any differences in voting rights are not taken into account, and the following factors are among those to be considered—

(a) The interest of each share in economic profits and losses (if different than the interest in taxable income);

(b) The interest of each share in cash flow and other nonliquidating distributions; and

(c) The interest of each share in distributions in liquidation.

(2) Distributions and any adjustments or determinations that are made under the Internal Revenue Code are taken into account before the allocation is made under the final regulations.
3. Preferred Stock.

a. "Preferred stock" is stock that is limited and preferred as to dividends and has a liquidation preference. Regs. §1.1502-32(d)(2).

(1) These rules apply automatically if the preferred stock is described in Section 1504(a)(4) (i.e., "plain vanilla preferred").

(2) A class of stock that is not described in Section 1504(a)(4), (e.g., preferred stock with a vote, conversion feature, or other equity interest), however, is not treated as preferred stock if members own less than 80 percent of each class of common stock.

(3) Preferred stock that is not subject to these rules is treated as a second class of common stock for purposes of determining the stock basis adjustments allocable to it.

b. Positive stock basis adjustments (determined without taking distributions into account) are allocated to preferred stock to the extent required, when aggregated with prior allocations during the period that S is a member of the consolidated group, to reflect distributions described in Section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. Regs. §1.1502-32(c)(3).

c. If the amount of distributions and arrearages exceeds the positive amount (when aggregated with prior allocations), the positive amount is first allocated among classes of preferred stock to reflect their relative priorities, and the amount allocated to each class is then allocated pro rata within the class. *Id.*

d. A positive amount that is allocated to a share with respect to a period when the share is owned by a nonmember is not reflected in the basis of the share. For this purpose, if P and S cease to be members of one consolidated group and become members of another consolidated group, the allocation is made by taking into account the consolidated return years of the prior group. *Id.*

*Example (10):* On January 1 of Year 1, P owns all of S's common stock with an $800 basis, and nonmembers own all of S's preferred stock, which was issued for $200. The preferred stock has a $20
annual, cumulative preference as to dividends and has an initial liquidation preference of $200. During Year 1, S has $50 of taxable income, and no distributions are declared or made.

$20 of the $50 positive adjustment is allocated first to the preferred stock to reflect the dividend arrearage arising in Year 1. The remaining $30 of the positive adjustment is allocated to the common stock, and P increases its basis in S’s common stock from $800 to $830 as of the close of Year 1. (The basis of the preferred stock owned by nonmembers is not adjusted.)

Assume instead that S declares and makes a $20 distribution with respect to the preferred stock during Year 1 in satisfaction of its preference. The results are the same as above.

Assume instead that S has no income or loss during Years 1 and 2, P purchases all of S’s preferred stock at the beginning of Year 3 for $240, and S has $70 of taxable income during Year 3. $60 of the $70 positive adjustment is allocated to the preferred stock to reflect the dividends arrearages arising in Years 1 through 3, but only the $20 that arises in Year 3 is reflected in the basis of the preferred stock (the remaining $40 relates to periods when the preferred stock was owned by nonmembers). Thus, P increases its basis in S’s preferred stock from $240 to $260, and P increases its basis in S’s common stock from $800 to $810. If P had acquired all of S’s preferred stock in a transaction to which Section 351 applies and, under Section 362, P’s initial basis in S’s stock was $200 (determined by reference to the transferor’s basis), P’s basis in S’s preferred stock would increase from $200 to $220.

Assume instead that S declares and makes a $20 distribution with respect to the preferred stock in each of Years 1 and 2 in satisfaction of its preference and P purchases all of S’s preferred stock at the beginning of Year 3 for $200. $40 of the $70 positive adjustment is allocated to the preferred stock to reflect the distributions in Years 1 and 2, and $20 of the $70 is allocated to the preferred stock to reflect the arrearage arising in Year 3. However, only the $20 attributable to Year 3 is reflected in the basis of the preferred stock. Thus, P increases its basis in S’s preferred stock from $200 to $220, and P increases its basis in S’s common stock from $800 to $810.
4. Redetermination of Allocated Adjustments.

P's basis (or excess loss account) in each share of S's stock must be redetermined whenever necessary to determine a tax liability of any person. Regs. §1.1502-32(c)(4)(i).

a. The redetermination is made by reallocating the net adjustment under Regs. §1.1502-32(b)(2) (determined without taking distributions into account) for each consolidated return year (or other applicable period) of the group by taking into account all of the facts and circumstances affecting allocations as of the redetermination date. Id.

b. The reallocation is treated for all purposes (including subsequent redeterminations) as the original allocation of an amount under Regs. §1.1502-32(c) but the reallocation does not affect any prior period. Id.

c. An amount may not be reallocated, however, to the extent that the amount has been used. An amount has been used to the extent the reallocation would affect the amount taken into account, directly or indirectly, by any member in determining income, gain, deduction, or loss or in determining the basis of any property other than stock of a member. Regs. §1.1502-32(c)(4)(ii). For example, if P sells a share of S stock, an amount previously allocated to the share cannot be reallocated to another share of S stock, but an amount allocated to another share of S stock can still be reallocated to the sold share because the unallocated amount has not been taken into account.

Example (11): P owns all of S's common and preferred stock. The preferred stock has a $100 annual, cumulative preference as to dividends. During Year 1, S has $200 of taxable income, the first $100 of which is allocated to the preferred stock and the remaining $100 of which is allocated to the common stock. During Year 2, S has no adjustment, and P sells all of S's common stock at the close of Year 2.

P's basis in S's common stock must be redetermined as of the sale of the stock. The redetermination is made by reallocating the $200 positive adjustment for Year 1 by taking into account all of the facts and circumstances affecting allocations as of the sale. Thus, the $200 positive adjustment for Year 1 is reallocated entirely to the preferred stock to reflect the dividend arrearages arising in Years 1 and 2. The reallocation away from the common stock reflects the fact that, because of the additional amount arrearage in Year 2, the common stock is not entitled to any part of the $200 of taxable income from Year 1. Thus, the common
stock has no positive or negative adjustment, and the preferred stock has a $200 positive adjustment. These reallocations are treated as the original allocations for Years 1 and 2. The results for the common stock would be the same if the preferred stock was owned by nonmembers.

Assume instead that S does not issue its preferred stock until the beginning of Year 2, S has no further adjustment for Years 2 or 3, and P sells S's common stock on December 31 of Year 3. The $200 positive adjustment for Year 1 is initially allocated entirely to the common stock. The $200 adjustment is reallocated to the preferred stock to reflect the arrearages arising in Years 2 and 3.

Assume instead that, during Year 2, S has a $200 loss which results in a negative adjustment of the common stock before any redetermination. For purposes of the basis redetermination the Year 1 and 2 adjustments are not netted. Thus, the redetermination is made by reallocating the $200 positive adjustment for Year 1 entirely to the preferred stock. In addition, the $200 negative adjustment for Year 2 is allocated entirely to the common stock. Consequently, the preferred stock has a $200 positive cumulative adjustment, and the common stock has a $200 negative cumulative adjustment. The results would be the same if there were no other adjustments, P sells S's stock on December 31 of Year 3 rather than Year 2, and an additional $100 arrearage arises in Year 3; only adjustments under Regs. §1.1502-32(b) may be reallocated, and there is no additional adjustment for Year 3.

Assume instead that, during Year 1, S declares and makes a distribution to P of $100 as a dividend on the preferred stock and of $100 as a dividend on the common stock. The taxable income and distributions result in no Year 1 adjustment for either the common or preferred stock. However, the redetermination is made by reallocating a $200 positive adjustment for Year 1 to the preferred stock. Consequently, the preferred stock has a $100 positive cumulative adjustment ($200 of taxable income, less a $100 distribution with respect to the preferred stock) and the common stock has a $100 negative cumulative adjustment (for the distribution).

Example (12): P owns all of S's stock, and S owns all of T's common and preferred stock. The preferred stock has a $100 annual, cumulative preference as to dividends. During Year 1, S has no investment adjustment, and T has $200 of taxable income, the first $100 of which is allocated to the preferred stock, and the remaining $100 of which is allocated to the common stock. S and T have no investment adjustments for Years 2 and 3. X, the common parent of another consolidated group, purchases all of S's stock on December 31 of Year 3, and S and T become members of the X group. During Year 4, T has $200 of taxable income, and the tier up of this amount is S's only investment adjustment.
The allocation of S's adjustments (determined without taking distributions into account) must be redetermined as of the time X acquires S's stock. As a result of this redetermination, T's common stock has no positive or negative adjustment and the preferred stock has a $200 positive adjustment. The allocation of T's $200 positive adjustment for Year 4 to T's preferred stock with respect to arrearages is made by taking into account the consolidated return years of both the P group and the X group. Thus, the allocation of the $200 positive adjustment for Year 4 to T's preferred stock is not treated as an allocation for a period for which the preferred stock is owned by a nonmember. Thus, the $200 adjustment is reflected in S's basis in T's preferred stock.

F. Anti-Abuse Rules.

1. In General.

If any person acts with a principal purpose contrary to the purposes of the basis adjustment rules or to avoid the effect thereof or applies the rules of Regs. §1.1502-32 to avoid the effect of any other provision of the consolidated return regulations, adjustments are required to be made as necessary to carry out the purposes of the rules. Regs. §1.1502-32(e)(1).

2. Predecessors and Successors.

For purposes of Regs. §1.1502-32, any reference to a corporation or to a share of stock includes a reference to a successor or predecessor as the context may require. A corporation is a successor if the basis of its assets is determined, directly or indirectly, in whole or in part, by reference to the basis of another corporation (the predecessor). A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor). Regs. §1.1502-32(f).

Example (13): S has 100 shares of common stock and 100 shares of preferred stock described in Section 1504(a)(4). P owns 80 shares of S's common stock and all of S's preferred stock. P anticipates that S will have negative adjustments under Regs. §1.1502-32(b) during Years 1 and 2, all of which will be allocable to S's common stock, and positive adjustments thereafter. When the preferred stock was issued, P intended to cause S to recapitalize the preferred stock into common stock at the end of Year 2 in a transaction to which Section 368(a)(1)(E) applies. P's temporary ownership of the preferred stock is with a principal purpose to limit P's basis reductions to 80 percent of the anticipated negative adjustments. The recapitalization is intended to cause significantly more than 80 percent of the anticipated positive adjustments to increase P's basis in S's stock because of P's increased ownership of S's common stock immediately after the recapitalization.
Under Regs. §1.1502-32(e)(1), all of S's common and preferred stock owned by P is treated as single class of common stock in Years 1 and 2. The allocation is made under the principles of Regs. §1.1502-32(c)(2)(ii), and P decreases its basis in both the common and preferred stock accordingly.

Example (14): P forms S with a capital contribution of $800, $200 of which is in exchange for S's preferred stock described in Section 1504(a)(4) and the balance of which is for S's common stock. During Years 1 through 3, S has $160 of ordinary income, $60 of which is distributed with respect to the preferred stock in satisfaction of its $20 annual preference as to dividends. Under Regs. §1.1502-32, P's basis in S's preferred stock is unchanged, and its basis in S's common stock is increased from $600 to $700. On December 31 of Year 3, to reduce its gain from the anticipated sale of S’s preferred stock, P forms T with a capital contribution of all of S's stock in exchange for corresponding common and preferred stock of T in a transaction to which Section 351 applies. At the time of the contribution, the fair market value of the common stock is $700 and the fair market value of the preferred stock is $300. P subsequently sells T's preferred stock for $300.

Under Section 358(b), P ordinarily has a $630 basis in T's common stock (70 percent of the $900 aggregate stock basis) and a $270 basis in T's preferred stock (30 percent of the $900 aggregate stock basis). However, because P transferred S's stock to T with a principal purpose to distort the allocation of basis adjustments under Regs. §1.1502-32, P has a $700 basis in T's common stock and a $200 basis in T's preferred stock. Consequently, P recognizes a $100 gain from the sale of T's preferred stock.

Example (15): During Year 1, the P group has $40 of consolidated taxable income, all of which is attributable to S, and P increases its basis in S’s stock by $40. P anticipates that S will have a $40 ordinary loss during Year 2 that will be carried back and offset S’s income in Year 1 and cause P to decrease its basis in S’s stock by $40 for Year 2. With a principal purpose to avoid the decrease, P causes S to issue voting preferred stock that results in S becoming a nonmember at the beginning of Year 2. As anticipated, S has a $40 net operating loss during Year 2, which is carried back to Year 1 and offsets S’s income from Year 1.

Because P caused S to cease to be a member with a principal purpose to avoid negative basis adjustments, and P continues to own stock of S, the basis of the retained S stock is decreased by $40 for Year 2. If P has less than a $40 basis in the retained S stock, P must recognize income for Year 2 to the extent of the excess.
G. Records Required.

1. The proposed regulations would have required an annual statement to be attached to the consolidated return for each subsidiary reflecting the net adjustment to the basis of the subsidiary's stock. See Prop. Regs. §1.1502-32(g).

2. The final regulations eliminate this requirement, but require that permanent records be maintained from which the adjustments mandated by the regulations may be computed. Regs. §1.1502-32(g).

H. Effective Dates.

1. The final rules generally would apply to determinations of stock basis in consolidated return years beginning on or after January 1, 1995. If the final rules apply, basis generally must be determined or redetermined as if the new rules were in effect for all consolidated return years of the group. Regs. §1.1502-32(h)(1).

2. However, if P disposes of S's stock in a consolidated return year beginning before January 1, 1995, P's income, gain, deduction, or loss and the basis reflected in that amount are not redetermined. Nevertheless, if determinations or adjustments to P's basis in S's stock reflect determinations or adjustments with respect to stock of a lower-tier member, the determinations or adjustments are redetermined if S later disposes of the lower-tier member's stock under the final rules even though they were previously taken into account in P's disposition of S's stock. Regs. §1.1502-32(h)(2).

3. Deemed dividends under the current rules continue to be taken into account under the new rules, and negative adjustments are generally not made for distributions, before the effective date of the new rules, of affiliated, nonconsolidated E&P. Regs. §1.1502-32(h)(3).

4. The negative basis adjustment for expired loss carryovers is not required if S became a member of a consolidated group in a consolidated return year beginning before January 1, 1995, and S had a loss carryover from a separate return limitation year at that time, even if the carryover expires in a taxable year beginning on or after January 1, 1995. Regs. §1.1502-32(h)(4).
III. EARNINGS AND PROFITS OF CONSOLIDATED GROUP MEMBERS.

A. Background.

1. The consolidated return regulations effective for taxable years beginning after 1965 did not originally cause the earnings and profits (E&P) or deficit therein of a subsidiary (S) to be reflected in the E&P of its parent (P).Regs. §1.1502-33(c)(4)(i)(a). Adjustments were only made in the case of actual (or deemed) dividend distributions. In this situation, a member's E&P computations were similar to those made when separate returns were filed.

2. However, for taxable years beginning after 1965 and before 1976, a consolidated group could elect to adjust its E&P currently to reflect the investment account adjustments to P's basis in the S stock. Regs. §1.1502-33(c)(4)(iii).

3. For taxable years beginning after 1975, the current adjustment of E&P is mandatory. Thus, a member generally will reflect the net positive and net negative investment adjustments made by it to the basis of stock of each other member under current Regs. §1.1502-33(c)(4)(ii)(a). Regs. §1.1502-33(c)(4)(ii)(a).

4. The adjustments required by Section 1503(e)(1) are not taken into account in calculating P's E&P due to the investment adjustment system. Thus, P's E&P will be increased by the excess of S's accelerated depreciation over the straight-line amount even though this differential is not reflected in P's basis in the S stock.

B. In General.

1. The new rules establish a separate system for adjusting and tiering up E&P.

2. Consequently, anomalies resulting from the interdependence of stock basis adjustments and E&P adjustments are eliminated. For example, if S sustains an E&P deficit and a corresponding tax loss, P's basis in S's stock is not reduced to reflect the E&P deficit under the current rules until the tax loss is absorbed. This creates "phantom E&P" at the P level.

3. References in the new regulations to earnings and profits include, as the context may require, deficits in earnings and profits. Regs. §1.1502-33(a)(1).
4. If S has earnings and profits that are reflected in the earnings and profits of P under Regs. §1.1502-33(b), and S then transfers its assets to P in a liquidation to which Section 332 applies, S's earnings and profits that P succeeds to under Section 381 are adjusted to prevent duplication. Regs. §1.1502-33(a)(2).

C. Tiering Up of E&P.

1. The adjustments are determined as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the E&P of any person, and they are applied in the order of the tiers, from the lowest to the highest. Regs. §1.1502-33(b)(1).

   a. The adjustment to P's E&P is treated as E&P of P for the taxable year in which the adjustment occurs. Id.

   b. In determining the amount of the adjustment to P's E&P, any unused losses of S are currently taken into account and the tax sharing rules under Regs. §1.1502-33(d) apply rather than the principles under Regs. §1.1502-32(b). Id.

2. An allocable part of S's E&P is reflected in P's E&P based on P's ownership of S's stock. P's allocable part of S's E&P is determined under the allocation principles of Regs. §1.1502-32(c).

   Example (1): P forms S on January 1 in Year 1 with a $100 capital contribution. S has $100 of E&P during Year 1 and no E&P during Year 2. During Year 2, S distributes a $50 dividend to P. S's $100 of E&P for Year 1 also increases P's E&P for Year 1. P has no additional E&P for Year 2 as a result of the $50 distribution in Year 2, because there is a $50 increase in P's E&P as a result of the receipt of the dividend and a corresponding $50 decrease in S's E&P under Section 312(a) that is reflected in P's E&P.

   Assume instead, that S distributes the $50 dividend at the end of Year 1 rather than during Year 2. P's E&P are increased by $100 (S's $50 of undistributed E&P, plus P's receipt of the $50 distribution). Thus, S's E&P increase by $50 and P's E&P increase by $100.

   Assume instead that after P forms S on January 1 of Year 1 with a $100 capital contribution, S borrows additional funds and has a $150 deficit in E&P during Year 1. The corresponding loss for tax purposes is not absorbed in Year 1 because the group has a consolidated net operating loss for Year 1. Instead, S's loss is included in the group's consolidated net operating loss carried forward to Year 2. However, S's $150 deficit in E&P decreases P's E&P for Year 1 by $150.
Example (2): P owns all of S's stock and S owns all of T's stock. During Year 1, T has $100 of E&P. The E&P of T tier up to S and to P. S and P have no other E&P for Year 1. At the end of Year 1, S distributes T's stock to P in a distribution to which Section 355 applies.

Because S's distribution of T's stock is a distribution to which Section 355 applies, the applicable principles of Regs. §1.1502-32(b)(2)(iv) do not require P's E&P to be adjusted by reason of the distribution. In addition, although S's E&P may be reduced under Section 312(h) as a result of the distribution, the applicable principles of Regs. §1.1502-32(b)(3)(iii) generally would not require P's E&P to be adjusted to reflect this reduction in S's E&P.

Example (3): P owns 80 percent of S's stock throughout Year 1. During Year 1, S has $100 of E&P. $80 of S's E&P is allocated to S's stock owned by P. Accordingly, $80 of S's E&P for Year 1 is reflected in P's E&P for Year 1.

3. P's E&P are increased upon a distribution by S of E&P accumulated in a separate return affiliation year before the group elected to file a consolidated return. Regs. §1.1502-33(b)(2).

a. P is nevertheless required to reduce its basis in the stock of S as a result of the distribution. Regs. §1.1502-32(b)(2)(iv).

b. Note that P's E&P is not increased for distributions by S if E&P accumulated in a separate return limitation year, i.e., generally a year before S joined the P group. Regs. §1.1502-33(b)(1) and (2).

Example (4): P forms S in Year 1 with a $100 capital contribution. S has $100 of E&P for Year 1 and no E&P for Year 2. During Year 2, S declares and distributes a $50 dividend to P.

P and S do not begin filing consolidated returns until Year 2. Because P and S file separate returns for Year 1, P's basis in S's stock remains $100 under Regs. §1.1502-32, S has $100 of earnings and profits, and none of S's earnings and profits is reflected in P's earnings and profits under Regs. §1.1502-33(b). S's distribution in Year 2 ordinarily would reduce S's earnings and profits but not increase P's earnings and profits. (P's $50 of earnings and profits from the dividend would be offset by S's $50 reduction in earnings and profits that tiers up.) However, the negative adjustment for S's distribution to P does not apply. Thus, S's distribution reduces its earnings and profits by $50 but
increases P's earnings and profits by $50. (If S's earnings and profits had been accumulated in a separate return limitation year, the distribution would reduce S's earnings and profits but not increase P's earnings and profits.)

D. Effect of Dispositions and Distributions on E&P.

1. For purposes of determining P's E&P from the disposition of S's stock, P's basis in S's stock is adjusted to reflect the allocable part of S's E&P determined under Regs. §1.1502-33(b) rather than under Regs. §1.1502-32. Regs. §1.1502-33(c)(1).

2. P may have an excess loss account in S's stock for E&P purposes, and the excess loss account is determined, adjusted, and taken into account in accordance with the principles of Regs. §§1.1502-19 and 1.1502-32. This rule reflects the general requirement under Section 312(f)(1) that separate tax and E&P basis be maintained if E&P adjustments differ from tax adjustments.

3. A distribution with respect to S's stock to which Section 301 applies is taken into account by members as S's shareholders become entitled to the distribution. Regs. §1.1502-14(a)(5).

   a. For example, if P becomes entitled to the distribution before it is made, S is treated as distributing the amount to P at the time P becomes entitled to the distribution. If it is later established, based on all of the facts and circumstances, that the distribution will not be made, the initial adjustment is reversed as of when it was made. *Id.*

   b. If S's stock is not wholly owned by members of the consolidated group, appropriate adjustments must be made to prevent acceleration of the members' portion of the distribution from affecting the E&P consequences of distribution to members. *Id.*


1. The new regulations retain the elective or "complementary" allocation methods. These rules are simplified but remain substantially unchanged from the current regulations. Regs. §1.1502-33(d).

2. In addition, a consolidated group may elect to conform its E&P computations to the method prescribed under Regs. §1.1502-32(b)(3)(iv)(D) which is used for purposes of calculating stock basis. Regs. §1.1502-33(d)(5)(ii)(B). If a conforming election is made, the group must make all adjustments necessary to prevent amounts from being duplicated or omitted.
a. The election is made by attaching a statement entitled, "ELECTION TO CONFORM TAX ALLOCATIONS UNDER §§1.1502-32 and 1.1502-33(d)," to the group's return for its first tax year beginning on or after January 1, 1995.

b. The statement must contain the following items:

(1) It must be signed by the common parent and must specify whether the method is conformed only for years beginning on or after January 1, 1995, or as if the method were in effect for all prior years.

(2) The statement must also describe the adjustments made by reason of the change (e.g., to reflect prior use of E&P).

F. Elimination of Subsidiary's E&P.

1. Immediately before it becomes a nonmember, S's E&P are eliminated to the extent that they were taken into account by any member under Regs. §1.1502-33. Regs. §1.1502-33(e)(1).

a. For this purpose, S is treated as becoming a nonmember on the first day of its first separate return year (including another group's consolidated return year). Id.

(1) However, no elimination occurs solely by reason of the termination of a group because of the acquisition of the stock, or the tax-free acquisition of the assets, of the common parent, if there is a surviving group that is, immediately thereafter, a consolidated group. Regs. §1.1502-33(e)(2).

(2) Elimination of a member's E&P would occur upon the acquisition of the common parent to the extent members of the terminating group do not become members of the succeeding group. Id. See, e.g., Section 1504(c) pertaining to life insurance companies.

b. The elimination of S's E&P does not tier up and eliminate the E&P of a higher-tier member of the group. Regs. §1.1502-33(e)(1).

c. Upon the elimination of S's E&P, if S makes a distribution to P before earning postconsolidation E&P, P's basis in the S stock may be reduced under Section 301(c)(2) or may create capital gain under Section 301(c)(3).
Due to the elimination of S’s E&P, the basis reduction account rules under Temp. Regs. §1.1502-32T(a) are no longer necessary and are eliminated prospectively.

2. If the stock of S is distributed in a transaction qualifying under Section 355, special rules are provided to allocate E&P in accordance with Section 312(h). Regs. §1.1502-33(e)(3).

a. Thus, P’s E&P rather than S’s E&P may be eliminated immediately before S becomes a nonmember. Id.

b. P’s E&P are eliminated to the extent that its E&P reflect S’s E&P after applying Section 312(h) immediately after S becomes a nonmember. Id.

Example (5): Individuals A and B own all of P’s stock, and P owns all the stock of S and T, each with a $500 basis. During Year 1, S has $100 of E&P and T has $50 of E&P. The E&P of S and T tier up to P, and P has $150 of E&P for Year 1. On December 31 of Year 1, P sells all of S’s stock for $600.

S’s $100 of E&P is eliminated immediately before S becomes a nonmember of the consolidated group because the E&P are taken into account under Regs. §1.1502-33(b) in computing P’s E&P. However, no corresponding adjustment is made to P’s E&P or to P’s basis in S’s stock for purposes of calculating E&P. P’s E&P for Year 1 remain $150 following the sale of S’s stock.

Assume instead that, at the close of Year 1, X, the common parent of another consolidated group, purchases all of P’s stock and P sells S’s stock during Year 3. The E&P of S and T are not eliminated as a result of X purchasing P’s stock. However, S’s E&P from consolidated return years of both the P group and the X group are eliminated immediately before S becomes a nonmember of the X group. Assume instead that S has a $550 deficit in E&P during Year 1. Assume that P also has an excess loss account in S’s stock for E&P purposes under the principles of Regs. §§1.1502-19 and 1.1502-32, and, under the principles of Regs. §1.1502-19(c)(2), the excess loss account is not taken into account as a result of X’s purchase of P’s stock. S’s deficit is not eliminated immediately before X’s purchase of P’s stock. However, S’s E&P deficit is eliminated immediately before S becomes a nonmember of the X group.

Assume instead that, at the close of Year 1, rather than selling S’s stock, P distributes S’s stock to A in a distribution to which Section 355 applies. P’s E&P may be reduced under Section 312(h) as a result of the distribution. To the extent that P’s E&P are reduced, S’s E&P are not eliminated under Regs. §1.1502-33(e)(1).

1. If P succeeds another corporation under the principles of Regs. §1.1502-75(d)(2) or (3) as the common parent of a group ("a group structure change"), the E&P of P are adjusted immediately after it becomes the new common parent to reflect the E&P of the other corporation immediately before the other corporation ceases to be the common parent. Regs. §1.1502-33(f)(1)(i).

   a. The adjustment is made as if P succeeds to the E&P of the other corporation in a transaction described in Section 381(a). Id.

   b. If the former common parent's stock is not wholly owned by members of the consolidated group immediately after it ceases to be the common parent, appropriate adjustments must be made to reflect in the new common parent only an allocable part of the former common parent's E&P. Regs. §1.1502-33(f)(1)(ii).

   c. To the extent that the former common parent is owned other than P, the E&P of the intermediate subsidiaries must also be adjusted consistent with the principles of Regs. §1.1502-33(f). Regs. §1.1502-33(f)(1)(iii).

   d. Note that the replication of E&P is not limited to nonrecognition transactions.

   e. If the former common parent had a deficit in E&P at the time of the group structure change, this deficit will likewise be replicated in P's E&P after the group structure change. See Regs. §1.1502-33(a)(1), which provides that references in Regs. §1.1502-33 to "earnings and profits" include, as the context may require, a deficit therein.

2. These rules are similar to Temp. Regs. §1.1502-33T. However, the current rules for replicating E&P are limited to group structure changes where there is at least 80 percent continuity of ownership of the group, whereas the new rules apply to any successor common parent in a transaction described in Regs. §1.1502-75(d)(2) or (3), e.g., a reverse acquisition with a more than 50 percent continuing ownership on the part of the acquired corporation's shareholders. Thus, the new rules merely focus on whether the group survives.

Example (6): On December 31 of Year 1, P is the common parent of a group with $100 of E&P, and X, the common parent of another consolidated group, has $20 of E&P. On December 31 of Year 1, X
acquires all of P’s stock in exchange for 70 percent of X’s stock. The exchange is a reverse acquisition under Regs. §1.1502-75(d)(3), and the P group is treated as remaining in existence with X as its new common parent.

X’s E&P are adjusted to reflect P’s $100 of E&P immediately before P ceases to be the common parent. The adjustment is made as if X succeeds to P’s E&P in a transaction described in Section 381(a). Thus, immediately after the acquisition, X has $120 of accumulated E&P and P continues to have $100 of accumulated E&P. Although the X group terminates on X’s acquisition of P’s stock, no adjustments are made to the E&P of any subsidiaries in the terminating X group.

Assume instead that, immediately before the acquisition of its stock by X, P is not affiliated with any other corporation. The exchange is a reverse acquisition under Regs. §1.1502-75(d)(3), and the P group is treated as remaining in existence with X as its new common parent. Consequently, the results are the same as above.

3. If the location of a member within a group changes, appropriate adjustments must be made to the earnings and profits of the members to prevent the earnings and profits from being eliminated. Regs. §1.1502-33(f)(2).

a. For example, if P transfers all of S’s stock to another member in a transaction to which Section 351 and Regs. §1.1502-13 apply, the transferee’s earnings and profits are adjusted immediately after the transfer to reflect S’s earnings and profits immediately before the transfer from consolidated return years.

b. On the other hand, if the transferee purchases S’s stock from P, the transferee’s earnings and profits are not adjusted.

c. This rule is similar to Temp. Regs. §1.1502-33T(a)(2).

H. Anti-Abuse Rules.

1. In General.

If any person acts with a principal purpose contrary to the purposes of Regs. §1.1502-33, or to avoid the effect of the rules of Regs. §1.1502-33, adjustments are required to be made as necessary to carry out the purposes of Regs. §1.1502-33. Regs. §1.1502-33(g).
2. Predecessors and successors.

For purposes of Regs. §1.1502-33, any reference to a corporation or to a share includes a reference to a successor or predecessor as the context may require. A corporation is a successor if its E&P are determined, directly or indirectly, in whole or in part, by reference to the E&P of another corporation (the predecessor). A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor). Regs. §1.1502-33(h).

I. Effective Dates.

1. The new rules generally apply with respect to determinations of E&P (e.g., for purposes of a distribution to which Section 301 applies) in consolidated return years beginning on or after January 1, 1995. If the new rules apply, E&P must be determined or redetermined as if the new rules were in effect for all consolidated return years of the group. Regs. §1.1502-33(j)(1).

2. However, if P disposes of S's stock in a consolidated return year beginning before January 1, 1995, P's E&P with respect to S are not redetermined. Nevertheless, if determinations or adjustments to P's basis in S's stock reflect determinations or adjustments with respect to stock of a lower-tier member, the determinations or adjustments are redetermined if S later disposes of the lower-tier member's stock under the new rules even though they were previously taken into account in P's disposition of S's stock. Regs. §1.1502-33(j)(2).

3. Regs. §1.1502-33(e) and -33(f) apply only to deconsolidations and group structure changes occurring in consolidated return years beginning on or after January 1, 1995. Regs. §1.1502-33(j)(3).

IV. Excess Loss Accounts.

A. Background.

1. The excess loss account (ELA) rules are an extension of the rules for adjusting stock basis. P's basis in the S stock is reduced as the group absorbs S's losses and as S makes distributions to P. The reductions are not limited to the group's basis in S's stock and, to the extent reductions exceed stock basis, they result in an ELA with respect to the S stock owned by P. P's ELA is included in its income when P disposes of the stock, and the income is generally treated as gain from the sale of the stock.
2. An ELA ordinarily arises with respect to a share of S's stock only if S's losses and distributions are funded with capital not reflected in the basis of the share. The reductions may be funded by creditors or by other shareholders, including other members.

B. In General.

1. The new regulations revise and simplify the current rules by applying principles instead of mechanical rules.

2. Generally, an ELA is treated as "negative basis" for computational purposes, which eliminates the need for special ELA rules paralleling the basis rules of the Code. Regs. §1.1502-19(a)(2)(ii). Similarly, the rules of the Code are generally used to determine the timing for inclusion of an ELA in the owning member's income.

3. The new regulations restate the principle that the purpose of an ELA is to recapture the group's use of S's deductions and losses with respect to a share, and the group's exclusion of S's distributions with respect to the share, to the extent they exceed P's basis in the share.

4. The election under Regs. §1.1502-19(a)(6) to reduce basis in the other stock of a subsidiary in lieu of recognizing ELA income is eliminated by the new regulations.

C. Recognition of ELA Income.

1. If P is treated as disposing of a share of S's stock, P's ELA in the share is taken into account as an amount realized by P from the disposition. Regs. §1.1502-19(b)(1).

   a. The disposition is generally treated as a sale or exchange for purposes of determining the character of the amount realized. Id.

   b. P's ELA income is treated as ordinary income to the extent of the lesser of:

      (1) The amount by which S is insolvent [within the meaning of Section 108(d)(3)] immediately before the disposition; or

      (2) P's ELA, redetermined without taking into account distributions with respect to S's stock under Regs. §1.1502-32(b)(2)(iv). Regs. §1.1502-19(b)(4).

      (3) For purposes of determining S's insolvency, liabilities include any amount to which preferred stock would be entitled if S were liquidated immediately before the
disposition and any former liabilities that were discharged but not taken into account as tax-exempt income by reason of Regs. §1.1502-32(b)(3)(ii)(C). *Id.*

2. P's ELA income from a disposition of a share is subject to any nonrecognition or deferral rules applicable to the disposition. Regs. §1.1502-19(b)(2)(i).

   a. For example, if P's stock in S is redeemed in a liquidation to which Section 332 applies or P transfers all of its assets (including S's stock) to S in a reorganization to which Section 361(a) applies, P's income or gain from the ELA is not recognized.

   b. However, if P's ELA is triggered on account of worthlessness or as a result of a deconsolidation of the S stock, the nonrecognition rule above does not apply. Regs. §1.1502-19(b)(2)(ii). For example, if P transfers S's stock to a nonmember in a transaction to which Section 351 applies, P's gain attributable to the ELA is taken into account.

   c. If stock of more than one subsidiary is disposed of in the same transaction, the ELA income is taken into account in the order of the tiers, from the lowest to the highest. Regs. §1.1502-19(b)(3).

*Example (1):* P has a $150 basis in S's stock, and S has a $100 basis in T's stock. During Year 1, P has $500 of ordinary income, S has no income or loss, and T has a $200 ordinary loss. On December 31 of Year 1, S sells T's stock to a nonmember for $60. Immediately before the sale, S decreases its basis in T's stock to zero and establishes a $100 excess loss account in T's stock. S is treated as disposing of T's stock on December 31 of Year 1 (the day of the sale). The excess loss account is treated as an additional $100 realized by S from the sale. Consequently, S recognizes a $160 gain from the sale, which is taken into account in determining the group's consolidated taxable income. Under Regs. §1.1502-32(b), T's $200 loss and S's $160 gain result in a $40 decrease in P's basis in S's stock as of the close of Year 1, from $150 to $110.

Assume instead that S sells T's stock to P for $60 at the close of Year 1 and P sells T's stock to a nonmember at a gain on January 1 of Year 5. S is treated as disposing of T's stock at the close of Year 1, and the excess loss account in T's stock is treated as an additional $100 realized by S from the sale. However, under Regs. §1.1502-13, S's $160 gain is deferred and taken into account in Year 5 when P sells T's stock. Thus, as of the close of Year 1, the absorption of T's $200 loss results in P
decreasing its basis in S's stock to zero and establishing a $50 excess loss account. As of the close of Year 5, S's $160 gain eliminates P's $50 excess loss account in S's stock and increases P's basis in the stock to $110.

Example (2): P owns all of the stock of S and T. On December 31 of Year 1, P has a $150 basis in S's stock, and P has a $100 excess loss account in T's stock. On that day, P transfers T's stock to S without receiving additional S stock in a transaction to which Section 351 applies. P is treated as disposing of T's stock on December 31 of Year 1 (the day of the transfer). Under Section 351, P does not recognize gain from the disposition. Under Section 358, P's $100 excess loss account in T's stock decreases P's basis in S's stock from $150 to $50. In addition, under Section 362, S has a $100 excess loss account in T's stock.

Assume instead that T merges into S in a reorganization to which Section 368(a)(1)(A) applies [and is also described in Section 368(a)(1)(D)], and P receives no additional S stock in the reorganization. Under Regs. §1.1502-19(b), P does not recognize gain as a result of the reorganization. Instead, P's $100 excess loss account in T's stock decreases P's $150 basis in the S stock that P owns before the merger to $50. Similarly, if S merges into T and P does not receive additional T stock, P's $150 basis in S's stock eliminates P's excess loss account in T's stock and increases P's basis in T's stock to $50.

Example (3): On December 31 of Year 1, P has a $30 excess loss account in S's stock, and S has a $90 excess loss account in T's stock. On that day, S distributes T's stock to P in a transaction to which Section 355 applies and on which no gain or loss is recognized. At the time of the distribution, T's stock represents one-third of the value of S's stock. S is treated as disposing of T's stock on December 31 of Year 1 (the day of the distribution). Under Section 355, S does not recognize any gain from the disposition. S's excess loss account in T's stock is eliminated, and P's $30 excess loss account in S's stock is treated as a negative amount allocated under Section 358 between S's stock and T's stock following the distribution. Consequently, P has a $20 excess loss account in S's stock and a $10 excess loss account in T's stock.

Assume instead that P has a $30 excess loss account in S's stock, S has no lower-tier subsidiaries, P distributes S's stock to P's shareholders on December 31 of Year 1 in a transaction to which Section 355 applies, and the distribution causes S to become a nonmember. P is treated as disposing of S's stock on December 31 of Year 1 (the day of the distribution). P's $30 gain from the distribution must be taken into account in the determination of the group's consolidated taxable income notwithstanding the nonrecognition rules of Section 355.
Example (4): On December 31 of Year 1, P has a $50 excess loss account in S's stock, and S has a $100 excess loss account in T's stock. On that day, T issues additional stock to a nonmember and, as a consequence, T becomes a nonmember. S is treated as disposing of T's stock on December 31 of Year 1 (the day T becomes a nonmember). S is treated as realizing $100 from the sale or exchange of T's stock. Under Regs. §1.1502-32(b), S's $100 gain from the disposition of T's stock eliminates P's excess loss account in S's stock and increases P's basis in S's stock to $50.

Assume instead that S (rather than T) issues the stock and, as a consequence, both S and T become nonmembers on December 31 of Year 1. P is treated as disposing of S's stock and S is treated as disposing of T's stock. Because both S and T become nonmembers in the same transaction and T is the lower-tier member, S is first treated as realizing $100 from the sale or exchange of T's stock. Under Regs. §1.1502-32(b), S's $100 gain from the disposition of T's stock eliminates P's excess loss account in S's stock and increases P's basis in S's stock to $50. Consequently, S's $100 gain from the disposition of T's stock is taken into account in the determination of the group's consolidated taxable income, but P's excess loss account in S's stock is eliminated immediately before P's disposition of S's stock.

Assume instead that T has $30 of gain that has been deferred under Regs. §1.1502-13 and is taken into account in determining consolidated taxable income immediately before T becomes a nonmember. T's $30 gain decreases S's excess loss account in T's stock from $100 to $70 immediately before S is treated as disposing of T's stock. S is treated as recognizing $70 from the disposition of T's stock. Thus, P's excess loss account in S's stock is eliminated, and P's basis in S's stock is increased from $0 to $50 immediately before S ceases to be a member.

d. The new regulations change a long-standing rule contained in current Regs. §1.1502-19(d). If the appreciated stock of a member in which ELA exists is distributed in a Section 301 distribution to another member of the group, the ELA is triggered and deferred. Regs. §1.1502-19(c)(1)(i)(A) and -19(e), Example (1)(d). This result is consistent with Temp. Regs. §1.1502-14T(c)(2), Example (2), and follows Rev. Rul. 81-84, 1984-1 C.B. 451, in the case of an actual sale. It is contrary to PLR 8917077 (Feb. 2, 1989).
D. Disposition Events.

1. P is treated as disposing of a share of the S stock upon the occurrence of the following:
   
a. When P transfers or ceases to own the share for federal income tax purposes, even if no gain or loss is taken into account, or P takes into account gain or loss with respect to the share;

b. When P becomes a nonmember, or a nonmember determines its basis in the share (or any other asset) by reference to P's basis in the share, directly or indirectly, in whole or in part (e.g., under Section 362);

c. When S becomes a nonmember, or P's basis in the share is reflected, directly or indirectly, in whole or in part, in the basis of any asset other than member stock (e.g., under Section 1071);

d. At the time that substantially all of S's assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes (e.g., under Section 165(a) or Regs. §1.1502-80(c), or if S's asset is stock of a lower-tier member, the stock is treated as disposed of);

e. At the time that an indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Regs. §1.1502-32(b)(3)(ii)(C); or

f. A member takes into account a deduction in loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income. Regs. §1.1502-19(c)(1).

g. For purposes of Items b. and c., above, a member is treated as becoming a nonmember if it has a separate return year (including another group’s consolidated return year). Regs. §1.1502-19(c)(2).

(1) However, no ELA restoration occurs solely by reason of the termination of a group because of the acquisition of the stock, or the tax-free acquisition of the assets, of the common parent, if there is a surviving group that is, immediately thereafter, a consolidated group. Regs. §1.1502-19(c)(3).
(2) Restoration of the ELA would occur upon the acquisition of the common parent to the extent members of the terminating group do not become members of the succeeding group. Id. See, e.g., Section 1504(c) pertaining to life insurance companies.

(3) A disposition event under Items b. or c. above is treated as occurring during a consolidated return year. For example, if the group ceases to file a consolidated return under Regs. §1.1502-75(c), the disposition event is treated as occurring immediately before the close of the last consolidated return year. Regs. §1.1502-19(c)(2).

(4) If a group terminates under Regs. §1.1502-75(d) because the common parent is the only remaining member, the common parent is not treated as becoming a nonmember. Id.

h. For purposes of Item d., above, even though S's stock may be worthless within the meaning of Section 165, the inclusion in income of P's ELA with respect to the S stock is deferred until S's assets are treated as disposed of. This rule provides a better coordination with other provisions of the Code, such as Section 382(g)(4)(D), and permits the continued use of S's losses.

Example (5): On January 1 of Year 1, P forms S with a $150 capital contribution. During Year 1, the P group has a $50 consolidated net operating loss (which, under the principles of Regs. §1.1502-79, is entirely attributable to S). During Year 2, P has $160 of ordinary income and S borrows $150 and has a $160 ordinary loss. Under Regs. §1.1502-32(b), P's basis in S's stock is reduced to zero and P has a $10 excess loss account in S's stock. During Year 3, the value of S's assets (without taking S's liabilities into account) continues to decline and S's stock becomes worthless within the meaning of Section 165(g). During Year 4, S earns $10 of ordinary income.

P is treated as disposing of S's stock on any day that substantially all of S's assets are treated as disposed of, abandoned, or destroyed within the meaning of Section 165(a). Thus, P is not treated as disposing of S's stock during Year 3 solely because of the worthlessness of S's stock, provided that S does not maintain its assets for the principal purpose of avoiding a disposition of its stock. Because S's stock is not treated as worthless, Regs. §1.1502-19 does not cause Section 382(g)(4)(D) to apply in Year 3, and S's net operating loss carryover may offset S's $10 of income in Year 4.
Alternatively, assume that, instead of S’s stock becoming worthless within the meaning of Section 165(g), S’s creditor discharges $40 of S’s indebtedness during Year 3 and S is insolvent by $60. The discharge is excluded from the P group’s gross income under Section 108(a), and $40 of S’s $50 net operating loss carryover is eliminated under Section 108(b). P is treated as disposing of S’s stock if the amount discharged is not included in gross income and is not treated as tax-exempt income under Regs. §1.1502-32(b). Because the $40 discharge is treated as tax-exempt income, P is not treated as disposing of S’s stock during Year 3 by reason of the discharge.

E. Determination of Basis.

If P has an excess loss account in any share of S’s stock, basis adjustments or determinations under the Code with respect to S’s stock of the same class owned by P are first allocated among P’s shares in the class to equalize and then eliminate the excess loss account. For example, if P owns 100 shares of S’s only class of stock, 50 with a $100 basis and 50 with a $100 excess loss account, and P makes a $200 capital contribution to S, the contribution first eliminates P’s excess loss account. If P contributes the $200 in exchange for an additional 100 shares of S’s stock in a transaction to which Section 351 applies, P’s excess loss account is eliminated before P’s basis in any shares is increased. Regs. §1.1502-19(d).

F. Anti-Abuse Rules.

1. If a person acts with a principal purpose contrary to the purposes of Regs. §1.1502-19, to avoid the effect of the rules of Regs. §1.1502-19 or apply the rules of Regs. §1.1502-19 to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of Regs. §1.1502-19. Regs. §1.1502-19(e).

2. For purposes of Regs. §1.1502-19, any reference to a corporation or to a share of the corporation’s stock includes a reference to a successor or predecessor or to a share of stock of a predecessor or successor as the context may require. Regs. §1.1502-19(f).

G. Effective Dates.

1. The new rules generally would apply to determinations of stock basis and excess loss accounts in consolidated return years beginning on or after January 1, 1995. If the new rules apply, the basis (or an excess loss account) generally must be determined or redetermined as if the new rules were in effect for all consolidated return years of the group. Regs. §1.1502-19(g)(1).
2. If P disposes of the S stock before the new regulations are effective, the amount of P's income, gain or loss is not redetermined. Regs. §1.1502-19(g)(2).

V. STOCK BASIS AFTER A GROUP STRUCTURE CHANGE.

A. In General.

1. These new rules incorporate the principles of current Temp. Regs. §1.1502-31T.

2. For the definition of a "group structure change" and its effect on the new common parent's E&P, see Regs. §1.1502-33(f) and III.G., supra.

B. Asset Acquisitions.

1. If a corporation acquires the former common parent's assets (and any liabilities assumed or to which the assets are subject) in a group structure change, the basis of members in the stock of the acquiring corporation is adjusted immediately after the group structure change to reflect the acquiring corporation's allocable share of the former common parent's net asset basis. Regs. §1.1502-31(b)(1).

2. For example, if S acquires T's assets in a group structure change to which Section 368(a)(2)(D) applies, P's basis in S's stock is adjusted to reflect T's net asset basis. The result is the same if P owned some of T's stock before the group structure change; P's basis in the T stock is not taken into account in determining P's basis in S's stock. Id.

C. Stock Acquisitions.

1. If a corporation acquires stock of the former common parent in a group structure change, the corporation's basis in the former common parent's stock immediately after the group structure change (including any stock of the former common parent owned before the group structure change) is redetermined in accordance with the results for an asset acquisition, above. Regs. §1.1502-31(b)(2).

2. For example, if all of T's stock is contributed to P in a group structure change to which Section 351 applies, P's basis in T's stock is T's net asset basis. Similarly, if S merges into T in a group structure change to which Section 368(a)(2)(E) applies, P's basis in T's stock is the same basis that P would have in S's stock under Regs. §1.1502-31(b)(1), pertaining to asset acquisitions, if T had merged into S in a group structure change to which Section 368(a)(2)(D) applies. Id.
D. Net Asset Basis.

1. The former common parent's "net asset basis" is the basis it would have in the stock of a newly formed subsidiary, if:
   a. The former common parent transferred its assets (and any liabilities assumed or to which the assets are subject) acquired in the group structure change to the subsidiary in a transaction to which Section 351 applies;
   b. The former common parent and the subsidiary were members of the same consolidated group; and
   c. The asset basis taken into account is each asset's basis immediately after the group structure change (including any income or gain recognized in the group structure change and reflected in the asset's basis). Regs. §1.1502-31(c).

2. A member's basis in the stock of the former common parent is adjusted to reflect the fair market value of any consideration not provided by the member. For example, if S acquires T's assets in a group structure change to which Section 368(a)(2)(D) applies, and S provides an appreciated asset (including stock of P) as partial consideration in the transaction, P's basis in S's stock is reduced by the fair market value of the asset. Regs. §1.1502-31(d)(1).

3. If a corporation receives less than all of the former common parent's assets and liabilities in the group structure change, the former common parent's net asset basis taken into account under Regs. §1.1502-31(b)(1) is adjusted accordingly. Regs. §1.1502-31(d)(2)(i).

4. If a corporation owns less than all of the former common parent's stock immediately after a group structure change, the percentage of the former common parent's net asset basis taken into account equals the percentage (by fair market value) of the former common parent's stock owned immediately after the group structure change. Regs. §1.1502-31(d)(2)(ii).

5. If a corporation has more than one class of stock outstanding immediately after the group structure change, basis is allocated among the classes in proportion to the fair market value of each class. (See Section 358(b).) Regs. §1.1502-31(d)(3).

6. To the extent that the former common parent is owned by members other than the new common parent, the basis of all subsidiaries owning, directly or indirectly, in whole or in part, an interest in the former common
parent’s assets or liabilities is adjusted in accordance with the principles of Regs. §1.1502-31. The adjustments are applied in order of the tiers, from the lowest to the highest. Regs. §1.1502-31(d)(4).

7. An irrevocable election may be made to treat all or any portion of a loss carryover attributable to the common parent as expiring for all federal income tax purposes immediately before the group structure change. Regs. §1.1502-31(e)(1).

a. This election permits the group to avoid a negative basis adjustment to the stock of the former common parent upon expiration of a loss carryover under Regs. §1.1502-32(b)(3)(iii)(A). See II. D. 4.a.(2)., supra, for a further discussion of this rule.

b. The election is made in a separate statement entitled “ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER §1.1502-31(e).”

(1) The statement must be filed with the group’s return for the year that includes the group structure change and must be signed by the former and the new common parent.

(2) The statement must also identify the amount of each loss carryover deemed to expire. Regs. §1.1502-31(e)(2).

8. For purposes of Regs. §1.1502-31, any reference to a corporation includes a reference to a successor or predecessor as the context may require. Regs. §1.1502-31(f). See Regs. §1.1502-32(f) for definitions of predecessors and successors.

Example (1): P is the common parent of one group and T is the common parent of another group. T has assets with an aggregate basis of $60 and fair market value of $100, and T has no liabilities. T’s shareholders have an aggregate basis of $50 in T’s stock. Pursuant to a plan, P forms S, and T merges into S with the T shareholders receiving P stock in exchange for their T stock. The transaction is a reorganization to which Sections 368(a)(1)(A) and (a)(2)(D) apply. The transaction is also a reverse acquisition under Regs. §1.1502-75(d)(3). Thus, the acquisition is a group structure change under Regs. §1.1502-33(f), and P’s E&P are adjusted to reflect T’s E&P immediately before T ceases to be the common parent.

P’s basis in S’s stock is adjusted to reflect P’s allocable share of T’s net asset basis. T’s net asset basis is $60, the basis T would have in the stock of a subsidiary under Section 358 if T had transferred all of its assets and liabilities to the subsidiary in a transaction to which Section 351 applies. Thus, P is treated as having a $60 basis in S’s stock.
Assume instead that T has two assets, an operating asset with an $80 basis and $90 fair market value, and stock of a subsidiary with a $20 excess loss account and $10 fair market value. T's net asset basis is $60. See Sections 351 and 358 and Regs. §1.1502-19. Consequently, P has a $60 basis in S's stock. S has an $80 basis in the asset and $20 excess loss account in the stock of the subsidiary.

Assume instead that P forms S with a $100 contribution on January 1 of Year 1, and, pursuant to a plan during Year 6, S purchases $100 of P stock and T merges into S with the T shareholders receiving P stock in exchange for their T stock. P's $100 basis in S's stock is increased by $60 to reflect T's net asset basis. However, P's basis in S's stock is decreased by $100 (the fair market value of the P stock) because the P stock purchased by S and used in the transaction is consideration not provided by P.

Example (2): P is the common parent of one group and T is the common parent of another group. T has assets with an aggregate basis of $60 and fair market value of $100, and T has no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P forms S and S acquires all of T's stock in exchange for P stock. The exchange is a transaction to which Section 368(a)(1)(B) applies. The transaction is also a reverse acquisition under Regs. §1.1502-75(d)(3). Thus, the acquisition is a group structure change under Regs. §1.1502-33(f), and the E&P of P and S are adjusted to reflect T's E&P immediately before T ceases to be the common parent.

Although S is not the new common parent of the T group, adjustments must be made to S's basis in T's stock consistent with the principles of Regs. §1.1502-31. Although S's basis in T's stock would ordinarily be determined under Section 362 by reference to the basis of T's shareholders in T's stock immediately before the group structure change, S's basis in T's stock is determined by reference to T's net asset basis. Thus, S's basis in T's stock is $60. P's basis in S's stock is adjusted to $60 consistent with the adjustment to S's basis in T's stock.

Assume instead that S has owned 10 percent of T's stock for several years and, pursuant to the plan, S acquires the remaining 90 percent of T's stock in exchange for P stock. The results are the same as above because S's basis in the initial 10 percent of T's stock is adjusted under the new regulations.

Assume instead that P owns only 90 percent of S's stock. S's basis in T's stock is the same as above; P's basis in its S stock is adjusted to $54 (90 percent of S's $60 adjustment).
**Example (3):** P is the common parent of one group and T is the common parent of another group. T has assets with an aggregate basis of $60 and fair market value of $100, and T has no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P acquires all of T's stock in exchange for $70 of P's stock and $30 in a transaction that is a group structure change under Regs. §1.1502-33(f). Because of the use of cash, however, P's acquisition of T's stock is not a transaction to which Section 368(a)(1)(B) applies. P's basis in T's stock is adjusted to reflect T's net asset basis. Thus, although P's basis in T's stock would ordinarily be a cost basis of $100, P's basis in T's stock under Regs. §1.1502-31 is $60.

E. Effective Dates.

1. The new regulations generally apply to group structure changes occurring in consolidated return years beginning on or after January 1, 1995. Regs. §1.1502-31(g)(1).

2. To the extent stock basis after a group structure change under the regulations is less than it would be under, e.g., Section 362, the validity of the regulations is seriously questioned.

VI. **ANTI-CIRCULAR BASIS RULES.**

A. Background.

1. Prior to the amendment of the consolidated return regulations in 1972, if gain was recognized on the sale of stock of a subsidiary and there was, apart from such gain, a consolidated net operating loss or net capital loss for the year of sale, or a consolidated NOL or NCL carryover, attributable to the subsidiary which was sold, such losses were absorbed entirely as a result of a series of circular adjustments to the basis of the subsidiary's stock in the hands of the selling member.

2. Current Regs. §1.1502-11(b) attempts to resolve this "circular basis" problem by providing that the current-year net operating or net capital loss and net operating or net capital loss carryover attributable to a subsidiary may not be used to offset gain on the disposition of its stock. Such losses may only be applied against the other current income of the group.

B. Determination of Limitation on Use of Losses.

1. If S recognizes deductions or losses in the taxable year in which P disposes of one or more shares of S's stock (or S carries over deductions or losses from a prior year to the year of disposition), the extent to which the deductions or losses offset income and gain may be limited. The
limitation is determined by tentatively computing taxable income (or loss) for the year of disposition, and any prior years to which the deductions or losses may be carried, by not taking into account any income or gain P recognizes from the disposition of S's stock. Regs. §1.1502-11(b)(2)(i).

2. S's losses and deductions may offset income and gain only in the amount determined under Regs. §1.1502-11(b)(2)(i). To the extent S's items arising in the year of disposition cannot offset income or gain because of the limitation, the items are treated as a separate net operating or net capital loss (as the case may be) arising in the year of disposition. Although the limitation is computed by tentatively determining the taxable income (or loss) of all members, the limitation, once determined, does not limit the use of deductions and losses of members other than S. Regs. §1.1502-11(b)(2)(ii).

3. These rules are substantially unchanged from the current regulations.

Example (1): On January 1 of Year 1, P has a $500 basis in S's stock. During Year 1, P has ordinary income of $30 (determined without taking P's gain or loss from the disposition of S's stock into account) and S has an $80 ordinary loss. On December 31 of Year 1, P sells S's stock for $520. To determine the limitation on S's loss and the effect of the absorption of S's loss on P's basis in S's stock under Regs. §1.1502-32(b), P's gain or loss from the disposition of S's stock is not taken into account. The group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus S's $80 loss). Thus, only $30 of S's loss offsets P's income or gain.

Under Regs. §1.1502-32(b), because $30 of S's loss is absorbed in the determination of consolidated taxable income, P's basis in S's stock is reduced from $500 to $470 immediately before the disposition. Consequently, P recognizes a $50 gain from the sale of S's stock and the group has consolidated taxable income of $50 for Year 1 (P's $30 of ordinary income and $50 gain from the sale of S's stock, less the $30 of S's loss). Because S ceases to be a member, the $50 of S's loss that is not taken into account in the determination of consolidated taxable income is a separate net operating loss that is apportioned to S under Regs. §1.1502-79 and carried to its first separate return year.

Example (2): P has a $400 basis in S's stock. During Year 1, P has a capital gain of $100 (determined without taking P's gain or loss from the disposition of S's stock into account) and S has both a $60 capital loss and a $200 ordinary loss. On December 31 of Year 1, P sells S's stock for $140.
The amount of S’s ordinary and capital losses that may offset income and gain is determined by tentatively computing the group’s consolidated net operating loss and consolidated net capital loss without taking into account P’s loss from the disposition of S’s stock. The limitation is necessary to prevent P’s loss from the disposition of S’s stock from affecting the absorption of S’s losses and thereby adjustments to P’s basis in S’s stock underRegs. §1.1502-32(b) (which would, in turn, affect P’s loss). Thus, the group is tentatively treated as having a $40 consolidated net capital gain and a $200 ordinary loss, which results in a $160 consolidated net operating loss for Year 1, all of which is attributable to S under the principles of §1.1502-79. As a result of the group’s absorption of $60 of S’s capital loss and $40 of S’s ordinary loss, P’s basis in S’s stock is reduced from $400 to $300 immediately before the sale of S’s stock, and P recognizes a $160 loss from the sale. This loss may be disallowed underRegs. §1.1502-20.

C. Multiple Dispositions.

To the extent that income, gain, deduction, or loss from a prior disposition of S’s stock is deferred under any provision of law, the limitation ofRegs. §1.1502-11(b)(2) is determined by treating the year the deferred amount is taken into account as the year of the disposition. If S is a higher-tier corporation with respect to another member (T), and all of T’s items of income, gain, deduction, and loss (including the absorption of T’s loss or deduction) would be fully reflected in P’s basis in the S stock underRegs. §1.1502-32, the limitation underRegs. §1.1502-11(b)(2)(i) with respect to T’s deductions and losses is determined by not taking into account any income, gain, deduction or loss recognized on the disposition of the stock of S or T. Regs. §1.1502-11(b)(4)(ii).

Example (3): P owns all of S’s stock and S owns all of T’s stock. On January 1 of Year 1, P’s basis in S’s stock and S’s basis in T’s stock are both $500. During Year 1, P has ordinary income of $30, S has no income or loss, and T has an $80 ordinary loss. On December 31 of Year 1, P sells S’s stock for $520.

To determine the limitation underRegs. §1.1502-11(b) on T’s loss and the effect of the absorption of T’s loss on P’s basis in S’s stock underRegs. §1.1502-32(b), P’s gain or loss recognized on the disposition of S’s stock is not taken into account. Thus, the group is tentatively treated as having a consolidated net operating loss of $50 (P’s $30 of income minus T’s $80 loss). Because only $30 of T’s loss offsets income or gain, P’s basis in S’s stock is reduced underRegs. §1.1502-32(b) from $500 to $470 immediately before the disposition of S’s stock. Consequently, P recognizes a $50 gain from the sale of S’s stock.

Assume instead that S has a $10 excess loss account in T’s stock rather than a $500 basis. Neither P’s gain or loss from the disposition of S’s stock nor S’s gain or loss from the disposition of T’s stock are taken into account for purposes of the tentative computations and the effect of any absorption underRegs. §1.1502-
32(b) on P's basis in S's stock and S's excess loss account in T's stock. Thus, the group is tentatively treated as having a consolidated net operating loss of $50 (P's $30 of income minus T's $80 loss), and only $30 of T's loss may offset the group's income or gain. The absorption of $30 of T's loss increases S's excess loss account in T's stock to $40 and the excess loss account is taken into account. Moreover, P's basis in S's stock is increased immediately before the sale by $10 (S's $40 gain minus T's $30 loss absorbed and tiered up), from $500 to $510. Consequently, P recognizes a $10 gain from the sale of S's stock, and S recognizes a $40 gain from the inclusion in income of its excess loss account in T's stock.

Example (4): P owns all of the stock of S1 and S2. On January 1 of Year 1, P has a $50 basis in the stock of each. During Year 1, the group has a $100 consolidated net operating loss (under the principles of Regs. §1.1502-79, $50 attributable to S1 and $50 to S2) determined without taking gain or loss from the disposition of member stock into account. On December 31 of Year 1, P sells the stock of S1 and S2 for $100 each.

Regs. §1.1502-11(b)(4) does not apply to the loss of S1 or S2 with respect to the disposition of stock of the other. Consequently, each subsidiary's loss may offset P's gain from the disposition of the stock of the other subsidiary. Because this absorption results in a $50 reduction in P's basis in the stock of each subsidiary under Regs. §1.1502-32(b), P's aggregate gain from the stock dispositions is increased from $100 to $200, $100 of which is offset by the losses of the subsidiaries.

Note that this result retains the "iterative" effect of the circular basis adjustments, i.e., all available losses of a subsidiary can be used against the gain on the sale of another subsidiary in the same chain of ownership.

D. Effective Dates.


VII. LOSS DISALLOWANCE RULES.

The Service has issued rules to conform Regs. §1.1502-20 to the revised investment adjustment system. Certain technical provisions are unnecessary and have been eliminated.
VIII. ALLOCATION OF A SUBSIDIARY’S INCOME AND DEDUCTIONS.

A. Background.

1. Under the current rules, a consolidated return must include the common parent’s items of income, gain, deduction, loss, and credit for the entire consolidated return year and each subsidiary’s items for the portion of the year for which it is a member. If S is acquired during a consolidated return year, its income for the portion of its original taxable year for which it is not a member must be included in a separate return (which may be the consolidated return of another group).Regs. §1.1502-76(b)(1) and (2).

2. Allocation of S’s income between the consolidated and separate returns must be based on the income shown on its permanent records, and if the allocation of an item cannot be determined from its permanent records, it must be allocated ratably. Regs. §1.1502-76(b)(4).

B. In General.

1. A consolidated return must include the common parent’s items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary’s items for the portion of the year for which it is a member. Regs. §1.1502-76(b)(1).

Example (1): P and T are the only members of the P group. On June 30 of Year 2, P sells all of T’s stock to individual A. P’s consolidated return for Year 2 includes P’s income for the entire taxable year and T’s income for the period from January 1 to June 30, and T must file a separate return for the period from July 1 to December 31.

Assume instead that, on July 31 of Year 2, P acquires all the stock of S (which filed a separate return for its year ending on November 30 of Year 1). P’s consolidated return for Year 2 includes P’s income for the entire year, T’s income from January 1 to June 30, and S’s income from August 1 to December 31. T must file a separate return that includes its income from July 1 to December 31, and S must file a separate return that includes its income from December 1 of Year 1 to July 31 of Year 2.

Note that if P had acquired S after December 31 of Year 2, the P group that included T is a different group from the P group that includes S. Thus, the P group that includes S must make a new consolidated return election if desired.

2. If a corporation (S) becomes, or ceases to be, a member during a consolidated return year, the corporation’s taxable year is treated for all federal income tax purposes as ending as of the event causing the corporation to become or cease to be a member. Regs. §1.1502-76(b)(1).
As a result, S must generally close its books upon entering or leaving a consolidated group.

3. If a corporation (S) becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the date on which its status changes, and its tax year ends for all federal income tax purposes at the end of that day. Regs. §1.1502-76(b)(1). This approach is consistent with the approach of other rules under Subchapter C of the Code that may apply to the event causing a corporation to join or leave a group. See, e.g., Sections 338, 381, and 382.

4. If, on the day of S’s change in status as a member, a transaction occurs that is properly allocable to the portion of S’s day after the event resulting in the change, S and all persons related to S under Section 267(b) immediately after the event must treat the transaction for all federal income tax purposes as occurring at the beginning of the following day. Regs. §1.1502-76(b)(1)(ii)(B).

5. The returns for the years that end and begin with S becoming (or coming to be) a member are separate tax years for all federal income tax purposes. Regs. §1.1502-76(b)(2)(i).

6. If a common parent ceases to be the common parent but the group remains in existence, adjustments must be in accordance with the principles of Regs. §1.1502-75(d)(2) and (3). Regs. §1.1502-76(b)(1)(iii).

Example (2): P owns all of the stock of S and T. Shortly after the beginning of Year 1, P merges into T in a reorganization to which Section 368(a)(1)(A) applies [and is also described in Section 368(a)(1)(D)], and P’s shareholders receive T’s stock in exchange for all of P’s stock. The P group is treated under Regs. §1.1502-75(d)(2)(ii) as remaining in existence with T as its common parent. The P group’s return must include the common parent’s items for the entire consolidated return year and, if the common parent ceases to be the common parent but the group remains in existence, appropriate adjustments must be made. Consequently, although P did not exist for all of Year 1, P’s items for the portion of Year 1 ending with the merger are treated as the items of the common parent that must be included in the P group’s return for Year 1.

Assume instead that X acquires all of P’s assets in exchange for more than 50 percent of X’s stock in a reorganization to which Section 368(a)(1)(D) applies. The reorganization constitutes a reverse acquisition under Regs. §1.1502-75(d)(3), with the X group terminating and the P group surviving with X as its common parent. Consequently, P’s items for the portion of Year 1 ending with the acquisition are treated as the items of the common parent that must be included in the P group’s return for Year 1, and an
allocable portion of X's items must be included in the P group's return for the portion of Year 1 beginning with the acquisition.

C. Ratable Allocation of a Subsidiary's Income and Deductions.

1. In lieu of a mandatory closing of a subsidiary's books when it joins or leaves a consolidated group, the new regulations provide an election under which S may ratably allocate items of income, gain, deductions, losses, and credits. Regs. §1.1502-76(b)(2)(ii).
   a. The election is not available, however, if S is required to change its annual accounting period as a result of joining or leaving the consolidated group. Regs. §1.1502-76(b)(2)(ii)(A)(1).
   b. For example, the election would not be available if S is a calendar-year taxpayer and is acquired by a fiscal-year consolidated group.

2. Under ratable allocation, S's items affecting taxable income are generally allocated to each day of S's original taxable year.
   a. For this purpose, S's original taxable year is treated as a single taxable year.
   b. However, the years ending and beginning with the event that causes S's year to close are treated as different taxable years with respect to any item carried to or from those years. See, e.g., Sections 172 and 481. Regs. §1.1502-76(b)(2)(ii)(B).

Example (3): On June 30 of Year 1, P sells all of T's stock to X. T is engaged in the production and sale of merchandise throughout Year 1 and is required to use inventories. The sale is treated as causing T's taxable year to end on June 30, and the periods beginning and ending with the sale are treated as two taxable years for federal income tax purposes. If ratable allocation is not elected, T must perform an inventory valuation as of the acquisition and also as of the end of Year 1.

If ratable allocation is elected, T must perform an inventory valuation only as of the close of Year 1, and T's income from inventory is ratably allocated, along with T's other items that are not extraordinary items, between the P and X consolidated returns.

Assume instead that T merges into a wholly owned subsidiary of X in a reorganization to which Section 368(a)(2)(D) applies, and P receives X's stock in exchange for all of T's stock. Because T's taxable year ends on June 30 under Section 381(b)(1), T's original year determined without regard to Regs. §1.1502-76(b) also ends on June 30. Consequently, a ratable allocation is the same as a closing of T's books.
3. If an existing corporation becomes a member of two different consolidated groups during the same original year and ratable allocation is elected with respect to both groups, ratable allocation is generally determined for both groups by treating the original year as a single taxable year. However, if ratable allocation is elected only with respect to the first group, the ratable allocation is determined by treating the original year as a short period that does not include the period that the corporation is a member of the second group. Regs. §1.1502-76(b)(2)(ii)(B)(3).

4. Ratable allocation is not available for “extraordinary items,” which must be allocated to the day that they are taken into account. Regs. §1.1502-76(b)(2)(ii)(B)(1). An extraordinary item consists of:

a. Any item from the disposition or abandonment of a capital asset as defined in Section 1221 (determined without the application of any other provision of law);

b. Any item from the disposition or abandonment of property used in a trade or business as defined in Section 1231(b) (determined without the application of any holding period requirement);

c. Any item from the disposition or abandonment of an asset described in Section 1221(1), (3), (4), or (5), if substantially all the assets in such category from the same trade or business are disposed of in one transaction (or series of related transactions);

d. Any item from assets disposed of in an applicable asset acquisition under Section 1060(c);

e. Any item carried to or from any portion of the original year (e.g., a net operating loss carried under Section 172) and any Section 481(a) adjustment;

f. The effects of any change in accounting method initiated by the filing of Form 3115 after becoming or ceasing to be a member.

g. Any item from the discharge or retirement of indebtedness;

h. Any item from the settlement of a tort or similar third-party liability;

i. Any compensation-related deduction in connection with S’s change in status (including, for example, deductions from bonus, severance, and option cancellation payments made in connection with S’s change in status);
j. Any dividend income from a nonmember that S controls within the meaning of Section 304 at the time the dividend is taken into account;

k. Any deemed income inclusion from a foreign corporation, or any deferred tax amount on an excess distribution from a passive foreign investment company under Section 1291;

l. Any interest expense allocable under Section 172(h) to a corporate equity reduction transaction causing this paragraph (b) to apply;

m. Any credit, to the extent it arises from activities or items that are not ratably allocated (e.g., the rehabilitation credit under Section 47, which is based on placement in service); and

n. Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included. Regs. §1.1502-76(b)(2)(ii)(C).

Example (4): On June 30 of Year 1, P sells all of T's stock to X and ratable allocation is elected. Under ratable allocation, the X group has a $100 consolidated net operating loss for Year 1, all of which is attributable to T under the principles of Regs. §1.1502-79. However, because of extraordinary items, T has $100 of income for the portion of Year 1 that T is a member of the P group. T's loss may be carried back from the X group to the portion of Year 1 that T was a member of the P group. Any item carried to or from any portion of the original year is an extraordinary item, and the loss therefore is not taken into account again in determining the ratable allocation.

Example (5): On June 30 of Year 1, P sells all of T's stock to X. On March 15 of Year 2, T contributes $100 to its retirement plan, which is a qualified plan under Section 401(a). T is not required to make quarterly contributions to the plan for Year 1 under Section 412(m). The contribution is deemed in accordance with Section 404(a)(6) to have been made on the last day of T's taxable period beginning on July 1 of Year 1.

Ratable allocation is not elected.

The sale is treated as causing T's taxable year to end on June 30, and the period beginning on July 1 is treated as a separate annual accounting period for all federal income tax purposes. T's income from January 1 to June 30 is included in the P group's Year 1 return, and T's income from July 1 to December 31 is included in the X group's Year 1 return. Thus, the $100 contribution is deductible by T for the period of Year 1 that it is a
member of the X group, subject to the applicable limitations of Section 404, if a contribution on the last day of that period would otherwise be deductible.

Assume instead that, in accordance with Section 404(a)(6), $40 of the $100 contribution is deemed to be made on the last day of T's taxable period beginning on January 1 of Year 1 and is deemed to be made on the last day of T's taxable period beginning on January 1 of Year 1. The remaining $60 is deemed to be made on the last day of T's taxable period beginning on July 1 of Year 1. The sale is treated as causing T's taxable year to end on June 30, and the period beginning on July 1 is treated as a separate annual accounting period for all federal income tax purposes. The $40 portion of the contribution is deductible by T for the period of Year 1 that it is a member of the P group, subject to the applicable limitations of Section 404 and provided that a $40 contribution on the last day of that period would otherwise be deductible for that period, and the $60 portion is deductible by T for the period of Year 1 that it is a member of the X group, subject to the same conditions.

Assume instead that P, T, and X elect ratable allocation and T's deduction for the retirement plan contribution is not an extraordinary item. T's deduction may be ratably allocated, subject to the applicable limitations of Section 404, and is allowable only if a contribution on the last day of Year 1 otherwise would be deductible for any period in the year.

If a member is a partner in a partnership or an owner of a similar interest with respect to which items of the entity are taken into account by the member, the member is treated, solely for purposes of determining the year to which the entity's items are allocated, as selling or exchanging its entire interest in the entity immediately before the member's change in status. Regs. §1.1502-76(b)(2)(v)(A).

Example (6): On June 30 of Year 1, P sells all of T's stock to X. T has a 10 percent interest in the capital and profits of a calendar-year partnership. T is treated, solely for purposes of determining T's taxable year in which the partnership's items are included, as selling or exchanging its entire interest in the partnership as of P's sale of T's stock. Thus, the deemed disposition is not taken into account under Section 708, it does not result in gain or loss being recognized by T, and T's holding period is unaffected. However, under Section 706(a), in determining T's income, T is required to include its distributive share of partnership items for the partnership's year ending within or with T's taxable year. Under Section 706(c)(2), the partnership's taxable year is treated as closing with respect to T for this purpose as of P's sale of T's stock. The allocation of T's
distributive share of partnership items must be made under Regs. §1.706-1(c)(2)(ii), i.e., either through an interim closing of the partnership books or a ratable portion of the partnership items for the full partnership tax year.

Assume instead that T has a 75 percent interest in the capital and profits of the partnership. T's distributive share of the partnership's items is treated as T's items for purposes of Regs. §1.1502-76(b)(2). Thus, if ratable allocation is not elected, T's distributive share of the partnership's items must be determined under Regs. §1.706-1(c)(2)(ii) by an interim closing of the partnership's books. Similarly, if ratable allocation is elected for T's items that are not extraordinary items, T's distributive share of the partnership's nonextraordinary items must also be ratably allocated under Regs. §1.706-1(c)(2)(ii).

6. For purposes of the new rules, if a member (together with other members) would be treated under Section 318(a)(2) as owning an aggregate of at least 50 percent of any stock owned by the pass-through entity, the method that is used to determine the inclusion of the entity's items in the consolidated or separate return must be the same method that is used to determine the inclusion of the member's items in the consolidated or separate return. Regs. §1.1502-76(b)(2)(v)(B).

7. To the extent properly taken into account during the member's taxable year, federal, state, local, and foreign taxes are allocated on the basis of the items or activities to which the taxes relate. Regs. §1.1502-76(b)(2)(iv).

8. If ratable allocation is not elected, S may elect only to ratably allocate its items taken into account in the month of its change in status. Regs. §1.1502-76(b)(2)(iii). For example, S may close its books both at the end of the preceding month and at the end of the month of the change and allocate only its items (other than extraordinary items) from the month of the change.

9. The election to ratably allocate items must be made in a separate statement entitled "THIS IS AN ELECTION UNDER §1.1502-76(b)(2)(ii) TO RATABLY ALLOCATE THE YEAR'S ITEMS OF [insert name and E.I.N. of the member]." The statement must:
   a. Identify the member's extraordinary items, their amounts, and the separate or consolidated returns in which they are included;
   b. Identify the member's aggregate amount to be ratably allocated and the portion of the amount included in the separate and consolidated returns; and...
c. Include the name and E.I.N. of the common parent (if any) of each group that must take the items into account.

d. The statement must be signed by the member and by the common parent of each affected group and filed with the returns including the items for the years ending and beginning with S’s change in status.

e. If more than one member of the same consolidated group, as a consequence of the same plan or arrangement, cease to be members of that group and become members of another consolidated group, an election may be made only if it is made by each such member. Regs. §1.1502-76(b)(2)(ii)(D).

D. Effective Dates.

The new rules generally apply to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995. Regs. §1.1502-76(b)(5)(i).

IX. ELIMINATION OF THE THIRTY-DAY RULES.

A. Background.

The current regulations provide two rules of administrative convenience under which an election may generally be made to include a subsidiary in, or exclude a subsidiary from, as the case may be, a consolidated group if the subsidiary has either joined a consolidated group within 30 days of the beginning of the subsidiary’s tax year or has not been a member of a consolidated group for more than 30 days of the group’s tax year (the “thirty-day rules”). Regs. §1.1502-76(b)(5).

B. New Rules.

Due to a perceived abuse by some taxpayers in structuring transactions, the Service has eliminated these rules. Regs. §1.1502-76.

C. Effective Dates.

The thirty-day rules are repealed with respect to corporations becoming or ceasing to be members of consolidated groups on or after January 1, 1995. Regs. §1.1502-76(b)(5)(ii).
X. **NONAPPLICABILITY OF OTHER CODE PROVISIONS.**

A. **In General.**

In order to implement more fully the single theory of consolidated returns, the Service has also proposed rules which make certain Internal Revenue Code provisions inapplicable to consolidated groups.

B. **Section 357(c).**

1. Upon a transfer of assets subject to a liability, Section 357(c) generally requires the transferor to recognize gain to the extent the liability exceeds the transferor's tax basis in the assets transferred.

2. The proposed regulations specify that this provision would no longer apply to such transfers between members of the same consolidated group. Regs. §1.1502-80(d). Instead, in the case of a Section 351 transaction, the excess of the liability over asset basis reduces the transferor's stock basis in the transferee and could therefore create an excess loss account with respect to such stock. The transferee will take a carryover basis in property received.

3. Alternatively, if one member of a consolidated group (S) merges into another member (T) in a Section 368(a)(1)(D) reorganization, P's basis in the stock of T is increased by P's former basis in the stock of S, and T succeeds to S's basis in its assets subject to its liabilities. Regs. §1.1502-80(d)(1).

4. These rules are effective for transactions between members of a consolidated group in a consolidated return year beginning on or after January 1, 1995. Regs. §1.1502-80(d).

C. **Section 165(g).**

1. A deduction is generally allowed under Section 165(g) on account of the worthlessness of stock of a corporation. This deduction may be partially or wholly disallowed by Regs. §1.1502-20.

2. In order to match more closely the deduction with the worthlessness of a subsidiary's assets, the new regulations postpone the timing of the owning member's worthless stock deduction until substantially all of the subsidiary's assets are treated as disposed of, abandoned, or destroyed. Regs. §§1.1502-80(c) and -19(c)(1)(iii).

   a. In most cases, this change is favorable to taxpayers, since it permits the subsidiary's net operating losses and losses on the sale of the subsidiary's assets to continue to be used to offset the
income of other members of the group, which might effectively be
 denied if the worthless stock deduction were permitted or required
 in a prior year. See, e.g., Section 382(g)(4)(D).

b. Note that a member of a consolidated group may still claim a
deduction with respect to a worthless security (other than stock) of
a corporation.

3. These rules are effective for consolidated return years beginning on or