REPORT #682

TAX SECTION

New York State Bar Association

Modified Loss Disallowance Regulations

January 29, 1991

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OFFICERS
1991 - 1992
JAMES M. PEASLEE
Chair
1 Liberty Plaza
New York, NY 10006
212/225-2000
JOHN A. CORRY
First Vice-Chair
1 Chase Manhattan Plaza
New York, NY 10005
212/530-4608
PETER C. CANELLOS
Second Vice-Chair
299 Park Avenue
New York, NY 10171
212/371-9200
MICHAEL L. SCHLER
Secretary
Worldwide Plaza
825 Eight Avenue
New York, NY 10019
212/474-1588

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TAX SECTION

New York State Bar Association

January 29, 1991

The Honorable Fred W. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Mr. Goldberg:

We are writing to convey the comments of the Tax Section of the New York State Bar Association on proposed treasury regulation section 1.1502-20 issued on November 19, 1990 (the “Modified Loss Disallowance Regulations” or “Modified Regulations”), which replace temporary treasury regulation section 1.1502-20T adopted on March 9, 1990 (the “Original Loss Disallowance Regulations” or “Original Regulations”). While the Modified Regulations constitute an improvement over the Original Regulations, our view is that the revised regulations will continue to deny taxpayers the right to deduct economic losses in far too many cases. Mindful of the goals of simplification and ease of administration, we set out below recommendations that could alleviate some of the unfair or undesirable effects of these regulations without adding significant administrative difficulties.

Substantive Improvements Contained in the Modified Regulations

In response to the many comments submitted on the Original Regulations, the Modified Regulations represent a substantial improvement in several important respects. The deferral of the effective date of the Modified Regulations is a welcome change from the March 9, 1990 effective date of the Original Regulations. This modification is an appropriate response to the many concerns expressed that taxpayers be given a reasonable opportunity to take actions to mitigate the adverse consequences of regulatory changes that could not reasonably have been foreseen.

The statement in the preamble that a revenue procedure will be published detailing the means by which taxpayers may opt out of consolidated return filing status was also a welcome development, and as this letter was being put into final form Rev. Proc. 91-11 on that subject was issued. (The Tax Section may wish to comment on Rev. Proc. 91-11 at a later time.)

Most importantly, the modification of the loss disallowance rule from one of complete disallowance to one of disallowance only to the extent of (i) positive investment adjustments, (ii) gains from extraordinary dispositions, or (iii) potential loss duplication, is a significant structural improvement in the regulations. However, this rule is still far more restrictive than it need be to carry out the goals of the regulations. In its current form, this rule will disallow economic losses in numerous instances where it is readily determinable that the loss is not attributable to built-in gains that were present when the subsidiary was acquired and would not give rise to loss duplication issues. We believe these results stem from concerns about perceived abuses that are more hypothetical than real. Accepting that the final regulations will not take an approach that differs significantly from the general framework of the Modified Regulations, we nevertheless suggest that the regulations be further amended or clarified as set forth below.

1. The problem of duplicated “built-in” losses (Prop. Treas. Reg. $ 1.1502-20(c)(2) (iii) should be addressed by preventing the purchaser from claiming such loss, not by disallowing the seller's economic loss.

The proposal to disallow certain losses on the ground that they may later be duplicated by the purchasing group (or a successor to the purchasing group) raises several concerns. Commentators have already pointed out that authority for such a regulation may be lacking, noting that it creates a new, and perhaps unnecessary, dichotomy between consolidated returns and separate returns. We have expressed similar views in previous submissions. Nevertheless, our comments here are limited to our concern with the approach adopted to address the issue. Specifically, we do not believe it is necessary to disallow deductions to the seller group on the sale of stock of a subsidiary with built-in loss assets in order to prevent loss duplication.

This proposed rule creates a needless bias in favor of asset sales in the common situation where a subsidiary has built-in loss assets. Yet, in some circumstances asset sales are impractical or impossible. Further, taxpayers who find themselves in this situation will not be able to recognize their full economic loss by making a section 338(h)(10) election if the seller's basis in the stock of a subsidiary with built-in loss assets is higher than the inside asset basis. Assume, for example, a sale of the stock of a subsidiary would produce a loss that would be subject to partial disallowance solely by virtue of the loss duplication rule. In such a case, where P has a $90 basis in S stock, S has a $70 basis in the S assets and the value of S is only $40, a sale of S stock combined with a section 338(h)(10) election would result in only a $30 loss even though P's economic loss is $50. Thus, the rule will force sellers in these cases to cause their subsidiaries to sell the built-in loss assets and then to sell the subsidiary's stock. Continuing the above example, if S first sells its assets, it will recognize a $30 loss which would reduce P's basis in S stock to $60; P can then sell the S stock and recognize its remaining economic loss of $20 (since such loss would not be subject to a loss disallowance rule). By engaging in this two-step process, an otherwise disallowed loss (in part) from the sale of the subsidiary stock may be converted into an allowable loss. There is no reason to force taxpayers to engage in such needless transactions or to deny the economic losses of taxpayers who cannot engage in asset sales, since a simple alternative approach is available.

The alternative would be to allow the selling group to recognize a loss on the sale of the stock of a subsidiary to the extent the seller and purchaser jointly elect to reduce the inside basis of the subsidiary's assets by the amount of the potentially duplicated loss. A number of methods could be used to allocate the basis reduction among assets. For example, the step-down in basis could be made without appraisals by computing the reductions within a given class of assets by reference to the relative adjusted tax bases of the various assets included within the class. Also, the adjustments could proceed mechanically through the various asset classes described in Sections 338 and 1060 and the regulations promulgated there-under as if the basis reduction was produced by a reduction in the price paid. Alternatively, if considered necessary, the basis of depreciable property could be subject to reduction first in the manner prescribed in sections 108 and 1017.

This elective rule would prevent loss duplication by eliminating the potential for allowing losses to the purchasing group, which has not sustained any economic loss, rather than disallowing losses to the selling group, which has. Although a basis step-down rule such as this might seem novel, it is in fact no more than a corollary to the election already provided in Prop. Reg. § 1.1502-20(g), which allows the seller group to retain loss carry-forwards of the subsidiary that would normally carry over to the purchaser group.

2. The extraordinary gain disposition factor (Prop. Rea. § 1.1502- 20(c)(1)(i)) should be eliminated or modified.

The rule contained in Prop. Reg. § 1.1502-20(c)(1)(i) that disallows a loss on the sale of the stock of a subsidiary to the extent of the subsidiary's earnings and profits (net of directly related expenses) from “extraordinary” gain dispositions is unnecessary and should be eliminated. The positive investment adjustments factor set forth in Prop. Reg. § 1.1502-20(c)(1)(ii) is more than adequate to deal with the son-of-mirrors problem presented by Notice 87-14, and for this and other reasons, including the reduction of unnecessary complexity, we would urge that this factor include gains (and losses) from extraordinary dispositions, as well as other income and deductions, for a taxable year.

The preamble to Prop. Reg. § 1.1502-20 indicates that the extraordinary gain disposition factor is needed in addition to the positive investment adjustments factor “because not all recognized built-in gain results in positive investment adjustments. For example, a recognized built-in gain may be offset by an equal amount of post-acquisition loss.” While this is unquestionably true, it does not justify the rule. The assumption underlying the extraordinary gain disposition rule is that all gains from extraordinary dispositions are attributable to built-in gain, whereas all losses are attributable to post-acquisition losses. This simply is not true in a great many instances. Indeed, it seems just as likely that extraordinary losses are attributable to built-in losses, which should be permitted to offset built-in gains.

The extraordinary gain disposition factor will thus lead to the disallowance of economic losses in a great many cases. This seems unnecessarily harsh since the positive investment adjustment factor, modified as described above, appropriately deals with the son-of-mirrors problem. Furthermore, eliminating the extraordinary gain disposition factor would avoid the need to introduce an entirely new concept into the tax law and would otherwise help simplify the regulations, although the anti-stuffing rules would have to be expanded to prevent the contribution of built-in loss assets to shelter built-in gains.

If, however, it is nevertheless decided that this factor must be retained, we would recommend that certain clarifications or modifications be made. For one, the flush language of Prop. Reg. § 1.1502-20(c)(2)(i) should be modified to make it clear that not all “discharge of indebtedness” transactions would be treated as extraordinary gain dispositions. Only those that actually result in “extraordinary” income for purposes of computing earnings and profits in the year of discharge should be covered. For example, a transaction whereby a bankrupt or insolvent taxpayer reduces the basis of its assets under Sections 108 and 1017 by the amount of any income from the discharge of its indebtedness should not be considered to be an extraordinary gain disposition. The same should apply to a discharge transaction arising in the ordinary course of business. In addition, in the interests of further limiting this factor to transactions that are truly “extraordinary,” we recommend that dispositions of capital assets or Section 1231(b) property be considered extraordinary gain dispositions only if (1) substantially all the assets from the same trade or business are disposed of in one transaction or a series of related transactions (by reference to the limitation that is already provided in Prop. Reg. § 1.1502-20(c)(2)(i)(C) for other property, such as inventory) or (2) alternatively, such assets are disposed of in an applicable asset acquisition under Section 1060(c) (by reference to the limitation that is already provided in Prop. Reg. § 1.1502-20(c)(2)(i)(D)). As discussed below, we also recommend, in any event, that extraordinary gain dispositions not include gains from the dispositions of assets clearly acquired by a subsidiary after it became a member of the consolidated group (“after acquired assets”) or income from the cancellation of indebtedness clearly incurred by the subsidiary after it became a member of the group (“after acquired indebtedness”).

3. Neither the extraordinary gain disposition factor (Prop. Reg. § 1.1502-20(c)(1)(i) nor the positive investment adjustment factor (Prop. Reg. § 1.1502-20(c)(1)(ii)) should apply to gains from the disposition of after acquired assets or income from the cancellation of after acquired indebtedness.

While we understand the Treasury's concerns about tracing and administrative complexity, we nevertheless believe that it is inappropriate for the regulations to disallow a loss on the sale of stock of a subsidiary to the extent that gains (or other income) were derived by the subsidiary from the disposition of after acquired assets which are acquired by purchase from unrelated parties or from the cancellation of after acquired indebtedness. These cannot be attributable to built-in gains. Accordingly, we recommend that Prop. Reg. § 1.1502-20(c) be amended to provide that neither the extraordinary gain disposition factor (if indeed this factor is retained at all, see discussion above) nor the positive investment adjustment factor would apply if the taxpayer can prove that (i) a capital gain or

Section 1231(b) gain recognized by the subsidiary was from the disposition of an after acquired asset (for this one purpose gain should be excluded only to the extent the amount realized exceeds original cost, not reduced by depreciation or depletion), (ii) income of the subsidiary was derived from the cancellation of an after acquired indebtedness, or (iii) ordinary income of the subsidiary was derived from the disposition of an asset (such as inventory) described in Section 1221(1), (3), (4) or (5) that was not of the type that was on hand to any extent at the time of the acquisition of the subsidiary (e.g., because of the acquisition by the subsidiary of a new business after that time). Consideration should be given as to whether similar rules would be applied to losses on after acquired assets. Since these transactions are extraordinary (or at least unusual), an exception along these lines should not require extensive tracing or otherwise cause undue administrative complexity.

In any event, the regulation should provide in all cases that the aggregate amount of the extraordinary disposition factor and the positive adjustment factor that would be applied so as to disallow losses would not exceed the original purchase price of the subsidiary's stock plus the amount of the liabilities of the subsidiary at the time of its acquisition. This approach would limit the loss disallowance to the absolute maximum potential built-in gain of the subsidiary, and yet would raise no new valuation issues. While (as stated in the preamble to Prop. Reg. § 1.1502-20) this approach would generally provide relief only if the subsidiary is owned for a substantial period of time, such a limitation still makes sense and would in fact provide appropriate relief where, for example, a significant portion of one or the other of these two factors is attributable to gains from the disposition of property that was not held by the subsidiary at the time of its acquisition or, even if so held, has substantially appreciated in value after that time. (This proposal should presumably not affect the loss disallowance factor set forth in Prop. Reg. § 1.1502-20(c)(2)(iii).)

4. Consideration should be given to amending the positive investment adjustment factor (Prop. Reg. § 1.1502-20(c)(1)(ii)) so as to allow a netting of operating gains and losses of the same business.

The modified loss disallowance rule allows the netting of profits and losses within the same year (other than profits attributable to extraordinary gain dispositions) but does not permit the netting of profits and losses arising in different taxable years. Consideration should be given to the netting of positive and negative basis adjustments arising in different taxable years where the operating gains and losses arise from the same trade or business.

To illustrate the fairness of a netting rule within the same trade or business, assume that P acquires T for $100. T's only asset is a 2-year leasehold interest with a $0 basis and $100 of value. T subleases the property in year 1 and nets $50 of taxable income. In year 2, the sublease produces a loss of $50 (i.e., the sub-lessee fails to pay, expenses are high, etc.). The leasehold is worth $0 at the end of year 2. P sells T for $0, suffering a $100 economic loss.

If, in the above example, all of the events had occurred in the same year, P would be entitled to the loss on the sale of the stock of T under the rules of Prop. Reg. § 1.1502-20(c)(1)(ii), which allows a netting of operating gains and losses within the same taxable year. The result should not differ if a net profit (or loss) from one acquired trade or business is realized over a period of several years.

5. The mark-to-market rules that apply following a deconsolidation (Prop. Reg. § 1.1502-20(b) and Temp. Reg. § 1.337(d)-2T(b)) should be amended so as to allow a basis recovery to the extent that the retained stock subsequently appreciates.

We agree that a basic deconsolidation rule along the lines set forth in Prop. Reg. § 1.1502-20(b) and Temp. Reg. § 1.337(d)-2T(b) is needed in order to prevent a circumvention of the loss disallowance rules. However, we are very concerned that there are many business motivated de-consolidations which could be needlessly penalized by such a rule and, in any event, if a deconsolidation is followed by a subsequent appreciation in the stock retained, we believe that the reduction of the taxpayer's cost basis in that stock is a severe penalty, unrelated to the repeal of General Utilities, loss duplication and issues ancillary thereto.

To illustrate this point, assume that P incorporates T for $10 and, in the next year, T needs working capital and sells 25% of its stock to the public. Assume that under Prop. Reg. § 1.1502- 20(b), P is required to mark down its $10 cost basis in the stock of T to $3. In year 3, if P's interest is sold for $9, then P must report a gain of $6, when in fact P had no economic gain (and in fact had an economic loss).

To require P in the above example to report $6 of phantom income -- with no hint of realized built-in gain which was reflected in basis or a potential duplicated loss -- cannot be justified. To avoid this punitive result, the parent (P in the above example) should be allowed to maintain a shadow basis reduction account (not unlike the “basis reduction account” under Temp. Reg. § 1.1502-32T(a)(3)), which would operate to restore basis if there is a subsequent sale or exchange for a price that exceeds the reduced basis in the retained stock. In effect, such a rule would allow the loss that otherwise would be realized if the retained stock were disposed of at the time of de-consolidation and there were no basis reduction ($7 in the above example) to offset the gain realized on the later sale of the retained stock ($6 in the above example) so as to ensure that only the economic gain, if any, on that later sale is reported by the parent. This proposal would be closely analogous to the rules of Section 267(d). These principles should also be made applicable to the successor rules of Prop. Reg. § 1.1502-20(d) (as they relate to company X in Example (1)).

We would be happy to further discuss any of our recommendations set out above with your staff at their convenience.

Very truly yours,

James M. Peaslee
Chair

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Stuart L. Brown
Acting Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20224

cc: Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service Room 3316
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Robert R. Wootton, Esq.
Tax Legislative Counsel
Department of Treasury
3046 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Deputy Tax Legislative Counsel
for Regulatory Affairs
Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220