REPORT #723

TAX SECTION

New York State Bar Association

Report Regarding Coordination of
Deferred Intercompany Transaction Rules
with Nonrecognition Provisions

June 22, 1992

Table of Contents

TAX SECTION
New York State Bar Association

June 22, 1992

The Honorable Fred T. Goldberg, Jr.
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Room 3120
Washington, D.C. 20220

Dear Assistant Secretary Goldberg:

I enclose a report regarding coordination of the deferred intercompany transaction ("DIT") rules under the consolidated return regulations with various nonrecognition provisions under the Internal Revenue Code. The report was undertaken at the invitation of members of your staff, and was prepared by Yaron Z. Reich, co-chair of the Committee on Consolidated Returns, with the assistance of Irving Salem, co-chair of the Committee, and Kirk Van Brunt.

The report recommends that the basic approach of the consolidated return regulations with respect to DITs be retained in the absence of major revisions to the Code and the consolidated return regulations. However, the report recommends that in general deferred intercompany gain or loss should continue to be deferred if property that was the subject of a DIT is transferred thereafter in a nonrecognition transaction that would otherwise constitute a restoration event. Subject to concerns about possible complexity, the report recommends approaches for reducing or eliminating inappropriate double taxation in certain such transactions.

We would be pleased to meet with your staff at their convenience to discuss this report and related matters.

Very truly yours,

John A. Corry \V

Identical Letter Sent to J
The Honorable Shirley Peterson

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

Alan J. Wilensky, Esq.
Deputy Assistant Secretary
of the Treasury for Tax Policy
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Terrill A. Hyde, Esq.
Tax Legislative Counsel
Department of the Treasury
3046 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515

Andrew Dubroff, Esq.
Associate Tax Legislative Counsel
Department of the Treasury 1500
Pennsylvania Ave., N.W.
4013 Main Treasury
Washington, DC 20220

Eric Solomon, Esq.
Assistant Chief Counsel
Internal Revenue Service
Room 4016
1111 Constitution Avenue, N.W.
Washington, DC 20224

Mary L. Harmon, Esq.
Special Assistant to the Chief Counsel
Internal Revenue Service
Room 3034
1111 Constitution Avenue, N.W.
Washington, DC 20224

John G. Broadbent, Esq.
Counsel to the Assistant Chief Counsel
Internal Revenue Service
Room 4008
1111 Constitution Avenue, N.W.
Washington, DC 20224

Edward S. Cohen, Esq.
Branch Chief, Branch 2
Internal Revenue Service
Room 4428
1111 Constitution Avenue, N.W.
Washington, DC 20224

Don A. Leatherman, Esq.
Branch Chief, Branch 4
Internal Revenue Service
Room 4230
1111 Constitution Avenue, N.W.
Washington, DC 20224

J. Judge Kelley, Esq.
Attorney Advisor
Department of the Treasury
1500 Pennsylvania Ave., N.W.
4021 Main Treasury
Washington, DC 20220

June 22, 1992

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON CONSOLIDATED RETURNS

Report Regarding Coordination of Deferred Intercompany Transaction Rules with Nonrecognition Provisions[*]

I. INTRODUCTION.

This Report discusses the application of the consolidated return regulations dealing with deferred intercompany transactions (DIT"s)[1] to situations in which a DIT is followed by a nonrecognition transaction, and also briefly discusses several related matters. This Report addresses specific issues as to which Treasury representatives requested timely comments from the Committee, and provides recommendations that may be taken into account by Treasury in finalizing the temporary regulations and revising the existing regulations.

---

* This report was prepared by Yaron Z. Reich, co-chair of the Committee on Consolidated Returns (the "Committee"), with the assistance of Irving Salem, co-chair of the Committee, and Kirk Van Brunt. Helpful comments were received from Peter C. Canellos, John A. Corry, Carolyn Joy Lee Ichel, Peter V. Katsampes, Richard L. Reinhold, Michael L. Schler and Philip R. West.

1 These miles (including related provisions dealing with distributions) are presently set forth in Treasury regulations sections 1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, 1.267(f)-IT and 1.267(f)-2T. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the proposed, temporary and final regulations thereunder.

The Report is not intended to be a comprehensive review of the DIT regulations[2] and generally does not address the specific language, organization or details of the regulations.

II. SUMMARY OF RECOMMENDATIONS.

1. In general, the existing DIT regulations treat a consolidated group as a single entity for purposes of determining the taxable income of the group and the timing thereof, but treat each member as a separate entity for all other purposes relating to the DIT (including the determination of the amount, character and source of gain or loss recognized by each member). Subject to the specific recommendations made in this Report, the Committee recommends that this basic approach be retained in the absence of major revisions to the Code and the consolidated return regulations.

2. The Committee recommends that, subject to certain exceptions, if property (including stock of a member) that is the subject of a DIT is transferred by a member that owns such property any time after the DIT (the “owning member”) outside the group in a nonrecognition transaction, the deferred intercompany gain (“DIG”) or deferred intercompany loss (“DIL”) should continue to be deferred.

3. Similarly, in the case of a DIT involving the stock of a member, the Committee recommends that (i) a subsequent liquidation of that member under section 332, (ii) a subsequent sale of that member with an election under section 338(h)(10),

[2] For example, the Report does not generally analyze the various restoration events under the regulations referred to above (or regulations section 1.1502-19), nor does the Report consider carefully the issues relating to the restoration or deferral of losses, which are dealt with principally in the temporary regulations under section 267(f). Further, the Report does not discuss any special considerations raised by DITs involving debt instruments of members.

or (iii) a subsequent intra-group reorganization should not be treated as a restoration event. In addition, the Committee recommends that modifications be made in the applicable rules to avoid or at least mitigate the duplication of gain (and possible duplication of loss) in these situations. One approach that was previously suggested by the Tax Section would be to treat an intercompany sale or distribution of 80 percent or more of the stock of a member as a disposition of the assets of that member followed by a liquidation of that member.[3] The Committee recommends that this approach be made available on an elective basis and that, in addition, for taxpayers that cannot or do not elect to apply the foregoing approach, a mechanism be implemented that re-allocates gain or loss from a disposition of the assets of the member whose stock was transferred in the DIT to the selling member and reduces the amount of the DIG or DIL by the amount so re-allocated. Part V.C. below discusses the details of this suggested mechanism and issues that would need to be addressed in formulating its appropriate scope.

4. The Committee recommends that DIG or DIL continue to be deferred where a partnership interest was the subject of a DIT and the partnership is subsequently terminated under section 708(b).

5. While the Committee considers regulations section 1.1502-13T(1) to encompass this situation already, it would be desirable to clarify explicitly that an increase in “basis recovery” referred to in that provision includes a corporate distribution that is described in section 301(c)(2) and a partnership distribution that is treated as a return of capital under section 731.

---

[3] See New York State Bar Association Tax Section, Committee on Reorganizations, Report on Section 336(e), 24 Highlights & Documents 573, 579 (January 15, 1992).

6. Although the Committee concluded that a detailed analysis of the question is beyond the scope of this Report, the Committee believes that consideration can fruitfully be given to the advisability of treating a consolidated group as a single entity for purposes of applying various provisions of the Code and the regulations to property that is the subject of a DIT and in other contexts.[4] In each case, the approach should be based on whether treating the members of the group as a single entity would advance the policies underlying the provision in question. Situations worthy of consideration would appear to include: (i) the holding period of property that is the subject of a DIT, in the hands the selling member and the purchasing member;[5] (ii) whether a member should recognize gain or loss in respect of stock or notes of another member that it received as a capital contribution or in a section 351 transaction, as a result of the so-called "zero basis problem";[6] (iii) whether section 108(e)(5) applies where a member that purchases or sells property subject to purchase money indebtedness subsequently transfers the property (subject to the debt) or the purchase money debt, as the case may be, to another

---

[4] For existing examples applying a single entity approach to ancillary consequences of a DIT, see regulations sections 1.1502-3(f)(2) (ITC recapture) and 1.1502-12(g) ("new property" under prior depreciation rules).

To date, the question whether members of a consolidated group should be treated as a single entity for a particular purpose has been resolved on a piecemeal basis. Other provisions that apply a single entity approach include sections 338(h)(8), 384(c)(6), 469(j)(11), 864(e)(1) and (6) and 1092(d)(4) and proposed regulations section 1.1291-3(f).

[5] The regulations now provide for a new holding period to begin after the DIT. See regulations sections 1.1502-13(c)(4) and (g).

[6] <u>See</u>, <u>e.g.,</u> revenue ruling 74-503, 1974-2 C.B. 117. <u>See</u> <u>generally</u>, Manning, "The Issuer's paper: Property or What: Zero Basis and Other Income Tax Mysteries", 39 Tax L. Rev. 159 (1984); Letter of George B. Javaras to Internal Revenue Service dated July 19, 1990, 18 Highlights & Documents 1478 (August 7, 1990).

member;[7] (iv) whether a member should be treated as an "old and cold creditor" for purposes of section 382(l)(5)(E)(i) or a trade creditor described in section 382(l)(5)(E)(ii), in each case so long as the group as a whole satisfies the holding requirement for the indebtedness;[8] (v) whether a transfer of a partnership interest by one member to another should be taken into account for purposes of determining whether a partnership has terminated under section 708(b)(1)(B) as a result of a sale or exchange of 50 percent or more of the total interest in partnership capital and profits;[9] (vi) whether property qualifies as being held "for productive use in a trade or business or for investment" for purposes of section 1031 if the member participating in the like-kind exchange either received the property from, or transfers the property to, another member in whose hands it so qualified or qualifies immediately before or after the exchange, as the case may be;[10] (vii) whether a member can satisfy section 1033 by purchasing an asset from another member or can satisfy section 1071 by purchasing the stock of

---

[7] The legislative history of section 108(e)(5) states that that provision does not apply if the seller transfers the debt, or if the purchaser transfers the property, to a third party (whether or not related). See S. Rep. No. 1035, 96th Cong., 2d Sess. 16 (1980). Compare PLR 9037033 (June 18, 1990) (section 108(e)(5) applies where the original purchaser transferred the property in a section 351 transaction that was anticipated at the time of purchase).

[8] Proposed regulations section 1.382-3(d)(2) provides for no attribution of ownership.

[9] PLR 8851004 (August 21, 1988) holds that such an intra-group transfer should be taken into account. This approach is consistent with the formalistic rules of section 708(b)(1)(B), which treat all nontaxable exchanges as transfers (see, e.g., revenue ruling 81-38, 1981-1 C.B. 386 (section 351 exchange)). In the event a single entity approach were to be applied, it would be appropriate to treat a subsequent deconsolidation of the transferee member as a transfer for purposes of section 708(b)(1)(B).

[10] In the non-consolidated return context, compare revenue ruling 75-292, 1975-2 C.B. 333 (like-kind exchange followed by a section 351 transfer to a wholly owned corporation fails to qualify under section 1031) with Maloney v. Commissioner 93 T.C.89 (1989) (like-kind exchange followed by section 333 liquidation qualifies under section 1031) and cases discussed therein. If a single entity approach is applied in the context of section 1031, arguably it should also be applied in the context of section 1231 and, by extension, perhaps in the context of other Code sections dealing with the character of an asset.

another member;[11] and (viii) whether section 1038 applies where a member that holds a purchase money mortgage on real estate that it sold transfers the mortgage to another member which reacquires the property in satisfaction of the mortgage indebtedness.[12] On the other hand, it appears to be inappropriate to apply a single entity rule to Code provisions that are integrally related to the status or activities of the particular taxpayer, such as sections 582(c) (bank loans give rise to ordinary loss) and 595(b) (treatment of foreclosed property held by a thrift institution). Also, the Committee believes that a separate entity approach should continue to be applied for purposes of determining whether a transaction between members qualifies under sections 368 or 1031.

* * *

The Committee recognizes, as is discussed more fully in Part IV.B.3 below, that in general the recommendations made in this Report are likely to lead to increased complexity. Therefore, in determining whether to amend the regulations to address the issues discussed herein, the Treasury will have to balance this complexity against the equitable considerations that led to these recommendations. In most instances, the Committee believes that the equities should prevail. Nevertheless, the Committee recognizes that, at least in certain of the situations discussed in the Report, the issue is a close one on which the Treasury could reasonably take a different view.

III. OVERVIEW OF EXISTING DIT RULES: DEFERRAL VS. ELIMINATION SYSTEM.

---

11 PLR 8950029 (September 19, 1989) holds that it can.

12 TAM 7951011 (August 22, 1979) holds that section 1038 does not apply.

The existing regulations regarding DITs strike a balance between the single entity and the separate entity concepts. In general, the DIT regulations treat a consolidated group as a single entity for purposes of determining the taxable income of the group (and the timing thereof). For all other purposes relating to the DIT (e.g., the "location" issues of the amount, character and source of gain or loss recognized by each member, the holding period of the owning member in an asset, and earnings and profits), the regulations treat each member as a separate entity.[13]

Recent temporary regulations contained in sections 1.1502-13T and 1.1502-14T are intended to close perceived loopholes

---

[13] See T.D. 8295 (March 9, 1990):

> The present consolidated return regulations provide a system which replicates in many ways the federal income tax consequences which would arise if the members of an affiliated group of corporations filing consolidated returns were a single entity. Under the regulations, gain or loss realized and recognized on transfers of property from one member ("selling member") to another member ("purchasing member") of an affiliated group filing consolidated returns is deferred and taken into account by the selling member when, for example, the property is depreciated or disposed of outside the group by the purchasing member. Although the gain or loss is deferred, the purchasing member has a cost basis in the transferred property. See $ $ 1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, and 1.1502-31(a).
>
> Prior to 1966, the consolidated return regulations provided for the elimination of the selling member's gain or loss if the property was not sold outside the group during the same consolidated return year. Under the prior regulations, the purchasing member received a carryover basis in the property.
>
> The change to the deferral system was made because the gain elimination system resulted in certain gain escaping tax, being recognized by the wrong member of the group at the wrong time, and being characterized improperly. Further, the earnings and profits of the members were not properly reflected.
>
> The deferral mechanism was adopted to fix more accurately the location, character and source of the gain or loss on transactions between members. It generally was not intended to affect the group's overall income or loss (or other tax consequences) either while the transferred property remains in the group or after the property is disposed of outside the group.

in the application of the DIT rules and to “promote neutrality so that the overall tax consequences to the group generally are not affected by transfers of property among members.” T.D. 8295.In addition, temporary regulations sections 1.267(f)-IT and 1.267(f)-2T modify certain of the DIT rules in situations in which the DIT gives rise to a DIL.

The Committee endorses the basic approach of the existing and temporary regulations. Although some of the concerns that prompted the shift in 1966 from a gain elimination system for intercompany transactions to the DIT deferral system have been ameliorated as a result of other changes in the tax law,[14] it does not appear to be feasible to revert to a DIT elimination/carryover basis system, at least in the absence of substantial changes to the Code and consolidated return regulations.[15] Most significantly, such changes would have to address the issues raised by the potential disparity between the basis in the stock and the net basis in the assets of a member, and the ability to purchase and sell the stock of a member without requiring such disparity to be eliminated (e.g., by requiring either a mandatory section 338 election or that stock basis be equal to net asset basis).[16]

For example, if the members of a consolidated group were to be treated as a single entity for purposes of the “location” issues arising from intercompany transactions but the potential for

---

[14] For example, the repeal of the General Utilities doctrine makes it less likely that a consolidated group would be able to find a purchaser that would be willing to facilitate a transaction which achieves benefits similar to those in Henry C. Beck Builders. Inc., 41 T.C. 616 (1964).

[15] Another alternative, of immediate recognition of gains and losses arising from intercompany transactions, obviously is inconsistent with the basic policies underlying the consolidated return provisions.

[16] Of course, any such changes may have significant implications for other areas of the Code, including the reorganization provisions.

a disparity between stock basis and asset basis were not eliminated, the investment adjustment rules in regulations section 1.1502-32 would probably have to be revamped since a consolidated group could control which member recognized gains and losses on dispositions of assets and consequently the amount of earnings and profits (and basis adjustment) arising there from. Also in this regard, if it were readily possible to shift built-in gain from one member to another, consideration would have to be given to the efficacy of the loss disallowance rule approach to implementing the repeal of the General Utilities doctrine in the consolidated return context and to whether the two-year "anti-stuffing" rule of regulations section 1.1502- 20(e)(2) is adequate to deal with the potential sheltering of gains through the investment adjustment rules. Moreover, "location" issues remain relevant (i) when a corporation leaves the group (e.g., in respect of its tax attributes and earnings and profits after deconsolidation), (ii) for purposes of the SRLY rules and (iii) for purposes of those situations in which the treatment of a transaction depends upon the identity of the corporate taxpayer involved e.g., dealer, bank, insurance company).

In light of the foregoing, the Committee believes that the basic approach of the DIT regulations should be retained in the absence of major revisions to the Code and consolidated return regulations.

IV. DIT FOLLOWED BY NON-RECOGNITION TRANSACTIONS.

A. Background.

The temporary regulations and some prior private letter rulings require the recognition of DIG and DIL upon the occurrence of a restoration event described in regulations section 1.1502-

13(f) even if that event qualifies for non-recognition treatment.[17] A number of commentators have suggested that this result should be reconsidered and, at least in certain situations, changed.[18]

The issue arises in different contexts:

1. An asset DIT followed by a non-carryover basis nonrecognition transaction (e.g., pursuant to section 1031 or section 1033) with a non-member.[19]

2. A DIT of portfolio stock followed by (i) a recapitalization, (ii) an F reorganization or (iii) an acquisitive (A, B or C) reorganization,[20] in each case involving such portfolio stock.[21]

---

[17] See regulations section 1.1502-13T(m)(2). See also TAM 7850004 (August 31, 1978) (DIL attributable to a transfer of stock is restored upon a section 351 transfer to a nonmember subsidiary); PLR 7838045 (June 24, 1978) (DIG is restored upon a section 1031 like-kind exchange involving the property that was the subject of the DIT); GCM 38674 (April 3, 1981) (same); GCM 39608 (Mar. 5, 1987) (DIG oh a distribution of parent stock by a subsidiary to the parent, which is held as treasury stock, is restored upon issuance to a non-member in a section 1032 transaction). But see TAM 9201002 (Sept. 30, 1991) (restoration of DIG was not required where a portfolio investment in preferred stock that had previously been sold in an intercompany transaction was exchanged for common stock pursuant to a recapitalization of the issuer).

[18] See, e.g., Sheppard, "TAM Indicates Change in Consolidated Return Regs," 54 Tax Notes 247 (January 20, 1992); "Intercompany Stock Sales and Subsequent Liquidations", Consolidated Returns Tax Report (January 1992); Letter of John P.Z. Kent to Hon. Kenneth W. Gideon dated May 8, 1991 (AccServ & Microfiche Doc. 91-4305); Letter of William Ludgate to Ms. Terrill A. Hyde dated June 26, 1991 (18 Highlights & Documents 568, July 16, 1991).

[19] See Part IV.C on pages 18-19 below.

[20] References herein to different categories of reorganizations are to the categories described in the various clauses of section 368(a)(1).

[21] See Part IV. C on pages 18-19 below.

3. A DIT involving the stock of a member followed by an acquisitive (e.g., A, B or C) reorganization in which a non-member acquiror acquires that member.[22]

4. A DIT followed by a carryover basis nonrecognition transaction involving the asset[23] that was the subject of the DIT (e.g., a transfer of that asset to a non-member corporation or a partnership in a transaction described in section 351 or section 721, respectively).[24]

5. A DIT followed by a non-recognition transaction involving the owning member[25] (e.g., an A, B or C reorganization in which the owning member is acquired by a nonmember)[26]

6. A DIT involving the stock of a member followed by (i) a liquidation of that member under section 332, (ii) a sale of that member with an election under section 338(h)(10) or (iii) an intra-group A, D or 6 (and, perhaps, E or F) reorganization.[27]

---

22 See footnote 32 below.

23 The asset could also be portfolio stock or stock of a member.

24 See Part IV.C.1 on pages 19-21 below and, with respect to partnerships, Part VI.A on pages 40-42 below.

25 As used herein, "owning member" means the member (including a successor) that owns the property that was the subject of a DIT.

26 Part IV.D on pages 22-26 below.

27 Part V on pages 26-40 below.

7. A DIT followed by a section 355 spin-off or split-off.[28]

8. A DIT of a partnership interest that is followed by a section 708 termination of the partnership.[29]

B. Policy considerations.

The resolution of this issue appears to turn on a number of considerations, discussed below.

1. Separate vs. single entity principles. A principal consideration appears to be the appropriate balance that should be struck between the separate entity and single entity principles underlying the DIT rules.

If the DIT rules are viewed as being driven predominantly by the separate entity principle, so that DIG or DIL generally should be recognized without any deferral as if the parties to the DIT were unrelated taxpayers, and that the only reason for deferral is that the property and the parties to the transaction remain in the group, it is perfectly reasonable to have a mechanical trigger rule providing that if the property (or selling member or owning member) leaves the group, the DIG or DIL is restored, regardless of whether the transaction giving rise to the restoration event is a nonrecognition transaction.

However, T.D. 8295 suggests a more balanced approach to the separate entity/single entity tension (albeit in the context of closing loopholes): the separate entity principle should govern as to location, amount,

[28] 28 See Part IV. C. 2 on page 21 below.

[29] 29 See Part VI.B on pages 42-45 below.

character and source of gain or loss and other ancillary issues, but the single entity (neutrality) principle should govern as to the timing of recognition, since the DIT deferral mechanism "generally was not intended to affect the group's overall income or loss (or other tax consequences) either while the transferred property remains in the group or after the property is disposed of outside the group."[30] If so, it is appropriate to provide exceptions to the DIT restoration events for nonrecognition transactions, so long as the continued deferral does not adversely impact the location, amount, character, source, ultimate recognition, etc. of the DIG or DIL.[31]

2. Considerations of equity and other factors. A second consideration in assessing this issue is whether different factual situations should be treated differently, based on equitable or other factors. For example, arguably a DIT followed by an involuntary conversion described in section 1033 or a DIT of portfolio stock followed by a recapitalization (addressed in TAM 9201002), in which the nonrecognition transaction is beyond the control of the group, are more sympathetic cases than a DIT followed by a transaction described in section 721 or section 351

---

[30] See footnote 13 above. This approach is consistent with the growing ascendancy of the single entity approach throughout the consolidated return area. See, e.g., preamble to proposed regulations section 1.1502-20 (November 19, 1990), 1990-2 C.B. 696, 700 ("There has been a general statutory shift in favor of single entity treatment of consolidated groups. See, e.g., section 267(f) .... Recent changes to the consolidated return regulations have consistently reflected this policy shift in favor of single entity treatment."); preamble to proposed regulations sections 1.1502-91 through 1.1502-99, 1991-1 C.B. 728, 729 ("In general, these rules adopt a single entity approach to determine ownership changes and the section 382 limitations with respect to such losses.").

[31] Another argument that might be advanced for continued deferral is that the order of the steps should be irrelevant, and that the DIG or DIL would be deferred if the nonrecognition transaction had preceded the DIT. On the other hand, this may not be an adequate rationale for reordering the steps because in most cases the two steps are independent and would not be collapsed or reversed under a step transaction analysis.

where non-members of the group have substantial equity interests in the transferee.

While distinctions can be drawn between different categories of cases based on the perceived relative equities of those cases, on balance the Committee believes that such distinctions should not be made. The only principled reason for permitting continued deferral is the single entity (neutrality) principle, which does not provide a basis for drawing distinctions based on the equities of the situation. Moreover, Congress already made a determination that certain categories of transactions merit nonrecognition treatment, and there does not appear to be a reason to reconsider Congress' judgment on equitable grounds once it is decided that in the consolidated return context, nonrecognition treatment should generally be available if a nonrecognition transaction follows a DIT. On the other hand, as discussed below, some of the various factual situations do raise policy or practical issues that need to be taken into account in formulating an appropriate rule for those situations.

It also may be appropriate to contrast any exception that is proposed for a particular category of nonrecognition transactions with the basic DIT restoration rules. For example, why should a DIT involving the stock of a member followed by a transfer of such stock in a transaction described in section 351 or an acquisitive B reorganization in which the group retains a minority interest in the acquiring company be treated more favorably than a DIT involving the stock of a member that is followed by the issuance of 21 percent of the stock of the owning member to a new investor in a transaction described in section 1032? Indeed, as discussed in Part IV.D below, while continued deferral of gain appears to be appropriate where the nonrecognition transaction directly involves the asset that was the subject of the DIT, it is less clear what the result should be where the nonrecognition transaction also involves the owning member (e.g., an acquisitive reorganization of the owning member).

3. Complexity. An important consideration, of which the Tax Section is particularly mindful, is to minimize complex regulations, especially if those regulations impose significant administrative burdens on taxpayers and the Internal Revenue Service. It is at least arguable that, as to certain of the situations discussed in this Report, the problem to be addressed is sufficiently limited as a practical matter, and the other countervailing considerations discussed above are sufficiently balanced, that the solutions do not warrant adding any complexity to the Regulations.

Nonetheless, the Committee believes that the recommendations made in Part IV.C below (which relate to the transactions described in items 1-4 in Part IV.A above) can generally be implemented without giving rise to complex regulations or administrative burdens.

The re-allocation and offset mechanism recommended in Part V for situations involving a DIT of the stock of a member followed by a liquidation, intra-group reorganization or sale with a section 338(h)(10) election would add some level of complexity. In this regard, however, the situations addressed in Part V present, as an equitable matter, a compelling case for remedial regulations. Also, as discussed below, it may be possible to simplify the re-allocation and offset mechanism in certain respects

The partnership context, discussed in Part VI below, also raises complexity issues, some of which can be resolved on a basis that is similar to the re-allocation and offset mechanism.

C. Recommendations.

The Committee recommends that, subject to the special rules described below, if property (including stock of a member) that is the subject of a DIT is transferred by the owning member outside the consolidated group in a nonrecognition transaction, the DIG or DIL should continue to be deferred. In addition, in general the property received by the owning member in the nonrecognition transaction (the "substitute property") in exchange for the property that is the subject of the DIT should thereafter be treated as the property that is the subject of the DIT for purposes of the DIT rules (including the restoration provisions). Accordingly, in general the DIG or DIL would be restored pursuant to regulations section 1.1502-13(f)(1)(i) if such substitute property is disposed of outside the group (or, if earlier, upon the occurrence of another restoration event, such as immediately preceding the time when either the selling member or the owning member ceases to be a member of the group).

The Committee recommends that the foregoing rules should apply, for example, to a DIT of an asset that is followed by a like-kind exchange under section 1031 or an involuntary conversion under section 1033, and to a DIT of portfolio stock that is followed by a tax-free transaction (such as a recapitalization or acquisitive reorganization) involving such portfolio stock.[32] The application of this recommendation to other specific situations is discussed in the remainder of this Report.

1. Carryover Basis Situations. In order to prevent a non-member transferee of the DIT property in a carryover basis nonrecognition transaction from obtaining a stepped-up basis in the transferred property without a current taxable gain being recognized by the group in respect of the DIG, the transferee's carryover basis should be determined by reference to the basis of the transferred property in the hands of the selling member before the DIT.[33] As in other carryover basis nonrecognition transactions, the price of deferral is a duplication of gain -- (i) the DIT (which would be restored if the selling member, the owning member or the substitute property leave the group or if another restoration event occurs) and (ii) the built-in gain in the transferred property. While duplication of gain would appear to be undesirable as a general proposition (and as discussed below, should be eliminated in certain discrete situations), in the absence of a different rule generally, there does not appear to be

---

32 The foregoing rules should also apply to a DIT involving the stock of a member followed by an acquisitive (A, B or C) reorganization in which a non-member acquiror acquires that member, although in a B reorganization the basis of the acquiror in the stock of that member should be determined as described in paragraph 1 below for carryover basis situations.

33 This basis amount should be adjusted, as appropriate, to take into account circumstances arising during the period the asset was held by the owning member, including any DIT restoration events through and including the disposition of the DIT property by the owning member in the nonrecognition transaction (e.g., if there is taxable boot in the transaction, see paragraph 5 below). For example, in the case of a depreciable asset, the basis of the asset in the hands of the selling member before the DIT should be reduced for depreciation that would have been allowable to the selling member during the period of time the owning member held the asset. Similarly, the basis of the asset should be increased for any capital improvements thereto made by the owning member that have not been recovered through depreciation or otherwise. The foregoing rules for the determination of basis in the hands of the transferee would also need to be coordinated with the depreciation recapture provisions of the Code.

a rational basis for departing from the rule here. Similarly, it appears that where the DIT resulted in a DIL, the transferee's carryover basis in the transferred property should be determined by reference to the basis of the transferred property in the hands of the selling member before the DIT, notwithstanding the potential duplication of loss, except where the property is stock of a member and the DIL will be disallowed under the loss disallowance rule.[34] However, the owning member's substituted basis in the property received in the nonrecognition transaction should be determined by reference to the post-DIT basis in the transferred property, since the DIT rules continue to provide a workable mechanism for coordinating between the restoration of the DIG or DIL and the realization of benefits from the step-up or step-down.

2. Section 355 Transactions. A DIT of the stock of a member that is followed by a section 355 spin-off or split-off of that member, in which the member leaves the consolidated group, should trigger DIG or DIL, since the group does not receive substitute property to which the deferral can attach; the fact that the selling member and the owning member remain part of the group should be insufficient to permit continued deferral.

3. Partial Gain Recognition. If the owning member receives any money or other property that is not eligible for nonrecognition treatment (i.e., “boot”), any gain recognized by the owning member should be re-allocated to the selling member

---

[34] It is appropriate to provide for this exception where the transferred property is stock of a member if and to the extent the DIL, when restored, will be disallowed pursuant to regulations section 1.1502-20(a), in order to prevent “trafficking” in such disallowed loss through nonrecognition transactions. Moreover, this exception would appear to be necessary under the principles of regulations section 1.1502-20(b). See regulations section 1.1502-20(b)(6) Example 2.

to the extent of any DIG and should reduce the DIG.[35] This mechanism appears to be appropriate in order to minimize potential unwarranted double taxation to the group.[36] Allocating taxable proceeds first to the selling member also appears to be consistent with the principle underlying the DIT regulations of eliminating any DIG not later than the time the owning member recognizes corresponding consequences from the DIT.

D. Accruisitive Reorganization of Owning Member Following a DIT.

It is not clear to the Committee whether continued deferral of DIG or DIL should apply where the nonrecognition transaction also involves the owning member leaving the group. In that event, two restoration events under the DIT regulations are implicated—the owning member ceasing to be a member and the property being disposed of outside the group.[37] As a result, it may forcefully be contended that the justifications for continued deferral set forth in Part IV.B above cease to apply once both the asset and the owning member leave the group.

On the other hand, the application of a deferral rule to these situations might be defended on the grounds that it is consistent with the single entity principle that serves as a basis for deferral in the case of other nonrecognition transactions,

---

[35] To the extent the amount of gain recognized by the owning member is less than the amount of gain that would have been recognized by the selling member, such difference should be taken into account by the selling member as a DIG restoration event under regulations section 1.1502-13T(1).

[36] See Part V.C below.

[37] Moreover, to the extent that a departure from the current non-deferral rule is viewed to be appropriate on the ground that the deferral would have been available had the nonrecognition transaction preceded the DIT (see footnote 30 above), that argument cannot be made here because it is the owning member rather than the selling member that was acquired in the nonrecognition transaction.

and that the form of nonrecognition transaction through which the asset leaves the group should be irrelevant. In this regard, a distinction might be drawn between (a) an acquisitive asset (e.g., A or C) reorganization in which the owning member is acquired by a non-member, which arguably may be more deserving of deferral because the asset that was the subject of the DIT is directly transferred in a carryover basis transaction, and (b) an acquisitive stock (e.g., B) reorganization, where the asset is not directly disposed of, but only indirectly as a result of the disposition of the owning member.[38] However, such a distinction might be criticized as overly technical if the principle is accepted that deferral is appropriate even if the nonrecognition transaction involves the owning member leaving the group.

If deferral is permitted in either or both situations, it would be appropriate thereafter to treat the member that owns the greatest portion of the stock (other than stock described in section 1504(a)(4)) of the owning member prior to the transaction as the owning member for purposes of the DIT restoration rules[39] and the stock or securities received in the exchange as the property that is the subject of the DIT (i.e., substitute property) for such purposes. In addition, in order to prevent the transferee of the property that was the subject of the DIT from obtaining a stepped-up basis in the transferred property without a current taxable gain being recognized by the group in respect of the DIG, the basis of the transferred property after the nonrecognition transaction should be determined by reference to the basis of the transferred property in the hands of the selling member before the DIT, subject to appropriate adjustments (as discussed in Part IV.C.1 and footnote 33 above).

---

[38] In any event, it appears that continued deferral of DIG or DIL should apply where the owning member is the subject of an F reorganization.

[39] Cf. regulations sections 1.1502-13(c)(6) and 1.1502-13T(c).

One reason for perhaps not permitting deferral in either of these situations is a possible concern that step transaction principles[40] are not sufficiently clear or expansive to prevent taxpayers from circumventing the requirements for tax- free reorganizations by transferring discrete assets to members that are likely to be transferred as part of a single transaction. On the other hand, even if deferral were not permitted in these situations, sophisticated taxpayers would still be able to take advantage of whatever weaknesses exist in the application of those principles without implicating the DIT rules.[41] In any event, this concern could be addressed by requiring the DIT to have preceded the nonrecognition transaction by a specified amount of time (e.g., one or two years).

A second reason for perhaps not permitting deferral in either of these situations, or at least where the owning member is acquired in a stock reorganization, is that it would then be more difficult to justify not permitting deferral of DIG or DIL where the owning member ceases to be a member of the group as a result of the issuance of stock to a non-member in a transaction described in section 1032.[42] While the extension of a favorable deferral rule to such deconsolidations may appear at first blush to be reasonable, it would provide an additional incentive for a consolidated group that wishes to reduce its ownership interest in a subsidiary below the level required for consolidation to structure such a

---

[40] See, e.g., revenue ruling 70-140, 1970-1 C.B. 73.

[41] For example, the assets might be contributed to a new corporation prior to entering into discussions with the acquiror. Compare revenue ruling 70-140, supra.

[42] However, even if deferral of DIG or DIL were extended to a situation involving the deconsolidation of the owning member through the issuance of stock under section 1032, the rule contained in regulations section 1.1502-13T(o) for deconsolidations of a member whose stock was the subject of a DIT should be preserved because that rule implicates policies relating to the excess loss account provisions.

transaction as an issuance of stock by the subsidiary (preceded by a distribution from the subsidiary) rather than as a sale of shares by the subsidiary's parent.[43] A similar potential for abuse would not appear to exist where the owning member deconsolidates as a result of an acquisitive nonrecognition transaction, since the DIG would be restored to the extent of any "boot" received.[44]

V. DIT OF MEMBER STOCK FOLLOWED BY A LIQUIDATION, INTRA-GROUP REORGANIZATION OR SALE WITH SECTION 338(hWl01 ELECTION.

A. Introduction.

This Part discusses certain considerations that are raised by a DIT involving stock of a member that is followed by (i) a liquidation of that member under section 332, (ii) a sale of that ember with an election under section 338(h)(10) or (iii) an intra-group A, D or G (and, perhaps, E or F) reorganization. The DIT may involve (x) the distribution of the stock of that member by its shareholder to an upper-tier member in a transaction that fails to qualify under sections 355 or 368(a)(1)(D), as a result of which taxable gain is recognized under section 311,[45] or (y) a sale of the stock of the member by its shareholder to another member.[46]

---

[43] See Litton Industries, Inc. v. Commissioner, 89 T.C. 1086 (1987). Compare Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5 Cir.), cert. denied, 401 U.S. 939 (1971). While the DIG would not be triggered, the group may recognize gain as a result of the triggering of any excess loss account under regulations section 1.1502-19(b)(2)(i).

[44] 44 See Part IV.C.5 above.

[45] Alternatively, gain may be recognized under sections 255(c)(2) and (d).

[46] Regulations section 1.1502-80, as amended by T.D. 8402 on March 13, 1992, provides that section 304 does not apply to any acquisition of stock of a corporation in an intercompany transaction occurring on or after July 24, 1991. The Tax Section has supported this amendment. See New York State Bar Association Tax Section, Committee on Corporations, Report on Section 304(b)(4) (April 16, 1992). However, this amendment has increased the number of situations in which the problems addressed in this Part V are likely to arise.

Under regulations section 1.1502-13(f)(1)(i) and/or (vi), the DIT would be restored as a result of the disposition of such stock outside the group (the stock disappears) and/or the (actual or constructive) redemption of such stock in the subsequent transactions described above.

The foregoing fact patterns raise the same issue discussed generally in Part IV above of whether the DIT should continue to be deferred as a result of the nonrecognition transaction. However, the argument for continued deferral is more compelling in the case of a liquidation or an intra-group reorganization than in the case of most other nonrecognition transactions because the group has experienced no material change in its assets, but has merely eliminated a corporate layer.

In addition, the foregoing fact patterns raise an issue not found in most of the other nonrecognition transaction situations -- the potential duplication (and double taxation) of the same economic gain in the hands of the same taxpayer (the consolidated group). This problem is most acute in the case of a DIT that is followed by a stock sale with a section 338(h)(10) election (or in the case of a forward cash merger or an actual asset sale that is followed immediately by a liquidation under section 332), because the DIG on the stock of the member must be taken into account at the same time as the gain on that member's assets is taken into account.

EXAMPLE (1): P, the parent of a consolidated group, purchases all of the stock of T for $1,000. T's assets include all of the stock of S. T has a basis in the S stock of $0, and the S stock has a value of $500. S has a basis in its assets of $0 and S's assets have a value of $500. T distributes the S stock to P. Thereafter, P sells the S stock to non-member corporation M for $500 and a section 338(h)(10) election is made.

1. The distribution of S stock to P causes T to recognize gain of $500 under section 311(b), which is deferred under regulations section 1.1502-14T(a) until a restoration event occurs.

2. Under section 338(h)(10), the sale of S stock to M is treated as a sale of the assets of S followed by a liquidation of S under section 332. The deemed asset sale causes S to recognize gain of $500. The deemed liquidation of S is an event that, under regulations section 1.1502-13(f)(1)(vi), causes the deferred gain of T to be restored.

3. On its consolidated return, the P group will report total gain on the distribution and sale of S of $1,000.

The Committee believes that this result is inequitable and should be corrected.[47] A similar problem exists where the nonrecognition transaction that follows the stock DIT is a liquidation of the member under section 332 or an intra-group A, D or G (and, perhaps, E or F) reorganization, although in those situations, the duplicate gain will be recognized only if and when

[47] The Committee is mindful of the fact that the duplicate gain problem cannot be corrected simply by eliminating the DIT upon the occurrence of an intra-group liquidation or reorganization because such a solution would facilitate "bust up" mirror-type transactions in contravention of Congress' intent in repealing the General Utilities doctrine. Thus, in the foregoing example, if P were to liquidate S (instead of selling its stock with a section 338(h)(10) election) and the $500 DIT were to be eliminated as a result of such liquidation, P could sell T for $500 (its remaining value). Under the investment adjustment rules of regulations section 1.1502-32, P's basis in T immediately prior to the sale would be either $1,000 ($1,000 original basis, minus the dividend of $500 worth of S stock, plus the gain of $500 arising from the distribution of the S stock) or $500 (if the elimination of the DIT gain precludes an investment adjustment for such DIT gain). While P would be denied a loss under regulations section 1.1502-20, it will have achieved a "bust up" acquisition of T by selling T's unwanted assets without paying tax on the "bust up".

the member's assets are disposed of outside the group.[48]

B. Approach Based on Section 336(e).

One possible approach for dealing with the foregoing situations would be to provide that any intercompany sale or distribution of 80 percent or more of the stock of a member will (or, alternatively, may at the taxpayer's election) be treated as a disposition of the assets of that member followed by a liquidation of that member. The Tax Section has already recommended that, in the absence of an alternative remedy for the double tax problem presented by the foregoing situations, consolidated groups should be permitted to make such an election (a “section 336(e) election”), which would be patterned after section 338(h)(10).[49] Such an approach would achieve a technically correct result of only one level of tax, at the asset level, that would be deferred under the DIT rules until a restoration event occurs.[50]

The principal reservation that the Committee has in relying solely on a section 336(e)-type election is the administrative complexity that this approach would entail. This

---

48 Under current law it may also be possible to generate duplicate, deductible losses, at least in situations where an acquired member's assets decline in value after the member's stock was purchased by the group and there are no positive adjustments to the member's stock basis under section 1.1502-20(c). A sale of the member's stock by its shareholder to a sister company would give rise to a DIL, which would be restored when the member is liquidated (and, unless the anti-abuse rule of regulations section 1.1502- 20(e), as illustrated in Example 2 in regulations section 1.1502-20(e)(4) applies, would not be subject to disallowance). The assets could thereafter be sold at a loss.

49 See footnote 3 above.

50 Under regulations section 1.1502-13T(c), the deferred gain would not be restored upon the deemed liquidation of the member (which would be treated as the selling member), and its parent would be treated as successor of the selling member for purposes of the DIT restoration rules.

approach would require the taxpayer (without the benefit of an arm's-length sale to a third party) to appraise the value of a subsidiary's assets whenever the subsidiary is distributed or sold in an intercompany transaction and thereafter to track and account for DIT restoration events (including annual depreciation of each depreciable asset). For this reason, the Committee believes that this approach should not be made mandatory. An elective implementation of this approach, however, may not be adequate because many taxpayers may not anticipate a subsequent liquidation, intra-group reorganization or section 338(h)(10) sale at the time of the intercompany transfer, and may be reluctant to undertake the administrative complexities and costs of making the election.

A variation on this approach would be to provide that, upon a liquidation, intra-group reorganization or section 338(h)(10) sale that follows a DIT of the member's stock, the group may elect retroactively to treat the original intercompany transaction as if it were an asset sale, pursuant to a section 336(e)-type election. While this approach would eliminate administrative burdens if the second step never takes place, it would greatly exacerbate them if the second step does take place (particularly if the group did not obtain an appraisal at the time of the original intercompany transaction), and would therefore appear to be unworkable.

C. Re-allocation and Offset Mechanism Approach.

In light of the foregoing, the Committee recommends that a section 336(e)-type election be made available for intercompany transactions, particularly if such an election is generally made available. However, in addition to that elective remedy, the

Committee recommends that where the group does not or cannot[51] make a section 336(e)-type election, a DIT involving the stock of a member should continue to be deferred upon a liquidation, a section 338(h)(10) sale or an intra-group reorganization of that member. By analogy to regulations section 1.502-13T(c), the member that acquires the greatest portion of the assets (measured by fair market value) of the liquidated or reorganized member should thereafter be treated (or continue to be treated) as the owning member for purposes of the DIT restoration rules. In addition, in the case of an intra-group reorganization, any member that owned (immediately prior to such reorganization) stock of the reorganized member that was the subject of the DIT should also continue to be treated as the owning member for purposes of the DIT restoration rules, and the stock of the acquiring member that is actually or constructively received by the shareholder of the reorganized member in exchange for the stock that, was the subject of the DIT should thereafter be treated as "substitute property" for purposes of the DIT restoration rules.[52] Thus, the DIT would be restored inter alia if the selling member, any owning member or such substitute property were to leave the group.

In addition, in order to minimize (or eliminate) the duplication of gain or loss, the Committee recommends that a re-allocation and offset mechanism, described below, be implemented, subject to concerns about possible complexity. At a minimum, the

[51] For example, a 336(e)-type election would not be available if less than 80 percent of the stock of the member was transferred.

[52] For example, as illustrated in Example (2) at the end of this Part V.C, assume that P, the parent of a consolidated group, owns A, B and C, and A owns D. A has a basis of $60 in the stock of D, and sells D to B for $100. Thereafter, D merges into C. Both B and C should be treated as owning members, and the stock of C (actually or constructively) received by B should be treated as substitute property for D's stock, in order to prevent the group from disposing of either C (as successor to D's business) or such stock of C (which would have a substitute basis of $100 in B's hands) without recognizing the DIG. These results are consistent with the rules generally applicable in carryover basis situations (see Part IV.C.1 above).

Committee recommends that this mechanism be implemented in the case of a DIT of a member's stock (the “transferred member”) that is followed by a sale with a section 338(h)(10) election or an equivalent transaction.[53] The extent to which this mechanism should be applied in the other situations discussed in this Part V would appear to depend on whether its benefits are outweighed by administrative complexities and potential abuses, as discussed below, although the Committee recommends that this mechanism should apply in all of those situations.

Under the proposed re-allocation and offset mechanism, any gain or loss that is recognized in respect of the transferred member's assets would be re-allocated to the selling member to the extent of the DIG or DIL, respectively, and would reduce such DIG or DIL to the extent so re-allocated.[54] Any gain or loss in excess of the amount re-allocated to the selling member would be reported

---

[53] This would include a forward cash merger and an actual sale of all (or, perhaps, substantially all) of the assets of the transferred member immediately followed by a section 332 liquidation of the member.

[54] Any re-allocated gain or loss would be taken into account by the selling member for purposes of computing its earnings and profits as well as investment adjustments in its stock.

Any re-allocated loss should be recognized even if the corresponding stock DIL would be subject to the loss disallowance rule; as in the case of a section 338(h)(10) election that gives rise to a loss (cf. regulations section 1.1502-20(a)(5) Example 4), there is no reason to prohibit recognition of the economic loss on the sale of the assets because it would not be possible to duplicate the loss upon the disposition of the stock (since it is proposed that the re-allocated loss would reduce the DIL).

The Committee recommends that only gains and losses that are recognized in respect of the transferred member's assets should be taken into account for purposes of the re-allocation and offset mechanism, and that, for example, operating income that might be attributable to the consumption of those assets should not be taken into account (compare T.D. 8294, Example 3 (March 9, 1990), in the context of the loss disallowance rules). Whatever the conceptual merits might be of taking into account other items of income or loss, a more expansive approach would raise administrative complexities and, moreover, would facilitate “bust-up” transactions (see footnote 47 above) because it would permit a more rapid elimination of DIG without an actual sale of the transferred member's assets.

by the owning member. Any DIG or DIL remaining after the re-allocation of such gain or loss would continue to be deferred until a restoration event occurs.[55]

To simplify matters, and because the DIT arose with respect to different property (the stock of the transferred member) than the re-allocated gain or loss (which arises from the sale of the transferred member's assets), the Committee recommends that the determination of amount, character and source of the gain or loss to be re-allocated to the selling member generally should be determined by reference to the actual (or deemed) asset sale and the transferred member's tax situation in that regard rather than by reference to the selling member's situation in respect of

---

55 It should be recognized that this mechanism will not produce the same result as would have occurred under an expansive application of the single entity principle (e.g., under a DIT elimination/carryover basis system), at least where the value of the transferred member's assets appreciates or depreciates in a different direction after the DIT from the direction of the appreciation or depreciation in value of the transferred member's stock prior to the DIT. However, this disparity appears to be inevitable if the transferred member's stock basis and value must be taken into account, which seems to be necessary under existing law in order to avoid “bust up” transactions. See footnote 47 above. Accordingly, the Committee does not recommend that the remaining DIG or DIL should be eliminated. On the other hand, the Committee also does not recommend that the remaining DIG or DIL should be triggered if all of the assets of the member are disposed of (e.g., in a section 338(h)(10) transaction or forward cash merger) because (i) whether such remaining DIG or DIL is the result of a subsequent appreciation or depreciation in the transferred member's assets as described above or is the result of an erroneous valuation of the stock of the transferred member at the time of the DIT, there does not appear to be a compelling policy reason for forcing the group to recognize the remaining DIT earlier than upon a restoration event and (ii) it is desirable to have the consequences under the re-allocation and offset mechanism be similar, to the extent possible, to those under a section 336(e) election (where there would have been no stock DIT).

the transferred member's stock at the time of the DIT.[56]

A number of additional rules would appear to be necessary in order to minimize the opportunity for taxpayers to accelerate improperly the elimination of any DIG on the transferred member's stock through manipulation of the offset mechanism. These additional rules might be kept simple if the mechanism is made available only in the case of a section 338(h)(10) sale of the transferred member (or an equivalent transaction).[57]

The Committee believes, however, that if the re-allocation and offset mechanism were to be adopted, consideration should be given to making it applicable to all taxable dispositions of assets by the transferred member or its successor after the DIT, in all of the situations discussed in this Part V, and not only to dispositions under section 338(h)(10) (and equivalent transactions). Thus, the Committee believes that the re-allocation and offset mechanism should be available in the case of seriatim dispositions of assets by the transferred member after the DIT as well as in the case of dispositions of such assets by the owning member after a section 332 liquidation or intra-group reorganization involving the transferred member.

---

[56] While it would appear that such a simplification rule is unlikely to produce significant abuses, it might be appropriate for the Service to reserve the right to require that the character of the re-allocated gain or loss be determined by reference to the selling member's situation in potentially abusive situations (e.g., if the restoration event takes place within two years after the DIT).

[57] For example, it might be sufficient to have an anti-stuffing rule to the effect that any gain attributable to assets (other than money) that were transferred to the transferred member in a carryover basis transaction after the DIT cannot be re-allocated to the selling member. While this limited rule would not prevent a group from contributing cash or diverting profitable business opportunities to the transferred member, it may be viewed as achieving “rough justice” because this approach also would not provide an offset to the DIT for gains realized by the transferred member prior to the section 338(h)(10) transaction. In any event, the potential for such manipulation appears to be relatively limited where the sale of an entire subsidiary is involved.

In that event, it would be necessary to limit the re-allocation and offset mechanism to gains and losses that are recognized with respect to assets that were owned by the transferred member at the time of the DIT (or that have a substitute basis determined by reference to such assets). The taxpayer should have the burden of identifying those assets, although simplifying conventions can be set forth with respect to inventory and similar assets. Once rules are developed to address these situations, they should also apply to dispositions under section 338(h)(10) and equivalent transactions.

A somewhat more difficult issue is whether the amount of gain that is re-allocated to the selling member should be limited to the amount of built-in gain in respect of the particular asset at the time of the DIT. While the absence of such a limitation would result in accelerating the elimination of any DIG, including such a limitation would raise significant administrative problems regarding the establishment of asset values at the time of the DIT. Instead of imposing such a limitation, consideration may be given to providing that the amount of the DIT that is eliminated under this mechanism is to be adjusted from time to time so that it reflects only the net amount of gain or loss recognized in respect of all assets held by the transferred member at the time of the DIT.

The duplication of gain problem also arises when the selling member leaves the consolidated group, thereby triggering the DIT, but the transferred member and/or its assets are still owned by the group. A solution to this problem would require allocating the DIG among the transferred member's assets. In the Committee's view, the administrative complexities that such a solution would entail probably do not justify its implementation.

Finally, while there is a potential for duplication of gain when the owning member leaves the consolidated group, thereby triggering the DIT, the gain that would arise upon a subsequently sale of the transferred member's asset would not be includible in the income tax return of the consolidated group, except in the case of an intra-group reorganization as discussed in footnote 52 and the accompanying text above. Because such duplication of gain is similar to the duplication that typically arises in the context of a carryover basis nonrecognition transaction[58] and because of the administrative complexities adverted to in the preceding paragraph, the Committee believes that such duplication need not be addressed.

The recommendations made in this Part V.C can be illustrated through the following example.

> EXAMPLE (2); P, the parent of a consolidated group, owns corporations A, B and C, and corporation A owns corporation D. On December 31, 1992, D's stock has a basis of $60 in the hands of A and a fair market value of $100. On that date, D owns three assets, asset 1 with a basis of $20 and a fair market value of $50, asset 2 with a basis of $30 and a fair market value of $20 and asset 3 (which is not a capital asset) with a basis of $10 and a fair market value of $30.
>
> 1. On December 31, 1992, A sells D to B for $100. The transaction is a DIT, and the $40 of gain is deferred.
>
> 2. On March 31, 1993, D sells asset 3 to an unrelated person for $35 and acquires asset 4 with the proceeds. Under the Committee's recommendation, D's recognized gain of $25 would be re-allocated to A, would be reported as ordinary income by A, and would result in a reduction of the DIG to $15.
>
> 3. On March 31, 1994, when the value of D is $120, D merges into C in a transaction described in section 368, and B receives C stock in the exchange. Under the Committee's recommendation, A's remaining DIG of $15 would not be restored, and both B and C would become owning members for purposes of the DIT restoration rules. In addition, the C stock received by B, which would have a basis of $100 in the hands of B, would be substitute property, so that a subsequent disposition of such stock by B would result in a restoration of the remaining DIG.
>
> 4. On April 1, 1994, B distributes the C stock to P (or alternatively, B never receives c stock in the section 368 exchange and is therefore deemed to have received and

[58] See Part IV.C.1 above.

distributed such stock). B recognizes taxable gain of $20 under section 311, which is a DIG. The remaining $15 DIG on the D stock would not be restored, but would continue to be deferred by A because no restoration event has occurred. P would become an owning member with respect to both DIGs.

5. On April 15, 1994, C sells asset 4 for $40. The $5 gain would be reported by C and would not be re-allocated to A because D did not own asset 4 at the time of the DIT involving D's stock.

6. On April 30, 1994, C sells asset 2 for $15, recognizing a $15 loss. The $15 loss would not be re-allocated to A because the DIT of D stock resulted in a DIG. However, consideration might be given to adjusting the amount of the DIG previously offset under the re-allocation and offset mechanism so as to reflect only the net amount of gain recognized in respect of D's asset (i.e., $10, the difference between the $25 gain recognized on asset 3 and the $15 loss recognized on asset 2). If so, the DIG on the D stock would be increased from $15 to $25.

7. On June 30, 1994, C sells asset 1 for $40. The $20 gain recognized by C would be subject to the re-allocation and offset mechanism. If, as a result of the approach described in paragraph 6 of this Example (2), the DIG is $25, the entire $20 gain would be re-allocated to A and reported by it, and the DIG would be reduced to $5. If the DIG is $15 instead of $25, only $15 of the gain on asset 1 would be re-allocated to A, which would reduce the DIG on the D stock to 0. The remaining $5 of gain would be re-allocated to, and reported by, Bf and would result in a reduction of the DIG that arose from the distribution of the C stock, to $15.

8. On April 1, 1994, in lieu of distributing the C stock to P as described in paragraph 4 of this example (2), B sells the C stock to an unrelated person for $120. This sale would be a restoration event, since the C stock is substitute property, thereby resulting in the restoration of the DIG of $15 by A. In addition, B would recognize gain of $20. Upon the subsequent sale of asset 1 (see paragraph 7), C would recognize the entire $20 gain.

VI. PIT FOLLOWED BY A NONRECOGNITION TRANSACTION INVOLVING A PARTNERSHIP.

A. DIT Followed By a Section 721 Transaction.

1. Consistent with the general approach recommended for a DIT that is followed by a nonrecognition transaction, the Committee recommends that if an asset (including stock) that is the

subject of a DIT is contributed by the owning member to a partnership in a transaction described in section 721, the DIG or DIL should continue to be deferred, and the partnership interest received by the owning member should thereafter be treated as the property that is the subject of the DIT for purposes of the DIT rules (including the restoration provisions). For the reasons set forth in Part IV.C.l above, the partnership's carryover basis in the transferred asset should be determined by reference to the basis of that asset in the hands of the selling member before the DIT (subject to appropriate adjustments) but the owning member's basis in its partnership interest should equal its post-DIT basis in the transferred asset.

2. In view of the flow-through tax treatment of partnerships and their partners that is intended to produce only one level of taxation, it is desirable to minimize (and, to the extent possible, eliminate) any double taxation (or duplicate loss) that might otherwise arise in this situation. Accordingly, subject to concerns about possible complexity, the Committee recommends that a mechanism be adopted, similar to that described in Part V.C above, whereby any gain or loss attributable to the transferred asset that is allocated by the partnership to the owning member pursuant to section 704(c) would be re-allocated by the group to the selling member to the extent of the DIG or DIL, respectively, and would reduce such DIG or DIL to the extent so re-allocated. Moreover, because the owning member's basis in its partnership interest already reflects the DIG or DIL, such basis should not be further adjusted as a result of such re-allocated gain or loss, notwithstanding section 705(a). Any gain or loss in excess of the amount re-allocated to the selling member would be reported by the owning member, and would result in an adjustment in its partnership interest.

Any DIG or DIL remaining after the re-allocation to the selling member of any partnership gain or loss described in section 704(c) would continue to be deferred until a restoration event occurs.[59]

3. Consideration might also be given to reducing the possibility of double taxation or duplicate loss by providing that, if the selling member or owning member leaves the group and triggers a restoration event after the section 721 transaction, thereafter the adjusted basis of the transferred asset in the hands of the partnership is increased or decreased by the amount of the restored DIG or DIL, as the case may be.[60] Although such an adjustment would be inconsistent with the manner in which the carryover basis rules under the Code apply in general, it may be justified in the partnership context, where duplication of gain or loss can usually be avoided through a section 754 election.

B. Treatment of Section 731 Distributions and Section 708 Partnership Terminations.

1. In addressing nonrecognition transactions following DITs that involve partnerships, consideration should be given to the appropriate treatment of partnership distributions under section 731, including liquidating distributions in connection with a termination of the partnership. Such a DIT may arise, for example, as a result of the transfer of an asset by one member to another, which asset subsequently is contributed by the owning member to a partnership (as discussed in Part VI.A above),

---

59 In certain respects, any disparities between the amount of the DIG or DIL and the amount of gain or loss that is re-allocated to the selling member will reflect similar limitations arising as a result of the "ceiling rule" under section 704(c). The fact that this mechanism is not perfect should not result in its rejection.

60 If the partnership disposed of the transferred asset before the DIG and DIL is restored, duplicate gain or loss would be eliminated under the approach suggested in paragraph 2 above.

or it may arise as a result of a transfer of a partnership interest by one member to another.[61]

2. While the Committee considers regulations section 1.1502-13T(1) to encompass this situation already, it would be member's basis in its partnership interest was increased as a result of the DIT is treated as a DIT restoration event for the selling member in an amount equal to such increase in “basis recovery”[62]

3. A DIT of a partnership interest may be followed by a termination of the partnership under section 708(b)(1)(B). Under section 708(b)(1)(B), a partnership terminates if within a 12 month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. The partnership is deemed to distribute its assets to the purchaser and the other remaining partners in a distribution governed by section 731, and they are deemed to contribute those assets to a new partnership.[63] Because the property that is the subject of the DIT (the original partnership interest) has been disposed of outside the group (it in fact is no longer in existence), a DIT restoration event has occurred under regulations section 1.1502-13(f)(1)(i). The Committee believes that this result is inappropriate, since the group continues to hold an interest in the reconstituted

---

[61] Regulations section 1.1502-13T(1) appropriately precludes the group from obtaining an advantage from a section 754 election in connection with such a transfer.

[62] It may also be appropriate to clarify (i) that regulations section 1.1502-13T(1) applies to allocations of losses that, but for the DIT, would have been subject to the limitation of section 704(d), and (ii) that all allocations of losses and distributions that are treated as a nontaxable return of capital should be aggregated for purposes of applying regulations section 1.1502-13T(1). Similarly, regulations section 1.1502-13T(1) should include an example illustrating the application of that provision to basis recovery under section 301(c)(2) in the context of corporate distributions.

[63] Regulations section 1.708-l(b)(1)(iv).

partnership. Rather, there should be a DIT restoration event only to the extent of the amount of gain recognized under section 731, subject to the recommendations made in paragraph 2 above.

Accordingly, for purposes of applying the rules under regulations section 1.708-1(b)(1)(iv) relating to deemed distributions and recontributions of assets upon a termination of a partnership, the partner's adjusted basis in its partnership interest under section 732(b) should be determined by reference to the selling member's pre-DIT basis in the partnership interest (subject to appropriate adjustments, including for any gain recognized under section 731). However, the owning member's substituted basis in the new partnership interest should be determined by reference to its basis in the old partnership interest.

4. In the case of a distribution in liquidation of a partnership interest (or in complete liquidation of a partnership) in which taxable gain or loss is not fully recognized under section 731, the Committee believes that any DIG or DIL should continue to be deferred except to the extent that gain or loss is recognized as a result of the distribution.[64] Consistent with the objective of minimizing the duplication of gain or loss while preserving the location of the DIG or DIL, it would also be desirable to adopt a rule (similar to the reallocation and offset mechanism described in Part V.C above) whereby any gain or loss that is recognized upon a subsequent disposition of the assets received in the partnership distribution (including gain or loss recognized pursuant to section 751(b) as a result of a deemed

[64] See paragraph 2 above. Moreover, in the case of a non-liquidating distribution, for purposes of applying the limitation contained in section 732(a)(2) to the basis of assets distributed to a partner, the partner's adjusted basis in its partnership interest should be determined by reference to the selling member's pre-DIT basis in the partnership interest (subject to appropriate adjustments).

distribution and disposition of assets) would be re-allocated to the selling member to the extent of any DIG or DIL, respectively, and would reduce such DIG or DIL to the extent so re-allocated.