REPORT #813

TAX SECTION

New York State Bar Association

Report on Proposed Intercompany Transaction

Consolidated Return Regulations

December 16, 1994

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TAX SECTION
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December 16, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Deferred Intercompany Transaction Consolidated Return Regulations (CO-11-91)

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section commenting on the proposed consolidated return regulations relating to deferred intercompany transactions. The Report compliments the Treasury and the Service for their efforts to revise and restate the consolidated return regulations, both because of the importance of the project and because of the careful and generally balanced manner in which it has proceeded.

The comments made by the Report on the regulations include the following:

1. We generally support the expanded single entity treatment of consolidated groups required under the regulations. However, because such treatment can produce inappropriate results in some cases, the Service should announce its willingness to consider regulatory exceptions to single entity treatment to the extent experience proves exceptions appropriate.

2. The rules for member obligations and for intercompany stock should be modified in certain respects. In addition, consideration should be given to a rule applying single entity treatment to stock of the common parent corporation held within the group.

3. The acceleration rule should be modified so as to avoid inappropriate results that arise from treating certain transactions as if they were transactions with nonmember affiliates.

4. We accept the Service's commitment to anti-abuse rules, but note the breadth and uncertain scope of the rule in the regulations.

Please let me know if we can be of further help in the development of these regulations.

Very truly yours,

Michael L. Schler
Chair, Tax Section

New York State Bar Association

Tax Section

Report on Proposed Intercompany Transaction Consolidated Return Regulations

December 16, 1994

This Report considers recently proposed amendments to the consolidated return regulations (the “Proposed Regulations”) addressing the treatment of transactions between members of a consolidated group, so-called intercompany transactions.[1] The Proposed Regulations are an important element of what has been an ambitious and systematic effort by Treasury and the Internal Revenue Service[2] to revise and/or restate the basic operating rules of the consolidated return regulations. As is discussed in more detail within, the Service is to be complimented for its efforts on this project, both because of the substantive importance of the project and for the careful and generally balanced manner in which it has proceeded.

The Report will first summarize and compare the provisions of the existing intercompany transaction regulations and the proposed amendments thereto. Thereafter, the Report will analyze specific provisions of the Proposed Regulations, offering a number of recommended changes.

[1] The principal author of this Report is Dennis Ross, co-chair of the Committee on Consolidated Returns. Helpful comments and valuable other assistance were provided by Linda Mischel Eisner, Stephen Land, Carolyn Joy Lee, Yaron Reich, Richard Reinhold, Michael Schler and Tom Wessel.

[2] For ease of reference, the Report will not, beyond this initial reference, separately identify the two government offices involved in the development of tax regulations, and will instead employ the single term “Service” when referring to the government.

Summary of Conclusions

1. We generally support the expanded single entity treatment of intercompany transactions required under the Proposed Regulations. At the same time, we believe that single entity treatment, rigidly applied, can produce inappropriate results. Aside from the specific changes that we recommend be made currently, the Service should announce its willingness to consider regulatory exceptions to single entity treatment to the extent experience proves them appropriate.

2. The treatment of intercompany obligations should be modified to permit a group to elect separate entity treatment for intercompany transactions where one party is subject to the mark-to-market requirements of Section 475. In addition, we believe the “deemed retirement” treatment for member obligations that become intercompany obligations should not be applied so as to create a character mismatch for gain and loss that will be included on a single group's return.

3. We believe the asymmetrical treatment of gain and loss on redemptions of intercompany stock is inappropriate. More broadly we recommend that the Service extend the single entity principles of the intercompany obligation rules to intercompany transactions involving stock of the common parent.

4. We believe the acceleration rule should be modified to eliminate automatic treatment of the transaction as a deemed transaction with a nonmember affiliate.

5. We accept the Service's commitment to anti-avoidance rules, but note that the rule in this context is of exceptional breadth and entails considerable uncertainty.

Background

E Pluribus Unum. The consolidated return regulations are the federal income tax system's attempt to account for the activities of a group of separate corporations with common ownership. In broad outline, the regulations account for the group's activities by disregarding in significant respects the separate status of its members, and to that extent treating the group as a single entity for tax purposes. By their own premises, the consolidated return regulations do not seek true consolidated accounting, and settle instead for a hybrid regime blending single and separate entity principles. The Proposed Regulations would move that regime more in the direction of single entity accounting, but, again by their own terms, also stop short of true consolidation.

The Proposed Regulations plainly reflect a great deal of thoughtful attention, and are among the more conceptually interesting projects to be issued by the Service in recent years. That interest, as suggested above, relates principally to the conflict between single and separate entity concepts. The Proposed Regulations deal with those issues in an admirably open manner, setting forth in an attached notice of hearings on the regulations (the "Hearings Notice") a lengthy statement of the issues confronted in the regulations and a rationale for the principal choices made.

Format. The Proposed Regulations are notable as well for the format in which the new intercompany transaction rules are set forth. In a deliberate departure from past practice in the area, the Proposed Regulations abandon mechanical, rule-oriented guidance in favor of more loosely stated guiding principles. In and of themselves, the principles leave much unstated, a gap the Regulations seek to fill with numerous examples.

The Current Regulations

Intercompany Transactions. The Proposed Regulations would consolidate the provisions of Treas. Reg. §§ 1.1502-13, -13T, -14, and -14T (the “Current Regulations”) into a single section. Currently, §§ 1.1502¬13 and -13T address intercompany transactions, defined generally thereunder as any transaction between corporations that are members of the same group immediately after the transaction. Expressly excluded from this definition, however, are distributions or contributions with respect to a member's stock or sales or other dispositions with respect to member obligations, topics addressed under Treas. Reg. §§ 1.1502-14 and -14T.

With limited exceptions, the Current Regulations affect only the timing of items arising from an intercompany transaction. Through a series of more or less mechanical rules, the Current Regulations apply so-called “deferred sale” treatment to intercompany transactions, a regime under which the tax accounting for transactions is determined at the time of “sale” but deferred. Initially, the Current Regulations identify a subcategory of intercompany transactions, deferred intercompany transactions (“DITs”), which generally includes any intercompany transaction in which the purchasing, acquiring or paying member capitalizes its expenditure. As to DITs, the Current Regulations set forth the basic deferred sale rule that the “selling” member's gain or loss recognition is deferred. Such deferred gain or loss is “restored” upon the first to occur of a series of triggering events, including the buyer recovering its capitalized expenditure (e.g., by sale or depreciation) or the buying or selling member leaving the group.

For intercompany transactions that are not DITs, the Current Regulations provide a more simply stated rule of matched accounting. Thus, the Current Regulations require that any item arising from such transactions not be taken into account prior to the time that the corresponding item can be taken into account under the corresponding member's method of accounting.

Member Stock and Obligations. Treas. Reg. §§ 1.1502-14 and -14T, in conjunction with Treas. Reg. § 1.1502-32, generally extend deferred accounting principles to transactions involving member stock and obligations. Thus, dividends between members are "eliminated", and distributions in excess of earnings are excepted from the gain recognition ordinarily required under § 301(c)(3). Instead, distributions in excess of earnings reduce basis and create an excess loss account to the extent they exceed basis. Redemptive or liquidating distributions between members generally either result in nonrecognition for the recipient or recognition of deferred gain or loss subject generally to restoration when the distributee or distributing member leaves the group. Treas. Reg. § 1.1502- 14(b)(3).

For the distributing corporation, an in-kind distribution is subject to the generally applicable rules of Section 311, though again on a deferred sale model. Thus, a distribution of appreciated property results in the recognition of deferred gain. Although no loss is recognized on a distribution of depreciated property, the distributee apparently inherits the distributing corporation's basis in the asset. See PLR 8917077 (Feb. 2, 1989).

The treatment of obligations between members ("intercompany obligations") also reflects deferred accounting principles. A transfer of an intercompany obligation within the group results in deferral of any gain or loss recognition. Such gain or loss is restored upon a transfer of the obligation outside the group or when the obligor or obligee member leaves the group. Since the Bankruptcy Tax Act of 1980, these rules have been supplemented by the rules of Section 108(e)(4) and the regulations thereunder. Pursuant to those rules, for purposes of determining cancellation of indebtedness income, an obligor member will be treated as acquiring its own obligation to the extent such obligation (or, in certain circumstances, stock of a corporation holding such obligation) is acquired by another member of the group.[3]

The Proposed Regulations

Scope and Nomenclature. The Proposed Regulations provide tax accounting rules for "intercompany transactions", with that term expanded to include intragroup transactions with respect to member stock and obligations. The stated purpose of the Proposed Regulations is to prevent intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income. In working toward that purpose, the Proposed Regulations provide rules that treat members of a consolidated group as separate entities for some purposes (generally, determining an item's amount and location), and as divisions of a single entity for other purposes (generally, determining an item's timing, source, character and other attributes). As suggested above, the Proposed Regulations retain the general

[3] Section 108(e)(4) applies to "related party" acquisitions of an obligor's debt, with relatedness determined under Section 267 and 707. The rules thus apply

definition of an intercompany transaction as any transaction between corporations that are members of the same group immediately after the transaction. The definition is expanded, however, to include transactions involving member stock and obligations.

For ease of presentation, the Proposed Regulations refer to the member transferring property or providing services in an intercompany transaction as S, with S's income, gain, deduction or loss from the transaction identified as “intercompany items”. S's counterparty in an intercompany transaction is referred to as B, with B's income, gain, loss or deduction from the intercompany transaction or from property acquired in the intercompany transaction identified as “corresponding items”. There are deemed forms of both intercompany and corresponding items, generally identified as adjustments to basis (or a basis equivalent, such as a loss carryover) that are substitutes, respectively, for intercompany or corresponding items.

Matching. The principal operating rule of the Proposed Regulations is the “matching rule,” which expands the limited single-entity provisions of the Current Regulations to include not simply the timing but also the source, character and other attributes of intercompany and corresponding items. Thus, the matching rule provides that the attributes of intercompany and corresponding items, defined as all characteristics of the item necessary to determine its effect on taxable income other than “amount, location and timing,” are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation and the intercompany transaction occurred between those divisions. Similarly, the holding period of property transferred from S to B will generally aggregate the holding period of each.

As under the Current Regulations, the timing of intercompany and corresponding items is generally determined by reference to the accounting method of B. Thus, S takes account of its intercompany items in the same period or periods so as to reflect the difference between B's corresponding items, determined on a separate entity basis, and B's recomputed items, i.e., the corresponding items that would have been taken into account had S and B been divisions within a single corporation. Under a series of operating rules, single entity treatment proceeds on the assumption that S and B, although deemed to be divisions of a single corporation, operate separate trades or businesses (and thus may have separate accounting methods), and retain any special status they have for tax purposes (e.g., as a bank or insurance company).

Acceleration Rule. The other basic operating rule of the Proposed Regulations is the acceleration rule, which is analogous in concept to certain of the restoration rules of the Current Regulations. As its name implies, the rule accelerates S's taking account of intercompany items in any case where they can no longer be taken into account under single entity principles. This would generally occur where either S or B is no longer in the group, but would also include cases where the basis of property subject to an intercompany transaction may be taken into account by a nonmember.

Example. S sells property to B, recognizing gain that is deferred. Subsequently B transfers the property to a partnership. Because B's basis in the property will carry over to the partnership, it may affect the tax consequences of nonmember partners*. Since the consequences of the intercompany transaction can no longer be taken into account on a single entity basis, S, under the acceleration rule, is required to take its intercompany gain into account.

Although the acceleration rule is styled as a rule affecting the time at which intercompany items are taken into account, in application it may also alter the character of such items. Where the acceleration rule applies, the attributes of S's accelerated items are determined as though B sold the acquired property to a nonmember affiliate. Thus, the acceleration of intercompany items with respect to property subject to depreciation would generate ordinary income to S under Section 1239, without regard to whether any member of S's group would have generated corresponding depreciation deductions.

Member Stock and Obligations. The Proposed Regulations also provide special rules relating to transactions involving stock or debt obligations of members of the group. The rules relating to member stock have no apparent underlying theme, and are notable, in part, for the extent to which they fail to expand single entity principles. The Proposed Regulations provide initially that distributions with respect to a member's stock are excluded from the distributee's gross income, which is identified as merely a restatement of the “elimination” rule of the Current Regulations. Putting another lash on the horse of dividend stripping, the Proposed Regulations provide for exclusion only to the extent the distribution reduces the distributee's basis in the distributing member's stock.

The Proposed Regulations also provide that a member's acquisition of its own stock in an intercompany transaction will eliminate its basis therein, and will thus force intercompany items with respect to the stock to be taken into account. Because of that rule, an actual or deemed liquidation of a group member will cause any intercompany gain previously recognized but deferred with respect to that member's stock to be taken into account under the matching rule. Since that result may artificially generate gain in an intercompany transaction or duplicate gain in a 338(h)(10) transaction, the Proposed

Regulations provide certain elective mitigation rules. In particular, the Proposed Regulations provide a deemed reincorporation rule under which the group may, following a Section 332 liquidation of a member, transfer substantially all of the liquidated member's assets to a new corporation and, for purpose of the proposed Regulations, treat the new incorporation as part of the same transaction as the liquidation. This treatment is available on an elective basis, and requires the transfer to be complete prior to the due date (taking account of extension) for the group's return for the year of the liquidation. Similar principles are to apply with respect to other transactions, such as a downstream merger, that may have the same effect as a liquidation. Given the relatively brief period in which relief under this rule must be sought, it is likely best understood as a foot fault rule, permitting a taxpayer to undo an inadvertent step that is promptly discovered.

Under an alternative relief rule provided for Section 338(h)(10) transactions, the liquidating distributee may be treated as recognizing any loss it would recognize if the target's deemed liquidation were subject to Section 331. Since the target's deemed asset sale pursuant to the Section 338(h)(10) election would increase the distributee's basis in the target stock, Section 331 treatment serves generally to offset the target's asset sale gain with a corresponding loss on the liquidation. The character of the gain and loss, however, may not match. Moreover, neither of the above relief provisions is available if at any time between the transfer of the liquidating member's stock and its actual or deemed liquidation any of its stock is owned by a nonmember. In addition, the Section 338(h)(10) relief rule is not available if the target has made substantial noncash distributions during the 12 month period ending on the date of the qualified stock purchase.

Intercompany Obligations. The rules on obligations mark one of the Proposed Regulations' sharper departures from the existing regulations, and one of the areas in which single entity principles are most broadly expanded. Intercompany obligations are defined quite broadly to include not only conventional indebtedness, but also the class of financial and derivative contracts identified in Section 475(c)(2)(D) and (E) (and comparable contracts with respect to commodities). Although the Proposed Regulations do not disregard intercompany obligations, they treat any obligation that leaves or enters intercompany status as satisfied and reissued at such time. Thus, a nonmember corporation holding a member obligation is required to recognize gain or loss on the obligation immediately after joining the group. Although such gain or loss is reflected on the group's return, its attributes are determined on a separate entity basis.

In addition, the Proposed Regulations provide that any realization of income, gain, loss or deduction by a member due to the assignment or extinguishment of an intercompany obligation held or issued by the member, including a gain or loss under the mark-to-market rules of Section 475, is treated as a deemed satisfaction of the obligation, and the issuance of a new obligation to the extent the original obligation remains outstanding.

Anti-Avoidance Rule. Finally, in what has become de rigueur for newly issued regulations, the Proposed Regulations provide an anti-avoidance rule. Indeed, the Proposed Regulations go one step beyond and provide an anti-avoidance rule under the effective date provisions, in part, at least, to capture transactions structured to avoid the anti-avoidance rule.

The basic anti-avoidance rule applies to transactions structured with a principal purpose to avoid treatment as an intercompany transaction or to avoid the purposes of the intercompany transaction provisions. Although unremarkable in form, the rule has considerable potential breadth, given that the stated purpose of the intercompany transaction provisions is to provide rules that “clearly reflect” income of the group.

Discussion

Substantive Overview. We believe the expanded single entity treatment achieved by the Proposed Regulations is an understandable and generally defensible evolution of the law in the area of the consolidated return regulations. The Service's rationale for expanding single entity treatment is reflected in the Hearings Notice, which states that such treatment reduces “anomalies and planning opportunities, and better reflects the economic unity of a consolidated group.” Since the election of consolidated return status affords the taxpayer important benefits of single entity treatment, including the netting of group members' income and loss and the ability generally to defer the results of intercompany transactions, there is logic in requiring as a trade-off that taxpayers sacrifice the tax planning flexibility that is available through separate incorporation of various assets or activities.

We recognize as well that broadened single entity treatment will in some cases work to the taxpayer's benefit.

Example. B has outstanding indebtedness to S, a portion of which is allocable under the principles of Section 265 to tax-exempt bonds owned by B. Under the Current Regulations, B's interest expense and S's interest income are matched in timing, but otherwise determined under generally applicable principles. Thus, although a portion of B's interest expense is disallowed under Section 265, S's interest income is fully taxable. Under the Proposed Regulations, B's corresponding items include amounts disallowed under Section 265, and thus the matching rule permits S to exclude from income a corresponding portion of B's interest payments.

Example. S sells an appreciated business asset to B in year 1. In year 3, B exchanges the asset with X for an asset of like-kind within the meaning of Section 1031.

Under the current regulations, B's like-kind exchange is a disposition of the asset which triggers restoration of S's deferred gain. Under the Proposed Regulations, B would have no recognized gain in respect of the like-kind exchange and thus S's deferral of gain would continue. While we generally approve of the direction in which the proposed regulations would move the intercompany transaction rules, it is worth recognizing that single entity treatment does not invariably result in more rational tax accounting, or better reflect the economic results of a consolidated group's activities. Moreover, the shortcomings in the single entity approach go beyond those which the Service itself identifies in the Hearings Notice, namely that true single entity accounting is difficult to apply where there are minority interests or members move in or out of the group. The broader criticism of the single entity model is that, even in the pure case of a group with wholly- owned, unchanging members, it denies taxpayers the ability, which separate incorporation may allow, to avoid, or at least blunt, certain arbitrary features of our tax accounting system. For example, under our realization based system for recognizing asset gains, the character of gains as capital or ordinary is determined on an all-or-nothing basis at the date of pale, with the entire gain forced into one category or the other. This approach, of course, has deep roots and is justified by substantial administrative considerations. It is arguably distortive, however, in the not uncommon case where a taxpayer's use of the asset changes over time. A long history of passive, investment- oriented use of an asset, during which substantial appreciation may have occurred, can be erased by a final flurry of activity designed to prepare the asset for sale.

In order to avoid the arbitrariness of that result, taxpayers have often employed separate entities to segregate assets or activities generating capital gain from those generating ordinary income. When the use of an asset changes, the amount and character of the gain to that point may be locked in by a sale of the asset between related entities. Such self-help measures are permitted under the Current Regulations, which generally determine the character of income from an intercompany transaction on a separate entity basis, so that the buyer's subsequent use of the asset has no effect on the character of the seller's deferred gain. The Proposed Regulations change that result by determining the character of each member's gain or loss from an intercompany transaction by reference to the members' aggregated activities. Thus, the transaction is analyzed as though occurring between divisions of a single entity, which again forces the group's gain to be characterized as entirely capital or entirely ordinary.

A similar application of the Proposed Regulations can be seen in the context of the rules characterizing income as domestic or foreign for purposes of determining a taxpayer's allowance of foreign tax credits. The rules in this area are among the more arcane in the tax law, and taxpayers have historically employed separate entities to separate the component functions of an integrated activity, at least in part to achieve a different, and presumably advantageous, allocation of income between domestic and foreign sources.

For example, in the simple case of a corporation manufacturing goods in the United States for export abroad, income from the activity has both domestic and foreign components. The applicable rules for sourcing mixed foreign and domestic income provide that where no "independent factory price" exists to establish the value of the manufactured goods, income from the activity will be allocated between domestic and foreign sources under the so-called 50/50 rule. Thus, half of the income will be allocated based on the location of the corporation's assets, and half based on the location of its sales, generally determined under a passage of title rule.

Although the 50/50 rule may be administratively defensible, it is obviously something short of a precise measure of the foreign and domestic sources of income. Under the Current Regulations, however, a taxpayer may limit application of the 50/50 rule by separately incorporating various components of its business. Thus, in the above situation, the taxpayer might separately incorporate its foreign sales activities, leaving the income from such activity, which would be entirely foreign, outside of the 50/50 rule. This approach, assuming arm's length pricing, arguably produces an allocation of income for tax purposes that is closer to the sources of the economic activity producing the income.[4] Such segregation of activities would be prohibited under the Proposed Regulations, which, under the matching rule, would determine the source of income on an aggregate, single entity basis.

The Service may understandably be uncomfortable in the above and other contexts with allowing taxpayers to elect between

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[4] We recognize that in practice the segregation of activities will often serve to leave the 50/50 rule applicable in a manner that overstates the foreign component of income. Thus, in the above example, current law would permit application of the 50/50 rule to the taxpayer's manufacturing activity because of its offshore sales to its affiliate. Thus, half of the manufacturing income, which arguably is predominantly domestic, would be treated as a

single and separate entity treatment. We again accept the basic proposition that an election to file a consolidated return is in substantial part an election to accept the consequences, favorable and unfavorable, of single entity treatment. Taxpayers cannot freely be permitted to jump between the two alternatives so as to produce a hybrid and uniquely favorable regime of tax accounting. At the same time, we believe it important to recognize that the Proposed Regulations do not simply restrict taxpayer flexibility in these respects, they eliminate it, with no retained mechanism by which taxpayers may achieve separate entity treatment, even where it may produce a more appropriate result.

This aspect of the Proposed Regulations is somewhat ironic, since we understand that their reliance on general principles of application, rather than the mechanical rules of the Current Regulations, was intended to provide a more flexible form of guidance, one that might evolve over time consistent with changes in the tax law outside the consolidated return regulations. Part of this rationale is undoubtedly sound, but we again think it important to recognize that the administrative flexibility achieved by the Proposed Regulations also entails a form of substantive rigidity. As described above, taxpayers' use of separate entities has represented an adaptive mechanism, which, although not invariably appropriate, will in a number of cases produce not simply more favorable, but more accurate tax accounting results. The Proposed Regulations disarm that mechanism, forcing any group of corporations that elects the privilege of a consolidated return to submit to a single, and in our view somewhat inflexible, regime of tax accounting.

We offer the above comments recognizing that they cannot fully be responded to without largely scrapping the administrative approach, and, in part, the substantive philosophy, of the Proposed Regulations. Since we believe the Proposed Regulations are, on balance, a reasonable exercise of administrative discretion, we have targeted our recommendations to more incremental change, which is for the most part consistent with the basic approach of the Proposed Regulations. Beyond these targeted recommendations, however, we believe it important that the Service remain open to amending the Proposed Regulations as experience with them grows. The Proposed Regulations already incorporate a number of specific exceptions to the single entity principle of the matching rule where application of that rule would not be appropriate.[5] We believe the Service should, and should announce its willingness to, expand those exceptions over time as and to the extent experience with the Proposed Regulations indicates that rigid application of the single entity model produces inappropriate results.

At bottom, our concern is that the single entity, matching principle of the Proposed Regulations not be viewed by the Service as a final, conclusory statement of the proper treatment of intercompany transactions. There will undoubtedly be additional, as yet unanticipated, situations where it can be argued that the Proposed Regulations alter current law results that are appropriate as a matter of the economic measurement or characterization of income. An announced willingness to address such cases would serve some of the safety-valve function that the Service has articulated in support of anti-abuse rules, i.e., a means to prevent literalistic results that fail to reflect actual economic consequences.

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[5] See, e.g., Prop. Treas. Reg. § 1.1502-13(c)(3)(iii)(B) (special status of members, e.g., under Section 582, protected from application of matching rule).

Format. An additional question is whether, as a matter of form, the result-oriented, principle based format of the Proposed Regulations is an improvement over the Current Regulations. Although the Current Regulations can be criticized as overly mechanical, and somewhat complex, they, at least over time, have come to be generally understood and accepted, and in this respect have passed the threshold test of workability. Since the Proposed Regulations preserve a great deal of the Current Regulations, at least in result, we tend to believe that they too will prove workable for most taxpayers. At the same time, the text of the Proposed Regulations is in some respects quite difficult to absorb. The time-honored form of regulations begins with an expression of general principle, and moves progressively through increasingly specific statements of that principle's intended application. In contrast, the text of the Proposed Regulations remains at a relatively abstract level of expression, leaving the examples to illustrate what the Proposed Regulations intend in actual cases. While we accept this as a reasonable administrative choice, and, indeed, generally encourage regulations that focus on principle rather than detail, in this context it leaves some likelihood of unintended, or at least unanticipated, consequences. This is a further reason for the Service to assume an active monitoring responsibility, both to provide additional examples as issues arise from the textual gaps in exposition, and as discussed above, to revise and refine the Proposed Regulations as experience fleshes out their actual application.

Intercompany Obligations. As described above, the rules concerning intercompany obligations are perhaps the Proposed Regulations' broadest expression of the single entity concept. The practical effect of the rules is generally to disregard intercompany obligations, treating a member obligation as issued only when held by a nonmember, and as retired if subsequently held by a member.[6]

Although we believe the basic approach of these rules is sound, we again believe they will in certain instances produce inappropriate results. The definition of an obligation for purposes of these rules expressly includes the variety of derivative securities identified in Section 475(c)(2)(D) and (E). It is common practice for a consolidated group of corporations engaged on a group-wide basis in derivative trading activities to consolidate all positions in a central booking location, often with a single member of the group. This practice generally has little if anything to do with tax considerations, and serves instead as a risk management tool and to achieve transactional efficiencies. The 'booking' member will act as counterparty for member- initiated transactions, and then hedge such positions, on an aggregate basis, with offsetting transactions.[7]

Since the group booking unit in such cases may be treated as a dealer in securities subject to the mark-to-market rules of Section 475, its member counterparties will be required also to mark their positions to market under the member obligation rules, which deem any obligation marked to market under Section 475 as retired and reissued (to the extent it remains outstanding). The practical effect of the member obligation rules in this context is to require that all group

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[6] 6Such elimination of intercompany obligations is achieved only on an aggregate basis. Thus, specific items of interest income or expense, and gain or loss on intercompany obligations, are taken into account by individual members. As a consequence, intercompany obligations will affect individual member's gain or loss, and may, depending, for example, on the application of the separate return limitation year rules, affect the group's tax liability.

[7] The above greatly simplifies the variety of arrangements under which dealers in derivative securities

positions, regardless of whether entered into by a dealer subject to Section 475, be marked to market. That result appears inconsistent not only with Congress' general intention at the time Section 475 was enacted,[8] but also with the single entity policies of the Proposed Regulations. A single entity engaged both in dealer and proprietary trading activities in derivative securities is permitted to exempt its trading activities from the mark-to-market requirement of Section 475 if it can establish unambiguously the separateness of such trading from its dealer activities. Temp. Treas. Reg. § 1.475(b)-1T(c)(2). Although the evidentiary standard for establishing that separateness may be high, we assume that reflects administrative considerations rather than a substantive judgment by the Service that any proprietary trading activities of a dealer in derivative securities are appropriately subject to Section 475.

The apparent effect of the Proposed Regulations is to eliminate a group's ability to separate trading and dealer activities in derivative securities for any group that consolidates all such transactions in a separate entity, central booking location. We think this particularly inappropriate given that, in many cases, the separate entity status of an entity engaged in trading activities would otherwise satisfy the unambiguous proof standard that the Service has established to separate proprietary trading from dealer activities.

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[8] The legislative history to Section 475 states that Section 475 was to apply to non-inventory contracts between related parties as though the contract involved unrelated parties. H. Rep. No. 103-11, 103rd Cong., 1st Sess., at 224, fn. 37 (1993). Although the legislative history for this purpose makes illustrative reference only to Sections 267 and 707, it arguably indicates that mark-to-market gain or loss on derivative securities under Section 475 would also not be subject to the deferred accounting principles of the consolidated return regulations.

We thus recommend that the Service permit a group to elect separate entity treatment for intercompany derivative security transactions subject to the mark-to-market requirements of Section 475.[9] Under this approach, members entering into contracts with the mark-to-market member would be treated as entering into a contract with a nonmember.

We, of course, recognize that such treatment permits a mismatch in the timing of items for two parties to an intercompany transaction, a concern raised by the Service in the Hearings Notice. This result is appropriate, however, where the booking member marks-to-market, since its own positions will offset, with the same net effect on group income as if the originating member entered into the transaction with a nonmember. The practical effect of the Proposed Regulations is to force groups to restructure commonly utilized business practices in order to avoid adverse tax results. This result is especially inappropriate given that a true single entity could achieve the same segregation of its activities for purposes of Section 475.

We also question certain aspects of the implementation of the rules concerning the deemed retirement of a nonintercompany obligation that becomes an intercompany obligation. As described above, when a nonmember corporation that holds a member obligation becomes a member of the group, the obligation is treated as having been retired in a taxable transaction occurring immediately after the creditor joins the group. The same result could be required in part under current

[9] The Service has responded to comparable concerns in the context of proposed hedging regulations, permitting groups to elect in that context to treat certain intercompany transactions as entered into between unrelated parties. Prop. Treas. Reg. § 1.1221-2(d)(2). Our recommended change is an extension of the same principle and is supported by the same rationale.

Section 108(e)(4), which could apply in such cases to cause the debtor to recognize cancellation of indebtedness income.[10] The Proposed Regulations, however, go beyond Section 108(e)(4) both in that Section 108(e)(4) applies only to the extent the creditor corporation acquired the member obligation in anticipation of becoming related to the debtor, and that the Proposed Regulations also force the creditor to recognize gain or loss at such time.

We believe the above results are generally appropriate, consistent with the single entity approach of the member obligation rules. The Proposed Regulations, however, also require that the character of the creditor corporation's income or loss be determined, not under the matching rule, but on a separate entity basis. Assuming that gain or loss to the debtor in such cases would often be offset in amount by a loss or gain to the creditor, the effect of that rule will be to create a character mismatch, typically causing ordinary cancellation of indebtedness income to the debtor, and a capital loss to the creditor.

The Proposed Regulations justify separate entity treatment for the creditor corporation on the basis that its gain or loss accrued economically while it was not a member of the group. That is, of course, true, and it is further true that a direct retirement of the debt from the creditor would typically involve the same mismatch of ordinary cancellation of indebtedness income for the debtor and a capital loss for the creditor. We believe a different result is justified under the deemed retirement rule, however, given that the rule both accelerates the debtor's and creditor's tax consequences and places them within the same group. Thus, it seems unnecessary, if not gratuitously harsh, to accelerate the tax treatment of

[10] Treas. Reg. § 1.108-2(c).

offsetting economic positions in a manner that would often produce a positive tax liability. We, therefore, believe the creditor's loss and debtor's income should match not only in timing but in character.[11]

Moreover, to the extent the Service is concerned that taxpayers would structure transactions to take advantage of this result, e.g., by purchasing a corporation holding debt rather than the debt itself, the anti-avoidance rule would be available where the transaction lacked a predominant business purpose.[12] Since built-in loss limitations under Section 382 and the separate return limitation year rules would also be potentially applicable, we see no reason to force a character mismatch. See Prop. Treas. Reg. § 1.1502-13(h)(2), Ex. 3.

Member Stock. The rules governing transactions with respect to the stock of member corporations are one of the more curious portions of the Proposed Regulations. In this area, the Service has taken pains to preserve and to some extent enhance certain aspects of the Current Regulations that conform with separate entity treatment. The discussion of this issue in the Hearings Notice indicates that other approaches, more in the direction of single entity principles, were considered and rejected. The Hearings Notice argues generally that such approaches would have “far-reaching effects”, and would present intractable administrative problems.

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[11] Such matching would include deferral of the creditor's loss to the extent the debtor's income was excluded under Section 108. In such circumstances, the creditor should be entitled to recognize its loss as and to the extent the debtor's future taxable income is increased due to the tax attribute reduction generally required in connection with income exclusion under Section 108.

[12] Alternatively, availability of the rule might be denied in any case where the debt represented an excessive portion of the creditor's assets. Cf. Treas. Reg. § 1.108- 2(c)(4)(ii).

We believe the Service reaches this conclusion, in part, because of a focus on unnecessarily sweeping adoption of single entity principles, with too little consideration given to incremental changes that would represent limited but still positive steps in the direction of single entity treatment. The issue is put rather directly with respect to gain or loss recognition from intercompany redemptions of a member's stock. Under the Current Regulations, gain or loss on a redemption of a member's stock is either not recognized (if the redemption consideration is noncash) or recognized and deferred. Such deferral as a practical matter may result in permanent exclusion of any gain recognized, since the Service has previously taken the position that the deferred gain is not restored unless the exact shares redeemed subsequently leave the group. GCM 39608 (March 5, 1987).

In apparent reaction to that practical result, the Proposed Regulations partly reverse the Current Regulations and require current recognition of gain, although not loss, upon a redemption of member stock. That result is explained as based on the fact that the redeemed stock becomes treasury stock, losing its basis for tax purposes, and indeed losing its identity as an asset as to which future gain or loss could be recognized. This effectively precludes reliance on the matching rule to further track S's deferred gain or loss. As a consequence, the acceleration rule is invoked and S is required to take account of its intercompany items.

The dubious logic of this result is reflected in the fact that the Proposed Regulations in such cases deny loss recognition to the redeemed member. This is based on the principles of the matching rule, to reflect the nonrecognition character of the redemption for the redeeming member. Logically the same analysis should apply to any gain recognized by the redeemed member, but the Proposed Regulations provide otherwise.

The approach of the Proposed Regulations to this case is plainly inconsistent with the neutrality principle that lies at their core. Neutrality in this context requires generally that an intercompany transaction not produce a net effect on consolidated taxable income. Requiring recognition of gain on intercompany redemptions plainly violates that principle, at least to the extent the gain is attributable to appreciation in the redeemed stock occurring while it is held within the group. The asymmetrical treatment of loss recognition only compounds the result.

We believe a more satisfactory model for inter-company transaction involving member stock can be drawn from the rules of the Proposed Regulations addressing intercompany obligations. Although we accept, as argued in the Hearings Notice, that those rules would present significant administrative difficulties if extended to all intercompany transactions involving stock of any member, we believe that significant advantages could be obtained, at a reasonable administrative cost, if a single entity approach were followed in the context of intercompany transactions involving stock of the common parent of the group.

Under this approach, parent stock held by another member of the group ("Intercompany Stock") would be treated as redeemed and reissued immediately before the time it was either acquired by a nonmember or the member holding it became a nonmember. Similarly, parent stock held by a nonmember ("Nonintercompany Stock") would be treated as redeemed and retired immediately after becoming Intercompany Stock.[13] As an important collateral rule, the principles of the matching rule would apply so as to exclude both gain and loss recognized when Intercompany Stock becomes Nonintercompany Stock. Separate entity treatment would apply, however, to gain or loss recognized when Nonintercompany Stock becomes Intercompany Stock, in order to preserve taxation of gain or loss occurring while the stock was held outside the group.[14]

The practical effect of the above rules would be to treat parent stock held anywhere within the group as a form of treasury stock.[15] Such treatment would advance single entity treatment of intercompany stock transactions in one of the principal contexts where such treatment is likely to make a difference. Thus, stock of a common parent often moves in or out of the group as it is used, or repurchased, for such purposes as to support acquisitions, raise or reduce capital, or pay compensation. Under the Proposed Regulations, substantial differences in taxation would turn on whether such stock was issued or retired by the parent itself or by a subsidiary member.

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[13] 13Although there are certain parallels, we would not recommend extending this approach to a downstream merger of a nonmember holding parent stock into the parent. We note that the Service is now considering this issue across a broader spectrum, and see no reason to accelerate its resolution in this context. See Rev. Proc. 94-76, 1994-52 I.R.B.________ Moreover, whatever policy issues are presented by the current treatment of downstream mergers, they do not involve consolidated return issues or present the zero basis and other anomalies attendant to the Proposed Regulation's treatment of intercompany stock transactions.

[14] We recognize that separate entity treatment is not consistent with the approach we recommend with respect to nonintercompany obligations that become intercompany obligations. We believe the difference is supported by the fact that the issue in the context of stock is not the character of the income or loss but whether it will be excluded.

[15] We would apply these rules even if the member holding the stock was less than 100% owned by group members.

Acceleration Rule Mechanics. As described above, the acceleration rule applies to force S to take its intercompany items into account immediately before the occurrence of any event that makes it impossible to take those items into account under the single entity principles of the matching rule. Thus, for example, if B leaves the group of which S and B were previously members, B's items will be taken into account in a separate return and it will no longer be possible to replicate the effects of single entity accounting. As a consequence, S's items are taken into account immediately before B leaves the group.

Besides accelerating the timing of S's intercompany items, the acceleration rule also controls the character of those items. Thus, where the intercompany transaction is a transfer of property, the attributes of S's intercompany items are determined under the principles of the matching rule as if B sold the property to a “nonmember affiliate”. The consequence of this characterization is made plain in the examples under the acceleration rule. If the property subject to the intercompany transaction is depreciable, the deemed sale to a nonmember affiliate causes S's deferred gain to be characterized as ordinary income under Section 1239.

The application of Section 1239 to characterize S's deferred gain would seem appropriate where the transferred property remained within the group. Thus, if S rather than B left the group, the property and associated depreciation deductions would remain within the group, and it would seem, consistent with the policies of Section 1239, that the gain that generated those deductions be treated as ordinary income. The same result is difficult to understand, how-ever, if, as in the case where B ceases to be a member, the property has left the group. Section 1239 applies only where the seller and buyer are related, and thus serves to prevent gain and offsetting deductions from being taken into account by related parties at different rates. That arbitrage potentiality does not exist where the benefit of B's future depreciation deductions will flow to parties unrelated to B's old group.

We believe the nonmember affiliate rule produces plainly inappropriate results, and should be limited in application to situations in which the property has not left the group. In other cases, we believe that the property should be deemed transferred to the person that owns the property immediately after the transaction that triggers application of the acceleration rule. The application of rules such as Section 1239 would correspondingly be determined by reference to that deemed purchaser. This would be consistent with the result under the Proposed Regulations where the underlying asset rather than the B stock is sold outside the group.

To the extent the nonmember affiliate rule is retained, we believe the Service should clarify the scope of its application. An actual transfer of the property by B to a nonmember affiliate would bar or defer loss recognition to S or B under Section 267. Section 267 controls the timing of loss recognition, and the nonmember affiliate rule determines the <u>attributes</u> of S's items, which by definition do not include the timing of income or loss recognition. We, thus, assume it is not intended that the nonmember affiliate rule automatically require S to defer loss recognition, and that the application of Section 267 would instead depend on the actual relationship between S and the holder of the property. An example clarifying this intention would be appropriate.

Anti-Avoidance

The anti-avoidance rule of the Proposed Regulations applies to transactions structured with a principal purpose either to avoid treatment as an intercompany transaction or to avoid the purposes of the Proposed Regulations. We appreciate the Service's commitment to anti-avoidance rules, and have previously expressed our support for such rules in a number of different contexts. The principal rationale for such rules, as we understand the Service's view, is to dissuade literalistic application of specific tax rules where the effect is to produce results plainly inconsistent with more general tax accounting principles.

Although we have supported that rationale in the context of such rule-based regimes as Subchapter K and the original issue discount regulations, there is at least some irony in attaching an anti-avoidance rule to the Proposed Regulations, which are themselves a collection of broad, result-oriented principles. This is particularly so in that the rule addresses not simply avoidance of the definitional requirements of an intercompany transaction, where there is a substantial mechanical component, but also avoidance of the “purposes'* of the Proposed Regulations. Those purposes are “to provide rules to clearly reflect taxable income,” a standard so broadly stated as to leave taxpayers with little guidance as to the cases in which the Service might deem them avoided.[16]

Uncertainty as to the scope of the anti-avoidance rule is only amplified by the examples, which have no discernible theme. In Example 2, S and B are engaged in complementary

[16] We note, moreover, that the clear reflection purpose would seem directly contradicted by express provisions of the Proposed Regulations that, for example, require gain recognition on intercompany transactions involving member stock.

manufacturing activities and form a partnership for substantial business reasons. In order to force recognition of a built-in gain that could be absorbed by Section 382 restricted net operating losses, S sells land to the partnership. Although a sale to a nonconsolidated entity would ordinarily cause recognition of gain, the example provides that, pursuant to the anti-avoidance rule, the transaction will be treated as an intercompany transaction, resulting in a deferral of S's gain recognition.

Example 2 appears to announce a Section 267 analogue to gain recognition for consolidated groups. The rule applies, however, only when the gain recognized can be offset by existing losses or will otherwise reduce the taxpayer's tax liability over time. Given the variety of ways in which taxpayers can trigger gain realization, this would seem a marginal case for application of an anti-avoidance rule. This is particularly so in that the transferee partnership was established for non-tax reasons, and, although there is an implication that the transferred land was unrelated to the partnership's manufacturing activities, there is no express statement in the example that the transferred asset did not relate to those activities. Since the anti-avoidance test requires only a principal tax purpose, we fear it would reasonably be construed as automatically satisfied in any case where gain recognition advantaged the taxpayer, without regard, as a practical matter, to the relationship of the asset to the partnership's business.

Given that the partnership was wholly-owned by group members, we do not find the nonrecognition result in Example 2, in and of itself, objectionable. We question, however, why the nonrecognition result should be provided under an asymmetrical anti-avoidance rule, i.e., one that applies only to 'protaxpayer' gains rather than under the definitional requirements for an intercompany transaction. If the Service is unwilling, for administrative reasons or otherwise, to treat a transfer to a group-owned partnership as an intercompany transaction, the Service should clarify Example 2 to state that the transferred asset has no significant relationship to the partnership's business activities. In addition, we believe the Service should, in Example 2 or otherwise, give additional indication as to what level of group ownership of a nonmember transferee would invoke intercompany transaction n treatment. Given the low threshold the tax law generally imposes on taxpayers seeking to achieve gain recognition,[17] we question why this is an area in which reasonably bright lines need to be avoided.

Effective Date. The effective date provisions of the Proposed Regulations need additional development to explain fully the intended transition from the Current Regulations. In particular, the definition of an intercompany transaction appears to break out the component parts of what could otherwise be regarded as a single, overall transaction, see Prop. Treas. Reg. § 1.1502-13(b)(1)(iii) (each accrual of interest on an intercompany obligation is a separate transaction), so that it is unclear what prospective application will, in practice, mean. For example, the Service should clarify the treatment of an intercompany notional principal contract, which may involve a series of actual or deemed intercompany transactions, entered into prior to the effective date of the Proposed Regulations but continuing after that date. The Proposed Regulations imply that such transactions continue to be subject to the Current Regulations, but this point should be clarified.

[17] There aresq, for example, no statutory analogues to Sections 267, 1091 or 1092 for gain recognition.