Tax Report #940

New York State Bar Association

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NYSBA

November 24, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Secretary Lubick and Commissioner Rossotti:

In Notice 98-38, 1998-34 I.R.B. 7, the Treasury Department and the Internal Revenue Service announced that, instead of eliminating the separate return limitation year ("SRLY") rules from the consolidated return regulations, they are considering an approach that would replace the current SRLY limitation with a set of rules modeled on Section 382 (the "Proposed Approach"). As we have previously noted, the SRLY regime is voluminous, staggeringly complex and, in our experience, easily avoided. Moreover, we believe the legislative changes made to Sections 382[1] and 383 in 1986 render the SRLY rules largely redundant.[2]

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1 All "Section" references are to the Internal Revenue Code of 1986, as amended.

2 We have previously recommended elimination of the SRLY rules. See, *e.g.*, NYSBA Tax Section, Letter to Acting Assistant Secretary (Tax

(continued...)

As more fully set forth below, we continue to advocate the elimination of the SRLY rules. We support Notice 98-38 to the extent it adopts that approach. However, we believe that, in cases where a Section 382 ownership change does not occur, the Proposed Approach can result in harsh and unwarranted tax consequences that we discuss below.

Problems with Current Regime. After a corporation joins a consolidated group, the SRLY rules prevent the new member's pre-existing tax attributes from being freely available to the group. For example, the rules prevent the new member's net operating loss ("NOL") carryovers from offsetting income of the other members of the consolidated group. Sections 382 and 383, which impose annual limitations on the ability of a corporation to use its NOLs, built-in losses, and excess credits following an ownership change, limit (rather than prohibit) attribute utilization by other members of the group in most cases where the SRLY rules apply.

The SRLY rules generally can be avoided, or their impact minimized, by merging the new member into another member of the group or by "stuffing" assets or income opportunities into the new member.[3] Thus, the SRLY rules discriminate against entities that, for regulatory or other business reasons, cannot merge the new member into another member.

The SRLY rules also apply in situations where Code Sections 382 and 383 do not limit the use of the pre-acquisition losses and credits of a corporation that joins a consolidated group because there has been no ownership change (for example, if an acquiring group's long-standing ownership of the corporation increases from 70% to 100%). We do not believe the small category of transactions that involve changes in ownership falling below the threshold Congress determined appropriate to trigger the limitations on attribute utilization (generally more than 50 percent) warrants retaining the current complex and largely ineffective SRLY regime.

(...continued)

Policy) Lubick and Commissioner Richardson (Dec. 10, 1996), *available at* 96 TNT 244-29 (Dec. 17, 1996) (LEXIS, FEDTAX Library, TNT File); NYSBA Tax Section, Committee on Consolidated Returns, "Report on Proposed Regulations Under Sections 1.1502-15, -21 and -22" (Dec. 13, 1991), *available at* 91 TNT 258-31 (Dec. 20, 1991) (LEXIS, FEDTAX Library, TNT File).

3 Merging the new member into a single-member limited liability company (a "disregarded entity") would allow continuation of a limited-liability entity for non-tax purposes.

On June 27, 1996, the Treasury and IRS issued temporary regulations that revised the SRLY rules for NOL and capital loss carryovers and carrybacks.[4] The 1996 temporary regulations retained the general approach of the 1966 consolidated return regulations governing the absorption of loss carryovers and carrybacks from SRLYs but replaced the 1966 regulations' member-by-member and year-by-year approach to determining the limitation on SRLY attributes with a subgroup and cumulative approach. On January 12, 1998, additional temporary regulations were issued that extended the principles of the 1996 temporary regulations to the general business credit and minimum tax credit.[5]

In a recent report (the "ABA Report"),[6] members of the American Bar Association Section of Taxation recommended the retention of the SRLY rules to protect "the integrity of the separate return and consolidated return systems by preventing affiliated groups from selectively claiming the benefits of both systems, while avoiding their detriments." According to the ABA Report, "removing the SRLY rules would be destabilizing and lead to new complexity as piecemeal amendments are made to the Code and regulations to respond to problems that would result from the change." We do not believe that eliminating the SRLY rules would inevitably result in greater complexity. In our view, the benefits of simplification are likely to outweigh any loss of "accuracy" (or conceptual purity) that elimination of the SRLY rules would entail.

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4 T.D. 8677, 1996-2 C.B. 119. The 1996 temporary regulations adopted without substantive change rules that were proposed on February 4, 1991 (CO-78-90, 1991-C.B. 757).

5 T.D. 8751, 1998-10 I.R.B. 23. The 1998 temporary regulations made the SRLY limitations inapplicable to foreign tax credits, overall foreign losses, and separate limitation losses. The preamble to the 1998 temporary regulations indicated that the issues raised by commentators with respect to the application of the SRLY regulations in general will be addressed in connection with a review of comments received in response to the 1991 proposed regulations, the 1996 temporary regulations, and the 1998 temporary regulations, prior to the expiration of the 1996 temporary regulations in 1999.

6 "Comments Regarding Retention of the Consolidated Return SRLY Rules (CO-24-96, 1996-2 C.B. 437; REG-104062-97, 1998-10 I.R.B. 34)" (April 30, 1998), *available at* 98 TNT 93-23 (May 14, 1998) (LEXIS, FEDTAX Library, TNT File).

The ABA Report does not argue that the SRLY rules actually prevent consolidated groups from trafficking in tax attributes or from achieving inconsistent treatment by first filing separate returns to achieve specific separate entity benefits and then switching to consolidated returns in later years to achieve the benefits of single entity treatment. At most, the SRLY rules may prevent the group from gaining immediate access to a new member's tax attributes while preserving the group's outside basis in the new member's stock. The simplest means of avoiding the SRLY limitations — merging the new member into another member — involves a trade-off, because it transfers the basis of the new member's stock to the stock of the transferee member (or, in the case of a Section 332 liquidation, eliminates the new member's stock basis). But other means of "stuffing" the new member with income-earning assets may well be available. We do not believe that retention of the SRLY rules is justified if their sole real function is to make it more difficult (in some cases, impossible) for a purchasing group to preserve its outside basis in a new member's stock while treating the new member as part of a single entity in other respects.

In addition to the approach suggested by Notice 98-38, and the complete repeal of the SRLY regime, there appear to be essentially two additional ways of dealing with the tension between the separate entity and single entity aspects of the consolidated return regulations in the SRLY context. The ABA Report recommends retention of the existing compromise: retain the SRLY limitations as the cost of preserving the outside basis of a new member's stock.

A second possible approach would give preference to the single entity theory of consolidation by mandating a deemed acquisition of the assets of the new member. The model would be a deemed transfer of the new member's assets to a new corporation ("Newco") (by analogy to Section 338's "old target" and "new target") in a (D) reorganization. But the basis of Newco's stock would be determined as if the new member had liquidated and its assets and liabilities had been contributed to Newco. Thus, inside tax attributes would be preserved while outside stock basis would be eliminated. We do not recommend this approach because it would be inconsistent with the decision of the drafters of the intercompany transaction regulations to retain separate entity treatment of member stock.

The Proposed Approach. Subsequent to the ABA Report, Notice 98-38 was issued, suggesting the Proposed Approach. According to the Notice, "limitations on the extent to which a consolidated group can use attributes arising in a separate return limitation year remain necessary to protect the integrity of both the separate return system and the consolidated return system. Treasury and the Service, however, are concerned about any complexity in applying the current SRLY rules, particularly with respect to situations where both the SRLY rules and § 382 apply. Accordingly, Treasury and the Service are considering, inter alia, an approach that would replace the current SRLY limitation with an approach modeled on § 382."

The Notice does not clearly define the scope of the Proposed Approach. We assume that, under the Proposed Approach, a loss corporation would be deemed to undergo an ownership change when it became a member of a consolidated group, whether or not a Section 382 ownership change actually occurred. Section 382 — not separate SRLY rules — would be the only factor limiting the ability of a consolidated group to utilize losses arising in separate return years. To the extent of the Section 382 limitation, pre-acquisition losses could freely offset income of the consolidated group. Thus, if we have interpreted it correctly, the Proposed Approach would have the laudable effect of eliminating the separate SRLY regime. While this result is consistent with our prior recommendations, we believe the Proposed Approach would create harsh and unwarranted results in many circumstances where there is no Section 382 ownership change.

Assume, for example, that an individual owns 100 percent of two corporations, one with income and the other with loss carryforwards. A merger between the two would result in no Section 382 ownership change and no limitation on the use of losses; on the other hand, the contribution of the stock of the loss corporation to the profit corporation would, under the Proposed Approach (if we understand it correctly), result in a Section 382 limitation on the pre-acquisition losses of the loss corporation. Alternatively, assume that A (a consolidated group) and B invest $790 and $210, respectively, in the equity of a newly formed company, X. X loses $900 and when it is worth $100, A buys 2 percent of the stock from B for $2, increasing its percentage ownership to 81 percent and bringing X into the A consolidated group. As we understand the Proposed Approach, X's $900 loss would be subject to a Section 382 limitation based upon an equity value of $100, even though there was no actual Section 382 ownership change and 79 percent of the loss was economically borne by A.

In this context — where Section 382 would not otherwise be applicable — we believe that the Proposed Approach would have to be modified. If the Proposed Approach is adopted, we suggest a modification under which Section 382 principles would only apply to a percentage (the "Acquired Percentage") of the pre-acquisition loss represented by the aggregate owner shift of the loss corporation during the Section 382 testing period. For the purposes of determining the percentage owner shift, the consolidated group would be deemed to have acquired any stock of the loss corporation not owned by members of the group on the date that the loss corporation joined the group. The Section 382 limit would apply to the Acquired Percentage of the loss, which could otherwise be used freely by the consolidated group. The remaining loss would be free of limitations and could also be utilized against all income of the consolidated group. Thus, in the first case set forth above, where no owner shift at all occurs, the Acquired Percentage would be 0, and no limitation would apply. In the second case, the Section 382 limitation would apply to 21 percent of the loss, represented by the 2 percent of the stock purchased from B plus the 19 percent that B continues to own on the date the loss corporation joins the A consolidated group. As a result, $711 of the loss would be freely available; the remaining $189 of the loss could only be used at the annual rate of $100 [fair market value] x .21 [Acquired Percentage] x the long-term tax-exempt rate, but it could be utilized against all income of the consolidated group.[7]

<u>Specific Request for Comments</u>.

1. <u>Loss Carrybacks</u>.

The ABA Report points out that the SRLY rules perform a function in limiting the carryback of losses and credits to a selling consolidated group. Sections 382 and 383 do not apply to carrybacks, but there is no ability outside the consolidated return context for one corporation to carry back its losses and credits to offset the income of another corporation. If the current SRLY rules are eliminated, the issue of carrybacks to a selling consolidated group will have to be addressed. (If the new member was not a member of a selling consolidated group, carrybacks of losses or credits arising in a consolidated return year to a separate return year of the new member would not require any special rules.)

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[7] The Proposed Approach has its own anomalies and complexity. First, it is not clear how, or if, the Proposed Approach would apply where, for example, a loss corporation is merged into the common parent of a consolidated group in a transaction that does not involve a Section 382 ownership change. Second, the Proposed Approach would have to address the consequences of the loss corporation leaving the consolidated group, in particular, whether the deemed Section 382 limitation that was imposed on its joining the group would disappear.

Consideration could be given to simply eliminating the carryback of losses and credits to a selling consolidated group. This would avoid difficult issues in connection with the sale of a subsidiary, where the parties must deal with the possibility that post-acquisition losses of the subsidiary might be carried back to the selling group. Under Treas. Reg. § 1.1502-21T(b)(3)(i), if the buyer is another consolidated group and the selling group negotiates to prohibit loss carrybacks from the sold subsidiary, the buying group must waive all loss carrybacks, not just those of the new member. Prohibiting the loss carryback to the selling consolidated group would also simplify the analysis under Section 172(h).

2. Credits; Overall Foreign Losses.

Under Treas. Reg. §1.1502-4T(f), the SRLY rules no longer apply to foreign tax credits, an approach that is consistent with our general support for the elimination of the SRLY rules. However, it seems to us that if the Proposed Approach is adopted, it should also be applicable to credits by analogy to Section 383.

3. Section 382(l)(5).

We believe that in order to be consistent with the policies of Section 382(l)(5), no additional limitation should apply under the modified Proposed Approach to the losses or other attributes of a corporation that joins a consolidated group as a result of a transaction described in Section 382(l)(5).

4. Effect of a Member's Departure on SRLY Subgroup Limitation.

Our suggestions concerning the apportionment of a subgroup's Section 382 limitation, net unrealized built-in gain, and net unrealized built-in loss when a subgroup member leaves the consolidated group are contained in our recent report on the temporary consolidated Section 382 regulations.[8]

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[8] NYSBA Tax Section, "Report on Regulations Concerning the Application of Section 382 (continued...)

5. Valuation Rules.

We believe no special valuation rules should be applicable in this context and the general rules of Section 382 and the consolidated Section 382 regulations should apply to determine the value of the new member.

6. Transition Rules.

We believe the Proposed Approach should not apply to any corporation that joins a consolidated group before implementing regulations become effective, unless the group elects to apply the regulations retroactively. Transition relief could also be adopted in the case of binding contracts in existence on the date regulations implementing the Proposed Approach are proposed or become effective.

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We would be pleased to discuss these issues with you at your convenience.

Very truly yours,

Steven C. Todrys
Chair

cc:

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8 (...continued)
to Consolidated Groups" (Oct. 7, 1998), *available at* 98 TNT 204-19 (Oct.22, 1998) (LEXIS, FEDTAX Library, TNT File).