

NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON
PROP. REG. §1.1502-91(g)(7): DETERMINING SECTION 382 NET
UNREALIZED BUILT-IN GAIN AND LOSS OF A CONSOLIDATED GROUP

July 13, 2012

TABLE OF CONTENTS

I.	Introduction.....	1
II.	Summary of Recommendations.....	1
III.	Background.....	3
	A. Section 382 Background.....	3
	1. Treatment of built-in items under section 382(h)	4
	2. Effect on Alternative Minimum Tax (“AMT”) provisions.....	6
	3. Application of Section 382(h) with respect to a consolidated group	6
IV.	Description of Prop. Reg. §1.1502-91(g)(7).....	9
V.	Analysis of Prop. Reg. §1.1502-91(g)(7).....	10
	A. Technical Issues	10
	1. Measurement inaccuracies	10
	2. Additional technical complexities.....	18
	B. Policy Issues.....	23
	1. Consistency with redetermination of NUBIG and NUBIL in other areas	23
	2. Consistency with treatment of subsidiary liabilities	24
	3. Narrow issue – unduplicated stock gain or loss.....	25
VI.	The Majority’s Preferred Alternative.....	26
	A. Modify the anti-abuse rule of Reg. §1.1502-91(g)(2)(iv).....	27
	1. Acquisition of loss group with <i>a</i> principal purpose of benefitting from unduplicated stock loss	27
	2. Continued inclusion of group member with <i>the</i> principal purpose of benefitting from unduplicated stock loss	28
	B. Postpone reduction in NUBIL until RBIL from stock loss is absorbed under rules other than section 382	29
VII.	Conclusion	31

New York State Bar Association Tax Section

Report on Prop. Reg. §1.1502-91(g)(7): Determining Section 382 Net Unrealized Built-in Gain and Loss of a Consolidated Group

I. Introduction

The objective of this Report¹ is to help inform the decision-making of the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”) regarding whether to finalize Prop. Reg. §1.1502-91(g)(7) in its current form by illuminating policy choices that must be addressed, identifying technical issues to consider, and proposing an alternative approach to address the legitimate concerns that animate Prop. Reg. §1.1502-91(g)(7).

II. Summary of Recommendations

The proposed regulations respond to legitimate concerns about inaccurate results reached under the current regulations (Reg. §1.1502-91(g)), and we agree that Treasury and the Service should address these concerns. However, we do not recommend that Treasury and the Service adopt Prop. Reg. §1.1502-91(g)(7) in its current form. The proposed regulations would add a further layer of complexity to an already very complex area of tax law. In addition, the proposed regulations raise significant technical issues, with the effect that, while the proposed regulations cure certain inaccuracies, they would introduce others. As described more fully below, a majority of the Tax Section believes that Treasury and the Service should adopt a more targeted anti-abuse approach in lieu of finalizing Prop. Reg. §1.1502-91(g)(7) in its current form or adopting any similar set of rules that broadly would require a redetermination of net unrealized built-in gain (“NUBIG”) or net unrealized built-in loss (“NUBIL”) for unduplicated gain or loss recognized on the disposition of shares of a member of a loss group or subgroup. A significant minority of the Tax Section believes that Treasury and the Service should adopt the proposed regulations in modified form.

It is clear that current regulations are imprecise because they generally disregard unduplicated stock gain or loss in determining NUBIG/NUBIL. While the proposed regulations would improve measurement of NUBIG/NUBIL in certain cases, they would, in their current form, create measurement inaccuracies in other cases and would be complicated to administer for the government and taxpayers alike.

¹ The principal drafters of this Report are Lawrence Garrett, Lisa Joire, and Shane J. Kiggen. Substantial contributions were made by Lee Alison, Stuart J. Goldring, Vadim Mahmoudov, Andrew W. Needham, David R. Sicular and Lee Zimet. Helpful comments were received from Peter J. Connors, Steven Dean, Michael S. Farber, Michael L. Schler and Linda A. Swartz. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

All “section” or “§” references are to the Internal Revenue Code of 1986, as amended (the “Code”), or to Treasury regulations (“Regulations” or “Reg.”) thereunder.

In lieu of finalizing Prop. Reg. §1.1502-91(g)(7), the majority recommends that Treasury and the Service adopt a narrower set of rules to address the clearest examples of abuse:

1. The first rule would modify Reg. §1.1502-91(g)(2)(iv) so that it would apply to preclude membership of one or more subsidiaries in a loss group or subgroup if and to the extent that any person (or group of persons) (i) acquires a loss group or subgroup for a principal purpose of accessing an unduplicated stock loss free of the section 382 limitation, or (ii) includes such subsidiary in the loss group or subgroup for the principal purpose of accessing an unduplicated stock loss free of the section 382 limitation.
2. Under the second rule, any stock loss recognized during the five-year period following the ownership change (the “recognition period”) that would otherwise be treated as recognized built-in loss (“RBIL”) will not reduce a remaining NUBIL unless and until it is absorbed within such period.

While the majority acknowledges that some of the technical issues associated with the proposed regulations could be readily addressed, other issues would be more difficult and likely would create additional complexity in the context of an already complex regulatory framework. The majority’s concern about the complexity involved with respect to remedying these matters reinforces its view that the better course would be to adopt a narrower approach targeted at certain abusive transaction structures, rather than to finalize the approach taken in Prop. Reg. §1.1502-91(g)(7).

The minority recommends that Treasury and the Service should adopt Prop. Reg. §1.1502-91(g)(7) after remedying various technical issues addressed in this Report. These changes to the proposed regulations include the following:

1. Final regulations should eliminate the “cliff effect” associated with sales of stock of a member of a loss group (or subgroup) for no gain or loss to require the group to redetermine NUBIG/NUBIL when any member directly or indirectly takes an amount into account with respect to a share of stock of an included subsidiary.
2. Final regulations should correlate the redetermination of NUBIG/NUBIL with the amount of unduplicated gain or loss actually recognized during the recognition period, taking into account any increase or decrease in such recognized gain or loss attributable to changes in value of the member’s stock after the change date.
3. To diminish electivity, Treasury and the Service should consider whether final regulations should adopt a prospective “recapture” rule that would adjust the redetermined NUBIL or NUBIL (or the applicable section 382 limitation) to offset the benefit or detriment associated with asset gain or loss recognized prior to the redetermination event.

4. Final regulations should not require a redetermination of NUBIG/NUBIL until unduplicated stock loss is absorbed.
5. Final regulations should reduce unduplicated stock loss for purposes of redetermining NUBIG/NUBIL by stock basis that is reduced on the actual disposition of the shares under Reg. §1.1502-36.
6. Final regulations should permit a loss group (or subgroup) to change prospectively its choice of safe harbor alternative for determining recognized built-in gain (“RBIG”) or RBIL under Notice 2003-65 where a redetermination under Prop. Reg. §1.1502-91(g)(7) causes the loss group (or subgroup) to flip from a NUBIG to a NUBIL.
7. Final regulations should provide conventions for allocating items between pre-redetermination and post-redetermination periods (e.g., pro ration or closing of books).
8. Final regulations should provide that any redetermination of NUBIG/NUBIL under Prop. Reg. §1.1502-91(g)(7) not require a separate and parallel redetermination for adjusted current earnings purposes under section 56(g)(4)(G).
9. Final regulations should address the interaction of the redetermination rules under Prop. Reg. §1.1502-91(g)(7) with the rules of Reg. §1.1502-95(c) and (e) concerning allocations of section 382 attributes to departing members.
10. Final regulations should clarify the impact, if any, of a redetermination under Prop. Reg. §1.1502-91(g)(7) on the separate return limitation year rules of Reg. §1.1502-15.

III. Background

A. Section 382 Background

To prevent loss trafficking and to assure the integrity of the averaging function of loss carryforwards, section 382 provides rules that limit a corporation’s ability to offset its taxable income in years following an ownership change with pre-change losses. Pre-change losses consist of (i) net operating loss (“NOL”) carryforwards, capital loss carryforwards, and certain credits from taxable years ending prior to the year in which the ownership change occurred,² and (ii) the portion of any NOL or capital loss from the year that includes the ownership change to the extent it is allocable to the period on or preceding the date on which the ownership change occurred (the “change date”).³ Additionally, as discussed more fully below, if and to the extent that a corporation has a

² Section 382(d)(1)(A), Section 383(b) and Reg. §1.382-2(a)(2).

³ Section 382(d)(1)(B), Section 383(b).

NUBIL at the time of its ownership change, any RBIL during the recognition period is subject to limitation in the same manner as pre-change losses.⁴

Under section 382(a), the amount of taxable income for any post-change taxable year that may be offset by pre-change losses may not exceed the section 382 limitation for such year. The section 382 limitation generally equals the product of (i) the fair market value of the loss corporation's stock immediately before the ownership change,⁵ multiplied by (ii) the Federal long-term tax-exempt rate at the time of such ownership change.⁶

1. Treatment of built-in items under section 382(h)

To the extent of a loss corporation's NUBIG or NUBIL, as the case may be, built-in gain or loss on assets owned by the loss corporation at the time of an ownership change that is recognized during the five-year period following the ownership change receive special treatment under section 382(h). These special rules are grounded in two complementary principles: (i) a net built-in gain should increase the section 382 limitation, because, if the gain had been recognized before the ownership change, it could have been offset by pre-change losses without limitation; and (ii) a net built-in loss should not escape the section 382 limitation, because, if the loss had been recognized before the ownership change, it would have been subject to section 382. Consistent with the first principle, section 382(h)(1) provides that, if and to the extent that a loss corporation has a NUBIG at the time of an ownership change, the section 382 limitation is increased by RBIG taken into account during the recognition period. Consistent with the second principle, section 382(h)(2) provides that, if and to the extent that a loss corporation has a NUBIL at the time of the ownership change, any RBIL during the recognition period generally will be subject to the section 382 limitation in the same manner as a pre-change loss.

The terms "NUBIG" and "NUBIL" mean, with respect to an old loss corporation, the amount by which the fair market value of the assets of such corporation immediately before the ownership change is more or less than, respectively, the adjusted basis of such assets at such time.⁷ However, if the amount of NUBIG or NUBIL of any old loss corporation is not greater than the lesser of 15 percent of the fair market value of the assets of the old loss corporation (with some exclusions) immediately before the change

⁴ Section 382(h)(1)(B).

⁵ The fair market value of the loss corporation's stock generally may be reduced by the following amounts: (i) redemptions and other corporate contractions occurring in connection with the ownership change - section 382(e)(2); (ii) capital contributions received by the loss corporation pursuant to a plan a principal purpose of which is to increase or avoid the impact of section 382 - section 382(l)(1); (iii) substantial nonbusiness assets - section 382(l)(4); and (iv) the value of the stock of controlled, nonconsolidated corporations owned by the loss corporation - Reg. §1.382-8.

⁶ Section 382(b).

⁷ Section 382(h)(3)(i). Note that, if a redemption or other corporation contraction occurs in connection with an ownership change, determinations of NUBIG and NUBIL will be made after taking such redemption or other corporate contraction into account. Section 382(h)(3)(ii).

date, or \$10 million, then the NUBIG or NUBIL is considered to be zero (the “NUBIG/NUBIL Threshold”).

An RBIG is gain recognized during the recognition period on the disposition of any asset to the extent the new loss corporation establishes that (i) such asset was held by the old loss corporation immediately before the change date, and (ii) such gain does not exceed the excess of the fair market value of such asset on the change date over the adjusted basis of such asset on such date.⁸ An RBIL is any loss recognized during the recognition period on any asset except to the extent the new loss corporation establishes that (i) such asset was not held by the loss corporation immediately before the change date, or (ii) such loss exceeds the excess of the adjusted basis of the asset immediately before the change date over the fair market value of such asset on such date.⁹ A deduction for depreciation, amortization, and depletion taken during the recognition period is considered RBIL unless the taxpayer establishes that the deduction is not attributable to an asset’s built-in loss at the time of the ownership change.¹⁰

In Notice 2003-65,¹¹ the Service described two alternative approaches for determining NUBIG/NUBIL and built-in items for purposes of section 382(h): the “1374 Approach” and the “338 Approach.” Generally, NUBIG and NUBIL are calculated in the same manner under both approaches. NUBIG/NUBIL equals (i) the amount the loss corporation would have realized if it had sold all of its assets immediately before the ownership change at fair market value to a third party that assumed all of its liabilities, (ii) decreased by the loss corporation’s aggregate asset basis and by any deductible liabilities of the loss corporation that would be includible in the loss corporation’s amount realized, (iii) increased or decreased by the loss corporation’s section 481 adjustments that would be taken into account the sale, and (iv) increased by any RBIL that would not be allowed as a deduction on the sale under sections 382, 383, or 384.

Under the 1374 Approach, the actual amount of gain or loss recognized during the recognition period on the disposition of an asset will be treated as RBIG or RBIL to the extent of the gain or loss on the change date. Items of income and deduction attributable to the pre-change period are generally determined on the basis of the accrual method of accounting. Thus, items of income or deduction included or allowed during the recognition period generally will be considered attributable to periods before the change date and treated as RBIG and RBIL only if an accrual method taxpayer would have recognized income or taken a deduction for such item before the change date without regard to economic performance. However, the 1374 Approach departs from the tax accrual rule with respect to certain items, including amounts allowable as depreciation, amortization, or depletion deductions during the recognition period. Such amounts will be treated as RBIL regardless of whether they accrue for tax purposes before the change

⁸ Section 382(h)(2)(A).

⁹ Section 382(h)(2)(B).

¹⁰ *Id.*

¹¹ 2003-2 C.B. 747.

date, unless the taxpayer is able, using a reasonable method, to establish that the deduction is not attributable to an asset's built-in loss on the change date.

Under the 338 Approach, items of RBIG and RBIL are, in significant part, determined by comparing the loss corporation's actual items of income, gain, loss, and deduction with those that would have resulted if all of the loss corporation's stock had been acquired on the change date, and a section 338 election had been made for the hypothetical stock purchase. Thus, built-in gain assets may generate RBIG even if they are not disposed of during the recognition period. Deductions for contingent liabilities that exist on the change date may be considered RBIL.

2. Effect on Alternative Minimum Tax ("AMT") provisions

The provisions of the Code and Regulations relating to AMT require a special adjustment relating to ownership changes under section 382 that operates differently than the regular tax rules described above. Section 56(g)(4)(G) provides that, for purposes of determining a loss corporation's "adjusted current earnings" (i.e., ACE), if there is an ownership change under section 382 and there is a NUBIL under section 382(h), then the adjusted basis of each corporate asset immediately after the ownership change is its proportionate share of the fair market value of the assets of the corporation immediately before the ownership change. The effect of this change is to restate the bases of corporate assets after certain ownership changes to eliminate a NUBIL.

For an ownership change to occur for purposes of section 56(g)(4)(G), the corporation must be a loss corporation for regular tax purposes (i.e., it must have pre-change losses or credits or have a NUBIL determined by using the aggregate adjusted basis of its assets used in computing taxable income for regular tax purposes).¹² However, once it is determined that a corporation had an ownership change in this fashion, the aggregate adjusted basis of its assets that it uses for ACE purposes is used to determine whether it has a NUBIL and thus whether the basis of the assets has to be restated for such purposes.¹³

3. Application of Section 382(h) with respect to a consolidated group

Reg. §1.1502-91(d) and (g) provide rules for applying section 382(h) to members of a loss group (or subgroup). Consistent with the application of other rules of section 382 to consolidated groups, these rules generally apply section 382(h) for a loss group (or subgroup) on a group basis and not for each member separately. Thus, if a loss group (or subgroup) has a NUBIG on the change date, the section 382 limitation for any recognition period taxable year is increased for the loss group's (or loss subgroup's) RBIG for such taxable year. Similarly, if a loss group (or subgroup) has a NUBIL, the loss group's (or loss subgroup's) RBIL for any recognition period taxable year will be subject to limitation in the same manner as if such loss were a pre-change loss.

¹² Reg. §1.56(g)-1(k)(1).

¹³ Reg. §1.56(g)-1(k)(2).

If a consolidated group has a consolidated NOL (a “CNOL”), the determination of whether the consolidated group has a NUBIG includes all the members of the group (or subgroup) on the date that the determination is made.¹⁴ However, for purposes of determining whether the group (or a loss subgroup) has a NUBIL, certain members may have to be excluded from the computation.¹⁵ Because the set of members included in the NUBIG determination is not identical to the set of members that may be included in the NUBIL determination, a group (or subgroup) can have both a NUBIG and a NUBIL, resulting in certain RBIGs increasing the section 382 limitation and certain RBILs being subject to the section 382 limitation at the same time.¹⁶

The determination of whether a loss group (or subgroup) has a NUBIG or NUBIL is based on the aggregate amount of the separately computed NUBIG and NUBIL of each member that is included in the loss group (or subgroup) (an “included subsidiary”). Any unrealized gain or loss with respect to the stock (or intercompany obligations) of an included subsidiary is disregarded for purposes of the separate computations.¹⁷ This rule is based on the premise that any such stock gain or loss is duplicative of the same gain or loss inherent in the subsidiary’s assets, and that the consolidated return regulations generally prevent the group from taking that duplicative gain or loss into account more than once. If the subsidiary first recognizes duplicated gain or loss on its assets, Reg. §1.1502-32 generally eliminates the duplicative gain or loss reflected in stock basis. Conversely, if a member first recognizes duplicated loss on its stock, Reg. §1.1502-36 generally eliminates the duplicative asset loss. Although the regulations do not specifically address recognition of duplicated gain on stock, taxpayers often can avoid duplicative gain through actual or section 338 deemed asset sales or through stock elimination transactions, such as section 332 liquidations. Thus, because duplicative gain or loss is expected to be taken into account only once, the determination of NUBIG and NUBIL would be distorted if it included such amounts more than once.

Nevertheless, NUBIG or NUBIL will not be comprehensively measured if and to the extent that (i) unrecognized stock gain or loss is not duplicated in the unrecognized gain or loss in the subsidiary’s assets, and (ii) the unduplicated gain or loss on the stock remains disregarded in determining NUBIG or NUBIL. As the following example illustrates, where there is an unduplicated stock loss, the current approach understates the amount of loss available to the group.

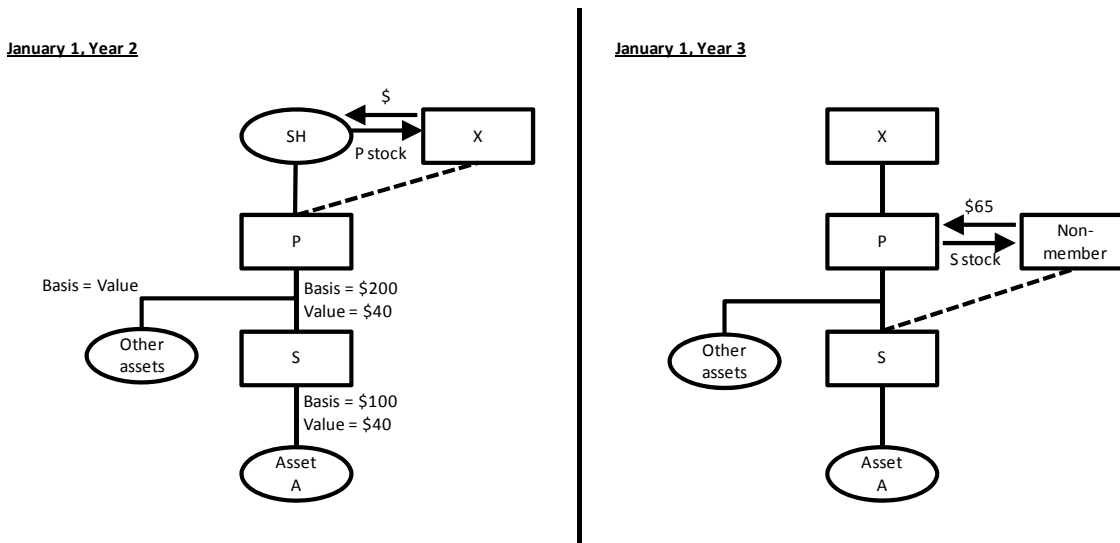
¹⁴ Reg. §1.1502-91(g)(2)(i).

¹⁵ Reg. §1.1502-91(d)(2), (g)(2)(ii).

¹⁶ Reg. §1.1502-91(g)(2)(v).

¹⁷ Unrealized gain or loss with respect to the stock of a member of the group is taken into account if the member is not included in the NUBIL subgroup under Reg. §1.1502-91(g)(2).

EXAMPLES 1&2



Example 1: P is the common parent of a consolidated group. P owns all of the stock of S, and has for at least 5 years. The P group has an \$800 CNOL carryforward for Year 1, none of which is attributable to S.

On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group. At the time of the ownership change, P's assets consist of (i) S's stock, which has a \$200 basis, and a \$40 value; and (ii) other assets with an aggregate basis and aggregate value equal to the same amount. S's sole asset consists of Asset A, which has a \$100 basis, and a \$40 value. Thus, at the time of the ownership change, the P loss group has a \$60 NUBIL, i.e., P's separately computed NUBIG/NUBIL (\$0) + S's separately computed NUBIL (\$60).

On January 1 of Year 3, P sells all of S's stock for \$65 to a nonmember, recognizing a \$135 loss that is not adjusted under Reg. §1.1502-36.¹⁸ Because the P loss group is considered as having a \$60 NUBIL, only \$60 of P's loss on the sale of S's stock is RBIL, and thus subject to limitation under section 382.

In Example 1, there was, at the time of the ownership change, \$160 of loss available to the P loss group: the \$60 duplicated loss (reflected in the basis of Asset A and S's stock), as well as the \$100 unduplicated loss in S's stock. However, because S's stock is disregarded in determining the S's NUBIG or NUBIL, only \$60 of P's loss is subject to limitation under section 382. The proposed regulations, discussed below, are intended to correct such measurement inaccuracies.¹⁹

¹⁸ Note that, if S's stock reflects a duplicated loss, S's net inside attributes may be adjusted under Reg. §1.1502-36(d). The reduction of S's inside attribute amount should have no effect on the redetermination of the P loss group's NUBIG/NUBIL, because the reduction should affect only duplicated gain or loss.

¹⁹ The Service has been aware of such measurement inaccuracies at least as far back as 2005. See TAM 200549007 (Aug. 5, 2005).

IV. Description of Prop. Reg. §1.1502-91(g)(7)

The proposed regulations would add Reg. §1.1502-91(g)(7) to require a loss group (or subgroup) to redetermine its consolidated NUBIG or NUBIL when any member directly or indirectly takes any amount of gain or loss into account with respect to a share of stock of an included subsidiary (“S”), regardless of whether such amount (in the case of a loss) is absorbed. The redetermination must include the unduplicated built-in gain or loss with respect to such share (but not any other share that has unduplicated gain or loss and is not disposed).

Unduplicated built-in stock gain or loss is identified by treating the separate NUBIG or NUBIL of each included subsidiary that is a lower-tier than S as having been taken into account and absorbed immediately prior to the change date. These amounts are then deemed to tier-up to tentatively adjust the basis in the S shares under the principles of Reg. §1.1502-32. The difference between the tentatively adjusted basis in a share of S stock and the fair market value of the share (as of the change date) is the unduplicated gain or loss in the S share.

The loss group must then redetermine its NUBIG or NUBIL by including its unduplicated gain or loss taken into account on the S share(s). The redetermined NUBIG or NUBIL is given effect immediately before the gain or loss on the stock is taken into account and has no effect on the treatment of built-in gain or loss that was recognized prior to the redetermination.

Prop. Reg. §1.1502-91(g)(7)(iv) provides an anti-abuse rule under which appropriate adjustments must be made to carry out the purposes of proposed regulations if any person acts with a principal purpose contrary to such purposes, to avoid the effect of the proposed regulations, or to apply the rules of the proposed regulations to avoid the purposes of any other consolidated return regulation.

The proposed regulations would apply to amounts taken into account with respect to a share of subsidiary stock after final regulations are published, but only with respect to ownership changes occurring on or after October 24, 2011.

The following example illustrates how the redetermination approach adopted in Prop. Reg. §1.1502-91(g)(7) is intended to correct the measurement inaccuracies of the current regulations.

Example 2: The facts are the same as in Example 1; see diagram on page 8 above.

Because P directly takes into account a loss with respect to an included subsidiary (S) that was held by P immediately before the ownership change, the P loss group must redetermine its NUBIG or NUBIL to include any unduplicated built-in gain or loss with respect to S’s stock.

The unduplicated built-in gain or loss with respect to S’s stock is computed by treating S’s separately computed \$60 NUBIL at the earlier change date as taken into

account and absorbed by the P group prior to such change. This amount is then deemed to tier-up under Reg. §1.1502-32 to tentatively adjust the basis in the S stock, resulting in a tentative reduction in the basis of such stock from \$200 to \$140. Because the tentatively adjusted basis in the S shares (\$140) exceeds the aggregate fair value of such shares immediately before the change date (\$40) by \$100, P has a \$100 unduplicated loss in such shares.

Thus, immediately before P takes into account its \$135 loss on the sale of S's stock, the P loss group's NUBIL is redetermined to be \$160, the sum of the P loss group's original \$60 NUBIL and the \$100 unduplicated loss in S's stock. Therefore, all of P's \$135 loss on the sale of S's stock is RBIL and subject to limitation under section 382(a) and (h).²⁰

V. Analysis of Prop. Reg. §1.1502-91(g)(7)

Treasury and the Service have identified an appropriate area of concern – that is, as a general matter, the failure of the current regulations to account for unduplicated stock gain or loss distorts the determination of NUBIG and NUBIL in certain circumstances. The redetermination of NUBIG/NUBIL required by Prop. Reg. §1.1502-91(g)(7) ultimately does lead to a more accurate measurement in a number of cases. Nevertheless, we believe that the approach taken in proposed regulations creates its own set of measurement inaccuracies, would be complicated to administer, and raises significant policy issues, discussed in detail below. On balance, in light of the issues raised by the proposed regulations, we would prefer a narrower approach more clearly targeted at transactions intended to achieve unwarranted advantages.

A. Technical Issues

1. Measurement inaccuracies

(a) The “Cliff Effect” and the effect of post-acquisition appreciation

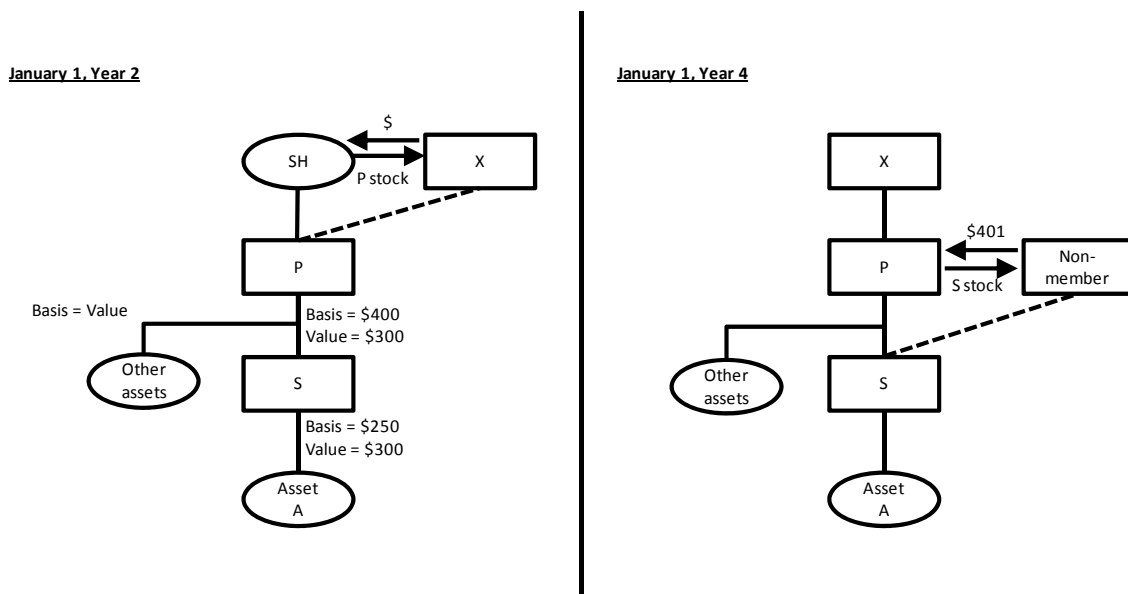
As described above, the proposed regulations would require a loss group (or subgroup) to redetermine its consolidated NUBIG or NUBIL when any member directly or indirectly takes any amount of gain or loss into account with respect to a share of stock of an included subsidiary. Because a redetermination is triggered only if a member takes into account any amount of *gain or loss*, no redetermination is required where stock of an

²⁰ Note that the proposed regulations could apply even in the case of the sale of stock of a subsidiary with conforming outside stock basis and net inside attribute amounts. For example, consider a case where P forms S with \$100 cash, and S loses its cash in a failed investment, leaving S with a \$100 NOL, none of which is absorbed by the P group. P's basis in its S stock will remain \$100, but S will have no inside asset basis. Thus, if the P group subsequently undergoes an ownership change, there will be a \$100 unduplicated loss in S's stock, which unduplicated loss would be taken into account in determining the P loss group's NUBIG/NUBIL on any disposition of the S stock in which P recognizes any item of gain or loss. While requiring a redetermination of the P group's NUBIG/NUBIL to take into account the unduplicated loss in S's stock is appropriate under the theory underlying the proposed regulations (i.e., because the stock loss is not duplicative of an asset loss otherwise taken into account in determining NUBIG/NUBIL), we note that Prop. Reg. §1.1502-91(g)(7) may apply to a wider class of cases than might be evident at first glance.

included subsidiary with unduplicated gain or loss as of the change date is subsequently sold for an amount precisely equal to its adjusted basis. This creates an unwarranted “cliff effect.” Accordingly, if Treasury and the Service ultimately decide to retain the approach of the proposed regulations, we recommend that they modify the regulatory language to require a loss group (or subgroup) to redetermine its consolidated NUBIG or NUBIL when any member directly or indirectly takes any amount into account with respect to a share of stock of an included subsidiary.²¹

More troubling, though, is that the amount of the redetermination is not correlated to the amount of unduplicated gain or loss actually recognized. For example, under Prop. Reg. §1.1502-91(g)(7), the loss group’s (or subgroup’s) NUBIG or NUBIL may be required to be adjusted by the full amount of the unduplicated loss that existed in the stock of a member on the change date even though the stock is actually sold at a gain as a result of post-change appreciation in value.

EXAMPLE 3



Example 3: P is the common parent of a consolidated group. P owns all of the stock of S, and has for at least 5 years. The P group has an \$800 NOL carryforward for Year 1, none of which attributable to S.

On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group. At the time of the ownership change, P’s assets consist of (i) S’s stock, which has a \$400 basis, and a \$300 value; and (ii) other assets with an aggregate basis and aggregate value equal to the same amount. S’s sole asset consists of Asset A, which has a \$250 basis and a \$300 value. Thus, at the time of the ownership change, the P loss group has a \$50 NUBIG, i.e., P’s separately computed NUBIG/NUBIL (\$0) + S’s separately computed NUBIG (\$50).

²¹ Cf. Reg. §1.1502-13(g)(3)(i)(A)(1) triggering a deemed satisfaction and reissuance of intercompany debt where any member realizes an amount from the assignment or extinguishment of the debt.

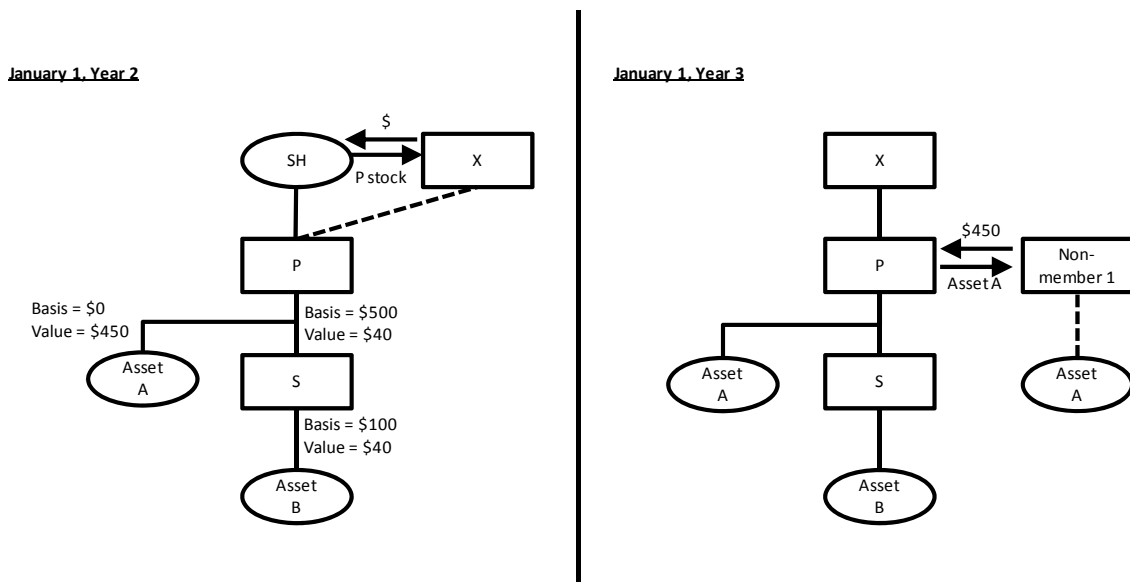
On January 1 of Year 4, P sells all of S's stock for \$401 to a nonmember, recognizing a \$1 gain. Under Prop. Reg. §1.1502-91(g)(7), the P loss group must redetermine its NUBIG to include the \$150 unduplicated built-in loss with respect to the S shares that existed on the change date immediately before the \$1 of gain on the S stock is taken into account. Immediately before P takes into account its \$1 gain on the sale of S's stock, the P loss group's \$50 NUBIG is redetermined to be a \$100 NUBIL, the sum of the P loss group's original \$50 NUBIG and the \$150 unduplicated loss in S's stock. After the redetermination, loss or excess depreciation or amortization recognized by P with respect to any built-in loss assets may be subject to the section 382 limitation.

As Example 3 demonstrates, there is no necessary correlation between the amount of stock gain or loss actually recognized and the amount of the redetermination required by Prop. Reg. §1.1502-91(g)(7). It is true that, in Example 3, P has benefitted from the built-in loss inherent in the S shares on the change date, as the "excess basis" is used to offset post-acquisition appreciation. However, the use of "excess basis" to offset post-acquisition appreciation appears to be an inherent feature of section 382(h), which treats as pre-change loss only the amount of built-in loss actually recognized during the recognition period.

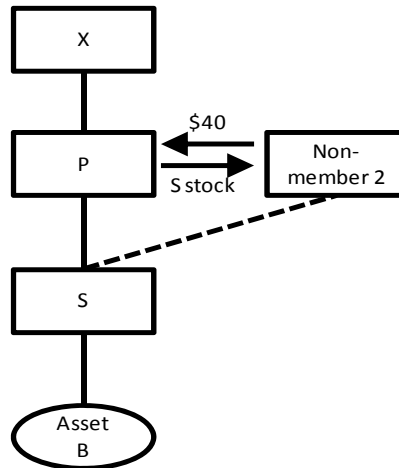
(b) Measurement inaccuracies attributable to lack of retroactive effect

The redetermination of NUBIG and NUBIL under Prop. Reg. §1.1502-91(g)(7) applies on a prospective basis only. As the following example illustrates, the failure to give the redetermination retroactive effect can be distortive where the benefit or detriment of a prior RBIG or RBIL becomes inconsistent with a redetermination under Prop. Reg. §1.1502-91(g)(7) resulting in a reduction in NUBIG or a change from NUBIG to NUBIL.

EXAMPLE 4



January 1, Year 4



Example 4: P is the common parent of a consolidated group. P owns all of the stock of S, and has for at least 5 years. The P group has an \$800 NOL carryforward for Year 1.

On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group. At the time of the ownership change, P's assets consist of (i) S's stock, which has a \$500 basis, and a \$40 value, and (ii) Asset A, which has a \$0 basis, and a \$450 value. S's sole asset consists of Asset B, which has a \$100 basis, and a \$40 value. Thus, at the time of the ownership change, the P loss group has a \$390 NUBIG, i.e., P's separately computed NUBIG (\$450) + S's separately computed NUBIL (\$60).

On January 1 of Year 3, P sells Asset A for \$450 to a nonmember. All of A's gain is RBIG, and the P group increases the amount of the section 382 limitation of the P loss group for Year 3 by its NUBIG (\$390), enabling the P group to use an additional \$390 of NOL carryforwards.

On January 1 of Year 4, P sells all of S's stock for \$40 to a nonmember, recognizing a \$460 loss that is not adjusted under Reg. §1.1502-36. Under Prop. Reg. §1.1502-91(g)(7), the P group must redetermine its NUBIG to include the \$400 unduplicated built-in loss with respect to the S shares immediately before the loss on the S stock is taken into account. Thus, immediately before P takes into account its \$460 loss on the sale of S's stock, the P group's \$390 NUBIG is redetermined to be a \$10 NUBIL, the sum of the P group's original \$390 NUBIG and the \$400 unduplicated loss in S's stock.

Prop. Reg. §1.1502-91(g)(7) specifies that the redetermination applies on a prospective basis only, and, therefore, does not alter the treatment of P's gain on the sale of Asset A as RBIG, even though the treatment of such gain as RBIG is inconsistent with the subsequent reduction in the P loss group's NUBIG. Moreover, if P had sold Asset A *after* the P loss group's NUBIG had been redetermined to be a NUBIL, none of the gain

on the sale of Asset A would have caused an increase in the P group's section 382 limitation for the year. Accordingly, the proposed regulations place a premium on the sequence of asset and stock transactions.

To diminish electivity, consideration should be given to whether a prospective recapture rule is warranted to mitigate such distortions. In Example 3, the P group's revised NUBIL could be increased by \$390, to offset the benefit of RBIGs that freed up NOL carryforwards. In cases in which there is a later recognition of unduplicated stock gain that decreases a NUBIL, an increase in the section 382 limitation could be provided as necessary to compensate for any prior disallowance of an RBIL.

(c) Redetermination triggered by unabsorbed, unduplicated stock loss

Prop. Reg. §1.1502-91(g)(7)(i) requires the redetermination of NUBIG or NUBIL “if, during the recognition period, any member of the consolidated group directly or indirectly *takes into account* any gain or loss with respect to a share of stock of an included subsidiary (S) that was held by another member of the loss group or loss subgroup immediately before the change date, *regardless of whether any such loss is absorbed.*” (emphasis added.) This disconformity between when a gain or loss is “taken into account” and when a loss is “absorbed” can lead to situations in which the loss group may be required to redetermine its NUBIG or NUBIL even though it has received no benefit from the stock loss – for example, if it has a capital loss on a stock sale and no capital gain against which to offset it. Given that the purpose of Prop. Reg. §1.1502-91(g)(7) is to accurately measure the amount of loss that is truly available to a loss group (or subgroup), it does not seem appropriate for an unabsorbed loss to cause the loss group to have a redetermination that results in a switch from NUBIG to NUBIL, or increases the size of a NUBIL.²²

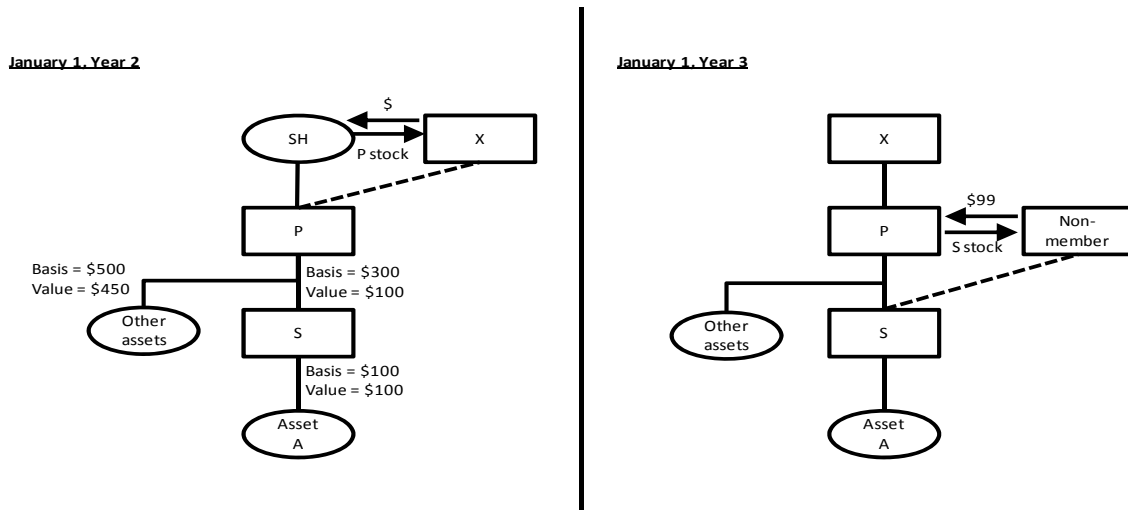
(d) Coordination with Reg. §1.1502-36

Prop. Reg. §1.1502-91(g)(7) does not provide rules coordinating its application with the rules of with Reg. §1.1502-36. Consequently, it appears that unduplicated loss is determined without an adjustment for basis that would be (or would be expected to be)

²² However, other adjustments may be appropriate. See Section VI.B below for a discussion of an alternative treatment of unabsorbed stock in certain cases.

reduced under Reg. §1.1502-36(b), (c), or (d).

EXAMPLE 5



Example 5: P is the common parent of a consolidated group. P owns all of the stock of S. The P group has an \$800 NOL carryforward for Year 1.

On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group. At the time of the ownership change, P's assets consist of (i) S's stock, which has a \$300 basis and a \$100 value, and (ii) other assets with an aggregate basis of \$500 and value of \$450. S's sole asset consists of Asset B, which has a \$100 basis, and a \$100 value. Thus, at the time of the ownership change, the P loss group has a \$50 NUBIL, i.e., P's separately computed NUBIL (\$50) + S's separately computed NUBIG/NUBIL (\$0). P's basis in S's stock reflects \$200 of positive adjustments under Reg. §1.1502-32, and P's disconformity amount under Reg. §1.1502-36(c)(4) is also \$200.

On January 1 of Year 3, P sells all of S's stock for \$99 to a nonmember, recognizing a \$1 loss, following a basis reduction of \$200 pursuant to the application of Reg. §1.1502-36(c). Notwithstanding that P recognized \$1 loss on the sale of S's stock, it appears that under Prop. Reg. §1.1502-91(g)(7), the P loss group must redetermine its NUBIG/NUBIL to include the full \$200 unduplicated built-in loss with respect to S's stock existing at the time of the ownership change, thereby subjecting subsequent RBILs to the section 382 limitation.²³

The rationale for modifying Prop. Reg. §1.1502-91(g)(7) to require a loss group (or subgroup) to redetermine its consolidated NUBIG or NUBIL following an ownership change derives principally from the observation that, where there is an unduplicated stock loss, the approach in the current regulations understates the amount of loss available to

²³ Apparently, as described above, no such redetermination would be required if P sold the S stock for exactly \$100, thereby not taking into account any gain or loss.

the group. This policy concern is not present where the unduplicated stock loss is effectively disallowed through basis reduction under Reg. §1.1502-36(b), (c), or (d).²⁴

Moreover, remedying this problem without abandoning the redetermination of NUBIG or NUBIL following an ownership change would require a method for adjusting the redetermination amount to take into account the application of Reg. §1.1502-36, which may operate to disallow some or all of the unduplicated stock loss otherwise taken into account under Prop. Reg. §1.1502-91(g)(7). For example, one potential method would require a tentative reduction in stock basis pursuant to a hypothetical application of Reg. §1.1502-36 at the time of the ownership change in determining unduplicated loss. It can be argued that this method is appropriate because it measures the true amount of unduplicated loss inherent in the stock of an included subsidiary as of the ownership change. However, because the value of the loss stock may appreciate following the ownership change, or because the loss corporation may not recognize all of the built-in gain inherent in its assets (and thus may not generate the full amount of net positive adjustments for purposes of Reg. §1.1502-36(c)), it appears that in many cases a hypothetical application of Reg. §1.1502-36 would not accurately reflect the actual reduction in stock basis pursuant to the application of Reg. §1.1502-36 at the time that the stock is sold.

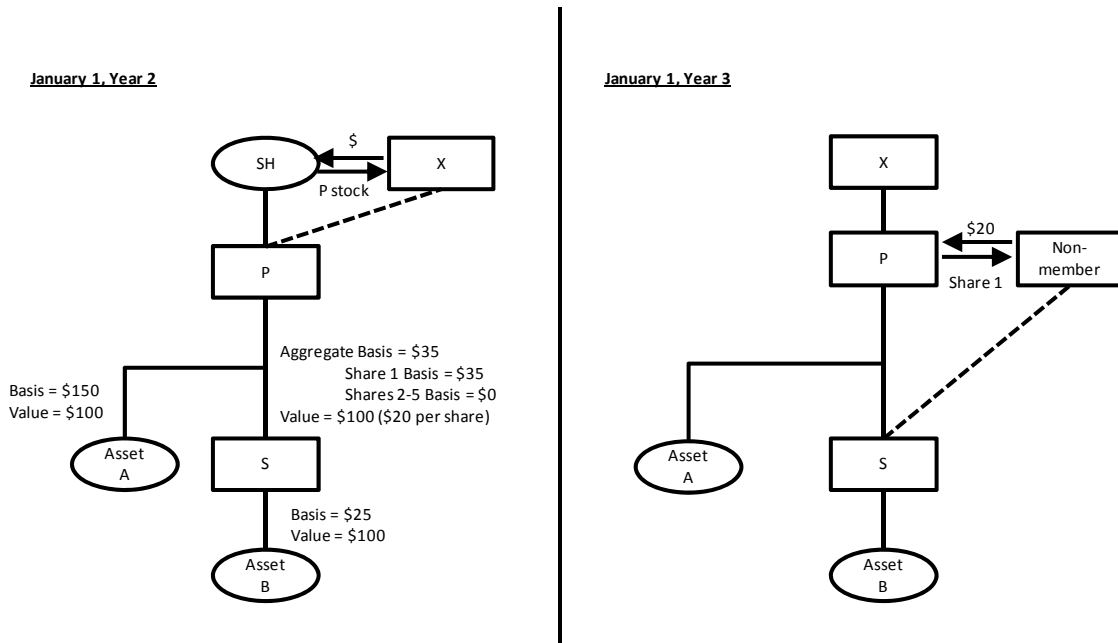
A better approach, which avoids the problems associated with a hypothetical computation, would be to reduce stock basis for purposes of calculating unduplicated loss by the amount of any basis reduction actually resulting under Reg. §1.1502-36 when the stock of an included subsidiary is sold.

(e) Sale of less than all of S's stock

The redetermination of NUBIG or NUBIL is based only on shares actually disposed. If P owns multiple shares of one or more classes of stock in a subsidiary, those shares may have offsetting unduplicated amounts, yet only unduplicated gain or loss with respect to shares actually sold would be taken into account under the Prop. Reg. §1.1502-91(g)(7) mechanics.

²⁴ For this reason, stock loss that is disallowed is not treated as RBIL. Reg. §1.1502-91(h)(2).

EXAMPLE 6



Example 6: P is the common parent of a consolidated group. P owns all of the stock of S. The P group has an \$800 NOL carryforward for Year 1. On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group.

At the time of the ownership change, P’s assets consist of (i) Asset A, which has a \$150 basis and a \$100 value; and (ii) S’s stock, which has an aggregate basis of \$35 and a value of \$100. S’s sole asset consists of Asset B, which has a \$25 basis and a \$100 value. Thus, at the time of the ownership change, the P loss group has a \$25 NUBIG (P’s separately computed NUBIG (\$50) + S’s separately computed NUBIG (\$75)). The \$35 of basis in the S stock is allocable entirely to one share (“Share 1”) with a value of \$20; the remaining 4 shares (“Shares 2-5”) each have a basis of \$0 and a value of \$20.

On January 1 of Year 3, P sells Share 1 for \$20 to a nonmember, recognizing a \$15 loss that is not reduced under Reg. §1.1502-36.²⁵ P must redetermine its NUBIG/NUBIL to reflect any unduplicated gain or loss in Share 1. The unduplicated built-in gain or loss with respect to Share 1 is computed by treating S’s separately computed \$75 NUBIG as taken into account and absorbed by the P group. This amount is then deemed to tier-up under Reg. §1.1502-32 to tentatively adjust the basis in the S stock, resulting in a tentative increase in the basis of such stock from \$35 to \$50 (P’s basis in Share 1 (\$35) + Share 1’s \$15 allocable portion of the \$75 positive adjustment under Reg. §1.1502-32(c)). Because the tentatively adjusted basis in the Share 1 (\$50)

²⁵ It is assumed for purposes of this example that there have been no positive investment adjustments allocated to Share 1 and no negative adjustments allocated to Shares 2-5. Thus, there is no basis redetermination under Reg. §1.1502-36(b). It is also assumed that there is no basis reduction under Reg. §1.1502-36(c) or (d).

exceeds the aggregate fair value of such shares immediately before the change date (\$20) by \$30, P has a \$30 unduplicated loss in such shares.

Thus, immediately before P takes into account its \$15 loss on the sale of S's stock, the P loss group's \$25 NUBIG is redetermined to be a \$5 NUBIL, the sum of the P loss group's original \$25 NUBIG and the \$30 unduplicated loss in S's stock. One-third of the \$15 loss is therefore subject to limitation. The limitation applies notwithstanding that P has unduplicated gain with respect to the remaining four shares of S stock. Shares 2-5 have an aggregate value of \$80 and their redetermined basis would be \$60, producing an unduplicated gain of \$20. The proposed regulations ignore this unduplicated gain unless and until it is recognized on a disposition of Shares 2-5. The failure to take into account the unduplicated gain in Shares 2-5 appears to be inconsistent with the general approach of section 382(h), which calculates NUBIG/NUBIL taking into account all unrealized gains and losses regardless of whether, or the order in which, such gains or losses are recognized.²⁶

2. Additional technical complexities

(a) Redetermination may change NUBIG/NUBIL status

Prop. Reg. §1.1502-91(g)(7)(i) states that the redetermination of NUBIG and NUBIL under Prop. Reg. §1.1502-91(g)(7) is effective immediately before the gain or loss on the stock of an included subsidiary is taken into account. As a result, the redetermination could change a loss group's status from having a NUBIG to having a NUBIL, or vice versa, in addition to changing the size of a NUBIG or NUBIL. If the redetermination were to change the loss group's status from NUBIG to NUBIL, several practical problems arise with respect to timing issues. For example, depreciation occurs throughout the year. A convention should be developed to separate depreciation deductions, which would potentially be RBIL if the loss group had a NUBIL, into the pre-redetermination and post-redetermination periods. This could be done using pro ration or a closing-of-the-books methodology.

Furthermore, it is unclear whether, in the event a redetermination were to change the loss group's (or subgroup's) status from NUBIG to NUBIL, or vice versa, such group (or subgroup) could change the safe harbor approaches that it relies upon for identifying built-in items for section 382(h) purposes. As discussed above, it is generally more favorable to use the 338 Approach in a NUBIG position and the 1374 Approach in a NUBIL position. The Service has permitted taxpayers to choose the safe harbor approach that better suits their particular position. Consideration needs to be given to whether similar flexibility should be afforded loss corporations where the redetermination changes the loss group's status from NUBIG to NUBIL, or vice versa. In light of the flexibility inherent in Notice 2003-65, it would seem inequitable to preclude a loss corporation from switching between the two methods in response to a change in their NUBIG/NUBIL

²⁶ To a limited extent, this issue would be addressed if final regulations included adjustments described in Part IV.A.1(b) above.

position resulting from a redetermination under Prop. Reg. §1.1502-91(g)(7). However, allowing such flexibility could engender considerable complexity.

(b) Coordination with ACE rules

The proposed regulations do not address whether a redetermination of NUBIG/NUBIL for ACE purposes is required by Prop. Reg. §1.502-91(g)(7) and, if so, the consequences of such a redetermination. Under the general principle that AMT is a separate and parallel system of taxation, it would appear that, absent a statement to the contrary, Prop. Reg. §1.502-91(g)(7) requires a redetermination for ACE purposes where gain or loss is taken into account with respect to stock of an included subsidiary. As described above, if there is an ownership change under section 382 for regular tax purposes and there is a NUBIL under section 382(h) calculated using ACE basis, then section 56(g)(4)(G) requires the loss group (or subgroup) to restate the bases of corporate assets after an ownership change to their respective fair market values, thereby eliminating a NUBIL for ACE purposes. The application of Prop. Reg. §1.1502-91(g)(7) for ACE purposes to a loss group (or subgroup) that switches from NUBIG to NUBIL, or from NUBIL to NUBIG, midstream is likely to be quite complex.

For example, consider the case of a loss group that was initially determined under the general rules of Reg. §1.1502-91(g) to have a NUBIG for ACE purposes at the time of the ownership change, but has a NUBIL following a redetermination under Prop. Reg. §1.1502-91(g)(7). In such a case, the loss group would apparently have to restate the basis of its assets as of the date of the redetermination. Presumably, the restated basis for each asset would be the fair market value of the asset as of the ownership change, as adjusted for interim depreciation and amortization to the date of the redetermination under Prop. Reg. §1.1502-91(g)(7). Conversely, in a case in which a redetermination causes a loss group originally having a NUBIL for ACE purposes to have a NUBIG for such purposes, the ACE basis of its assets as of the redetermination would have to be recomputed to equal their ACE basis immediately before the ownership change as adjusted for interim depreciation and amortization. In all events, it is clear that making separate and parallel redeterminations under Prop. Reg. §1.1502-91(g)(7) for ACE purposes would substantially complicate an already complex interaction between the regular tax and AMT rules for loss corporations. Given this complexity, we recommend that Treasury and the Service provide that any redetermination required under Prop. Reg. §1.1502-91(g)(7) not require a separate and parallel redetermination for ACE purposes. Although disregarding unduplicated stock gain or loss in determining NUBIG/NUBIL for ACE purposes would result in certain measurement inaccuracies, given the complex interaction between the regular tax and AMT rules for loss corporations, on balance, we believe that administrability considerations outweigh technical accuracy considerations in this limited context.

(c) Previous allocations of section 382 attributes to a departed member

Reg. §1.1502-95(c)(1) provides an election to apportion all or any part of a consolidated (or subgroup) section 382 limitation or a loss group's (or loss subgroup's)

NUBIG to a member (or subgroup) who leaves the consolidated group (or subgroup). If a loss group (or subgroup) is subject to a consolidated (or subgroup) section 382 limitation and a member leaves the loss group (or subgroup), the section 382 limitation with respect to such member's loss is zero absent an affirmative apportionment of the consolidated (or subgroup) section 382 election to such member. Similarly, the group (or subgroup) may elect to apportion all or a portion of the consolidated (or subgroup) NUBIG to the departing member. This election is made on the return for the year that the member leaves the group. Under Reg. §1.1502-95(e), a loss group's (or subgroup's) remaining NUBIL must be allocated between remaining members and departing members on a mandatory basis. The allocation generally is made on the basis of the relative amounts of unrecognized built-in losses attributable to remaining and departing members.

The proposed regulations do not address the interaction of Prop. Reg. §1.1502-91(g)(7) with the allocation rules for departing members. For example, a redetermination of NUBIG or NUBIL under Prop. Reg. §1.1502-91(g)(7) may require that amounts of NUBIG and NUBIL previously allocated to a departed member under Reg. §§1.1502-95(c) or (e)(2) to be redetermined as well. If so, this will complicate considerably the negotiation of agreements between buyers and sellers and significantly increase the level of coordination required of them post-closing. If not, the deconsolidation of subsidiaries may become a pathway to avoiding the impact of the proposed regulations, which would have to be policed by the anti-abuse rule of Prop. Reg. §1.1502-91(g)(7)(iv).

As one example, assume that a loss group has a NUBIL that does not exceed the NUBIG/NUBIL Threshold as of the ownership change date, determined by applying the general rules of Reg. §1.1502-91(g). During the recognition period, a subsidiary (S1) with significant built-in loss assets is sold to an unrelated buyer at a time when the amount of the group's NUBIL is zero (because of the operation of the NUBIG/NUBIL Threshold). After the sale but before the end of the recognition period, the group sells the stock of another subsidiary (S2) with significant unduplicated loss, resulting in a redetermination under Prop. Reg. §1.1502-91(g)(7) that causes the group to have a NUBIL that exceeds the NUBIG/NUBIL Threshold. If the redetermination does not result in a retroactive allocation of NUBIL to S1, absent an application of an anti-abuse rule, S1 will be able to use any RBIL recognized after the triggering event without regard to the section 382(a) limitation resulting from the initial ownership change. If the redetermination does result in a retroactive allocation to S1 of NUBIL, then S1 will be unable to use any of the RBIL under the section 382 limitation unless it negotiated for an allocation of a portion of the section 382 limitation (which it may not have done because the acquirer believed that the amount of the NUBIL at the time of the acquisition was zero).

(d) Additional administrability concerns

We have five additional concerns about the administrability of Prop. Reg. §1.1502-91(g)(7): (i) additional recordkeeping to make the hypothetical Reg. §1.1502-32 adjustments; (ii) reevaluation of which members to include in the NUBIG/NUBIL

calculation; (iii) complications arising when there are multiple ownership changes; (iv) complexity engendered by the need for a broad anti-abuse rule; and (v) coordination with the separate return limitation year (“SRLY”) rules.

As an initial matter, Prop. Reg. §1.1502-91(g)(7) would require additional recordkeeping to assure compliance with the hypothetical Reg. §1.1502-32 adjustments. The preamble to Prop. Reg. §1.1502-91(g)(7) states that “requiring all consolidated NUBIG and NUBIL determinations to include all unduplicated stock gains and losses would significantly increase the administrative burdens on both taxpayers and the government.” Nevertheless, if Prop. Reg. §1.1502-91(g)(7) were finalized, loss groups would be required, as a practical matter, to maintain more detailed information about stock basis, asset basis, and fair market values as of an ownership change date in order to be able to compute hypothetical Reg. §1.1502-32 adjustments on the change date, regardless of whether the stock of an included subsidiary is actually sold during the recognition period. Otherwise, a loss group (or subgroup) will be unable to assure compliance with Prop. Reg. §1.1502-91(g)(7) if and when stock of a subsidiary is later sold, or for that matter, to determine the tax consequences of selling (and thus whether it is advantageous to sell) the stock of the subsidiary during the recognition period.

Although taxpayers currently are required, at least in certain circumstances, to track gains and losses recognized with respect to subsidiary stock for purposes of determining whether such gains or losses constitute RBIG or RBIL, the loss group (or subgroup) is only required to determine whether there was a built-in gain or loss as of the ownership change and what the stock basis is as of the date of disposition. No hypothetical calculation as of the ownership change is required. And, in certain circumstances, no significant ownership change date analysis is needed at all (e.g., if the loss group has a NUBIG and the stock is later sold at a loss, or if the loss group has a NUBIL and the stock is sold at a gain).

Furthermore, Prop. Reg. §1.1502-91(g)(7) would introduce additional compliance burdens where a member of the loss group or subgroup has, at the time of the ownership change, a deferred gain or loss under section 267(f) or Reg. §1.1502-13 with respect to stock of an included subsidiary. If an amount deferred with respect to such stock before the ownership change is taken into account at any time during the recognition period (whether or not such loss is absorbed), NUBIG or NUBIL must be redetermined.²⁷ The proposed regulations further provide that the unduplicated stock gain or loss must be determined as of the time that the stock loss was deferred.²⁸ Accordingly, the loss group must calculate the subsidiary’s NUBIG or NUBIL as of the date of the intercompany transaction giving rise to the deferred stock gain or loss, a calculation that is based on asset values and basis that the loss group or subgroup is not otherwise required to determine under current law.

Prop. Reg. §1.1502-91(g)(7) also would require, where NUBIG/NUBIL must be redetermined, that there be a reevaluation of which members must be included in the

²⁷ Prop. Reg. §1.1502-91(g)(1)(ii)(C)(2), 1.1502-91(g)(7)(ii).

²⁸ Prop. Reg. §1.1502-91(g)(7)(ii).

NUBIG/NUBIL calculation. As mentioned above, in determining whether a loss group or loss subgroup has a NUBIG, all group or subgroup members are taken into account.²⁹ In contrast, in determining whether a loss group or loss subgroup has a NUBIL, some members are excluded.³⁰ If NUBIG/NUBIL is redetermined as proposed by Prop. Reg. §1.1502-91(g)(7), the members of the group taken into account in determining whether the loss group (or subgroup) has a NUBIL may also need to be redetermined. For example, Reg. §1.1502-91(g)(2)(ii)(C) includes in the loss group's NUBIL determination certain members that have not been members of the group for five years prior to the ownership change and have a NUBIG on the group's change date (e.g., a member of the group that had a NUBIL upon entering the group, did not have an ownership change at such time, and later crossed over to a NUBIG). However, under the proposed regulations, such a member may later be redetermined to have a NUBIL, presumably requiring that it be separately tracked and no longer be treated as a member of the loss group for purposes of determining whether the loss group has a NUBIL. The determination of which members must be included in the NUBIG/NUBIL calculation would add an additional layer of complexity to an already complex inquiry.

In addition, Prop. Reg. §1.1502-91(g)(7) would require additional rules governing how to make the redetermination if a loss group or loss subgroup with an unduplicated stock loss undergoes multiple ownership changes prior to the transaction that triggered the unduplicated loss. If an unduplicated stock loss is recognized after multiple ownership changes, the NUBIG/NUBIL calculation for each ownership change will have to be redetermined.

The broad anti-abuse rule of Prop. Reg. §1.1502-91(g)(7)(iv) presents additional administrability concerns. As described above, it requires unspecified adjustments where a taxpayer acts with a principal purpose contrary to the purposes of the proposed regulations to avoid the effect of the rules, or to use the proposed regulations to avoid the purposes of any other consolidated return rule. The proposed regulations provide no examples of what types of planning may run afoul of the anti-abuse rule. For example, the proposed regulations may be read to require adjustments where the sequencing of asset and stock dispositions is planned so as to minimize the impact of the proposed regulations (e.g., by selling an asset generating RBIG prior to selling stock generating unduplicated loss), or it could be aimed principally at stuffing transactions, effectively supplementing Reg. §1.1502-91(g)(4). Inserting a broad-based, anti-abuse rule of uncertain scope likely will create considerable uncertainty in an area intended to be largely mechanical.

Finally, the proposed regulations fail to address the interaction of the redetermination rule of Prop. Reg. §1.1502-91(g)(7) with the SRLY rules of Reg. §1.1502-15. The SRLY rules for built-in losses and deductions generally piggyback on the section 382 rules – the determination of whether a corporation or SRLY subgroup's built-in losses and deductions are limited under the SRLY rules is based on a determination of whether the corporation or SRLY subgroup has a NUBIL applying

²⁹ Reg. §1.1502-91(g)(2)(i).

³⁰ Reg. §1.1502-91(g)(2)(iii).

section 382 principles. The proposed regulations do not specify whether they intend for the redetermination under Prop. Reg. §1.1502-91(g)(7) also to apply for SRLY purposes and, if so, whether the SRLY cumulative register is determined retroactively or prospectively from the point of the redetermination.

B. Policy Issues

1. Consistency with redetermination of NUBIG and NUBIL in other areas

The redetermination of NUBIG or NUBIL after an ownership change is inconsistent with current guidance in a number of contexts providing that NUBIG or NUBIL is determined once, immediately before the ownership change, and not revisited to take into account events that may occur after the ownership change. The approach taken in current guidance reflects a sense that a loss corporation should be able to determine at the time of an ownership change which of its attributes are potentially subject to limitation.

As an initial matter, the preference for a single determination of NUBIG/NUBIL made at the time of the ownership change is reflected in the Code itself. Under section 382(h)(6)(C), NUBIG and NUBIL are adjusted for built-in items regardless of whether or not they are recognized within the recognition period. Accordingly, loss corporations are not permitted to “wait and see” whether the built-in items are, in fact, recognized during such period and adjust NUBIG and NUBIL depending on how the items actually play out.

Under current law, Notice 2003-65 confirms this approach specifically in regard to the treatment of contingent liabilities.³¹ In Notice 2003-65, the Service states that NUBIG or NUBIL is to be calculated the same way under the 1374 Approach and the 338 Approach, taking contingent consideration (including a contingent liability) into account without any subsequent adjustment to reflect subsequent changes in deemed consideration. Notice 2003-65 contains an example in which a loss corporation has a NUBIG of \$50 immediately before an ownership change, calculated by taking the \$100 fair market value of the loss corporation’s single asset and reducing it by the sum of its \$10 asset basis and a \$40 deductible contingent liability. The example states that, when a final legal determination fixes the contingent liability at \$10, “NUBIG is not readjusted to reflect the resolution of the amount of the contingent liability.”

A similar preference for finality in the NUBIG/NUBIL determination appears to underlie how the Service has administered Notice 2003-65 with respect to cancellation of debt (“COD”) income. In the case of distressed debt, in PLR 201051019, the Service ruled that NUBIG or NUBIL under the 338 Approach of Notice 2003-65 is determined

³¹ Taxpayers may rely on the 1374 and 338 approaches as safe harbors for ownership changes that occurred before or after the issuance of Notice 2003-65 until temporary or final regulations are issued under section 382(h). Such temporary or final regulations may adopt a different approach with respect to the treatment of contingent liabilities for purposes of determining a corporation’s NUBIG or NUBIL under section 382(h).

based on the adjusted issue price of liabilities immediately before the ownership change without regard to whether the liabilities are subsequently discharged at a discount during the recognition period.³² Under the facts of PLR 201051019, COD income recognized on the change date would have been excluded from income under section 108(a)(1) and it is not clear if such excluded COD income is applied to reduce pre-change NOLs under section 108(b) or asset basis under section 1017. Nevertheless, this ruling indicates that the excess of a debt's adjusted issue price over its fair market value may be included in the computation of NUBIG even if there is no potential for the associated COD income to be taken into account as RBIG. The Service's position requires NUBIG or NUBIL to be determined once, immediately before the ownership change without regard to the events that occur after that date.

If Prop. Reg. §1.1502-91(g)(7) were finalized in its current form, this would be the first time that Treasury and the Service would permit – indeed require – the redetermination of NUBIG or NUBIL after an ownership change date. As such, it would run contrary to the policy underlying section 382(h)(6)(C) and current law guidance under Notice 2003-65.

2. Consistency with treatment of subsidiary liabilities

Notice 2003-65 generally does not treat contingent liabilities as generating RBIL if the loss corporation utilizes the 1374 Approach because such liabilities generally cannot be deducted by an accrual method taxpayer prior to the ownership change. If a corporation has an unduplicated stock loss attributable to the existence of such liabilities at the level of a subsidiary (which liabilities reduce the value of the stock of such subsidiary economically but are not yet reflected in stock basis), it does not seem appropriate to treat that unduplicated stock loss as triggering a redetermination of NUBIG or NUBIL with the potential consequence of causing such stock loss to be RBIL. This incongruity possibly could be addressed by adopting tracing rules to distinguish stock loss attributable to contingent liabilities from stock loss attributable to other factors, but similar tracing methods have been rejected as overly complicated in the past.³³

³² See PLR 201051019 (Sept. 14, 2010) (ruling that “Liabilities immediately before the ownership change should be taken into account at their adjusted issue price regardless of whether they were subsequently discharged in whole or in part during the recognition period (which includes the change date) or thereafter.”)

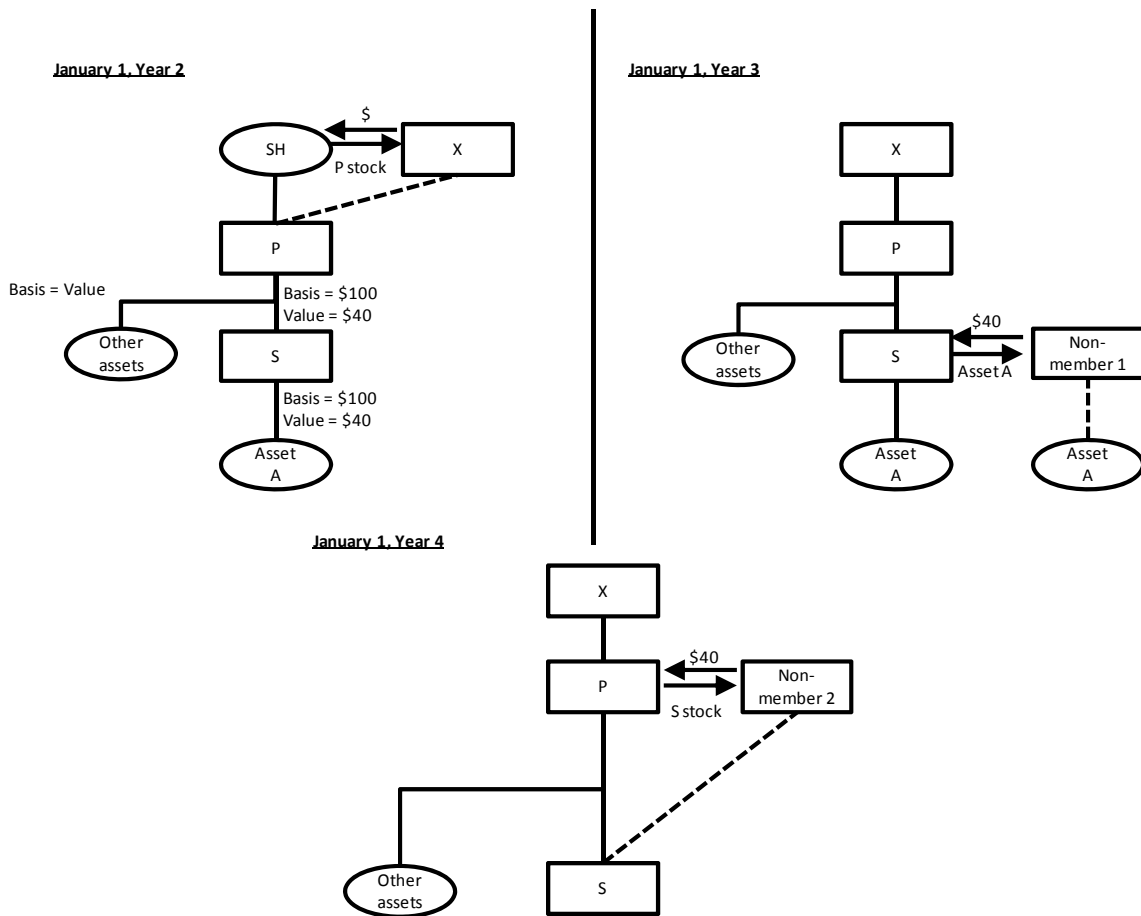
³³ See, e.g., T.D. 9424, 2008-2 C.B. 1012 (preamble to Reg. §1.1502-36, which expressly rejected a tracing approach).

3. Narrow issue – unduplicated stock gain or loss

Prop. Reg. §1.1502-91(g)(7) addresses a relatively narrow problem created by the interaction of the consolidated return rules and the calculation of NUBIG and NUBIL. There are other interactions which are not addressed, and it is not clear whether changes to the Regulations should focus on more comprehensively addressing the treatment of stock loss under Reg. §1.1502-91.

As one example, Prop. Reg. §1.1502-91(g)(7) does not address unabsorbed duplicative asset loss. Such loss may reduce remaining NUBIL and thus permit duplicate stock loss to escape classification as RBIL and thus be utilized without limitation under section 382.

EXAMPLE 7



Example 7: P is the common parent of a consolidated group. P owns all of the stock of S. The P group has an \$800 CNOL carryforward for Year 1, none of which is attributable to S.

On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group. At the time of the ownership change, P's assets consist of (i) all of the stock of S, which has a \$100 basis and a \$40 value; and (ii) other assets with an aggregate basis equal to their value. S's sole asset consists of Asset A, which has a \$100 basis, and a \$40 value. Thus, at the time of the ownership change, the P loss group has a \$60 NUBIL, i.e., P's separately computed NUBIG/NUBIL (\$0) + S's separately computed NUBIL (\$60).

On January 1 of Year 3, S sells Asset A for \$40 recognizing a \$60 loss treated as a RBIL. However, the X Group has a CNOL for Year 3 and none of S's loss is absorbed.

On January 1 of Year 4, P sells S's stock for \$40 and recognizes a \$60 capital loss. However, the X Group recognizes a \$60 capital gain in Year 4 from the sale of an unrelated asset. P's \$60 stock loss can be offset against the X Group's gain without limitation under section 382 even though the P subgroup had NUBIL of \$60 at the time of the ownership change because the P subgroup's remaining NUBIL after the Year 3 asset sale is zero.³⁴

VI. The Majority's Preferred Alternative

As described above, a majority of the Tax Section does not recommend the adoption of Prop. Reg. §1.1502-91(g)(7) in its current form or in a modified form that provides for a similar set of rules that broadly would require a post-ownership change redetermination of NUBIG or NUBIL in respect of unduplicated gain or loss recognized on disposition of shares of a member of the loss group (or subgroup). The majority's conclusion is based principally on the fact that redetermination of NUBIG and NUBIL would complicate an already complex regulatory regime and would lead to its own set of inaccuracies. In addition, the majority believes that the approach taken in the proposed regulations raises important policy concerns. Moreover, the majority's view is also informed by the fact that we have not seen, in practice, a proliferation of transactions advantaged by the treatment of unduplicated stock loss under the current rules. Accordingly, the approach taken by Prop. Reg. §1.1502-91(g)(7) would, in the majority's view, entail a level of complexity that is not warranted by the potential for abuse posed by the current regulatory framework.

In lieu of adopting Prop. Reg. §1.1502-91(g)(7), the majority recommends that Treasury and the Service adopt a more targeted approach aimed at two potential transactions that could occur in the marketplace and that most clearly gain an unwarranted advantage under the current rules. These two transactions and the majority's recommendations for the adoption of additional rules to address them are discussed below.

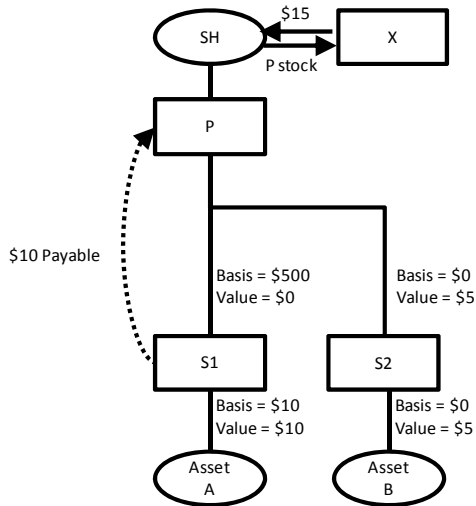
³⁴ Under Reg. §1.1502-36(d), S's NOL should be eliminated. Nevertheless, the P subgroup receives a benefit as it essentially has converted an asset loss limited under section 382 into an unlimited stock loss.

A. Modify the anti-abuse rule of Reg. §1.1502-91(g)(2)(iv)

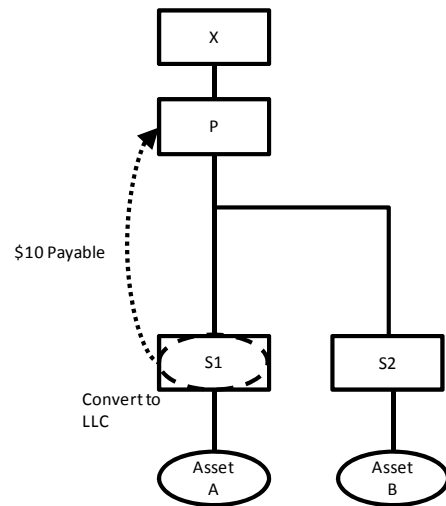
1. Acquisition of loss group with a principal purpose of benefitting from unduplicated stock loss

EXAMPLE 8

January 1, Year 2



Later in Year 2



Example 8: On January 1 of Year 2, unrelated Corporation X purchases all of the P stock for \$15, causing an ownership change of the P group. At the time of the ownership change, P's assets consist solely of (i) all of the stock of S1, which has a \$500 basis, and a zero value, and (ii) all of the stock of S2, which has a \$0 basis and a \$5 value. S1 is indebted to P in the amount of \$10. S1's only asset is Asset A, with a basis and value of \$10. S2's only asset is Asset B, with a basis of \$0 and a value of \$5. Under current Reg. §1.1502-91(g), the P group has a NUBIG of \$5, i.e., P's separately computed NUBIG/NUBIL (\$0) + S1's separately computed NUBIG/NUBIL (\$0) + S2's separately computed NUBIG (\$5).

Shortly after the acquisition, X causes S1 to convert to a limited liability company and, under Rev. Rul. 2003-125,³⁵ P claims a \$500 worthless stock deduction with respect to the S1 stock which is an ordinary deduction under section 165(g)(3). Subsequently, Corporation X uses P's loss to offset income from operations without limitation under section 382. A principal purpose of Corporation X's acquisition of the P group, including its indirect acquisition of S1, was to benefit from P's unduplicated loss with respect to the S1 stock.

Example 8 illustrates planning of a type that permits an acquirer to achieve an unwarranted advantage based on the favorable treatment of unduplicated stock loss under

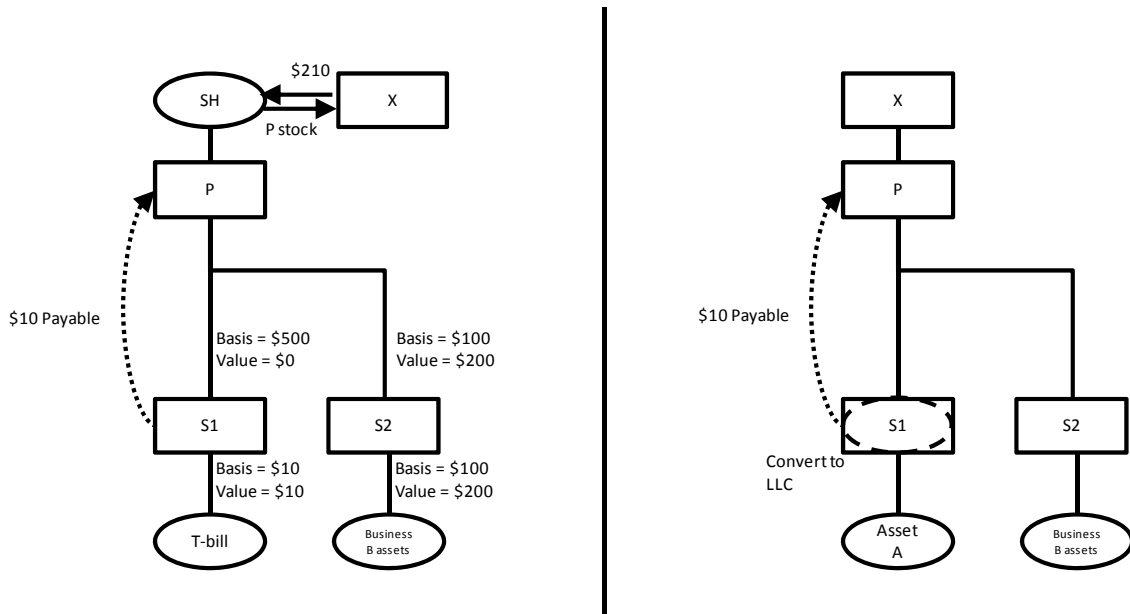
³⁵ 2003-2 C.B. 1243.

current Reg. §1.1502-91(g). Effectively, an acquirer can traffic in such loss. Although we are not aware of this transaction structure being implemented in practice, and notwithstanding that there are certain limitations on such planning under current law,³⁶ Treasury and the Service could remedy this problem by modifying the anti-abuse rule of Reg. §1.1502-91(g)(2)(iv). Under such a modified anti-abuse rule, a member of consolidated group would not be included in a loss group (or subgroup) if a principal purpose for acquiring the loss group (or subgroup) is to access unduplicated loss with respect to its stock.

Applying the amended rule to Example 8, S1 would not be included in the P subgroup, which would have a \$495 NUBIL (the sum of P's \$500 NUBIL – attributable to its S1 stock – and S2's \$5 NUBIG), rather than a \$5 NUBIG. Accordingly, \$495 of P's stock loss would be RBIL subject to limitation under section 382(a) and (h).

2. Continued inclusion of group member with *the* principal purpose of benefitting from unduplicated stock loss

EXAMPLE 9



Example 9: P is the common parent of a consolidated group that includes S1 and S2, each a wholly owned subsidiary of P. It is anticipated that P will be acquired by Corporation X following a recapitalization of P's capital structure. The acquisition by Corporation X will result in an ownership change of P.

At the time of the ownership change, P's assets consist solely of (i) all of the stock of S1, which has a \$500 basis and a zero value, and (ii) all of the stock of S2, which has a \$100 basis and a \$200 value. S1 is indebted to P in the amount of \$10. S1's only

³⁶ Reg. §1.269-7 provides section 269 may disallow a deduction, credit, or other allowance notwithstanding that such deduction, credit, or other allowance is subject to limitation under section 382.

asset is a U.S. Treasury bill, with a basis and value of \$10. S2 conducts Business B, the assets of which have an aggregate basis of \$100 and an aggregate value of \$200. Under current Reg. §1.1502-91(g), the P group has a NUBIG of \$100, i.e., P's separately computed NUBIG/NUBIL (\$0) + S1's separately computed NUBIG/NUBIL (\$0) + S2's separately computed NUBIG (\$100).

Shortly after the ownership change, P causes S1 to liquidate and, under Rev. Rul. 2003-125,³⁷ P claims a \$500 worthless stock deduction with respect to the S1 stock which is an ordinary deduction under section 165(g)(3). Subsequently, the P group uses P's loss to offset income from operations without limitation under section 382. The principal purpose of S1's continued inclusion in the P group through the ownership change – as opposed to liquidating S1 at the time of the recapitalization – was to benefit from P's unduplicated loss with respect to S1's stock.

Example 9 illustrates planning of a type that permits a loss corporation to achieve an unwarranted advantage based on the favorable treatment of unduplicated stock loss under current Reg. §1.1502-91(g). Treasury and the Service could remedy this problem by modifying the anti-abuse rule of Reg. §1.1502-91(g)(2)(iv) to provide that a member of consolidated group would not be included in a loss group (or subgroup) if *the* principal purpose for a member's continued inclusion in a loss group (or subgroup) was to access unduplicated loss with respect to its stock.³⁸

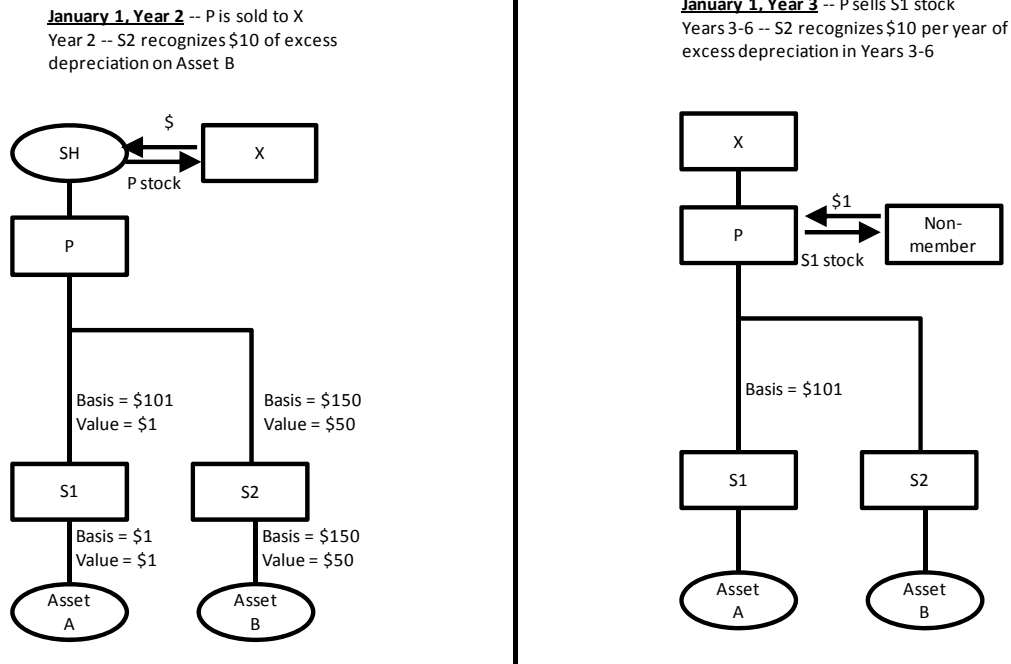
Applying the amended rule to Example 9, S1 would not be included in the P subgroup, which would have a \$400 NUBIL (the sum of P's \$500 NUBIL and S2's \$100 NUBIG), rather than a \$100 NUBIG. Accordingly, \$400 of P's stock loss would be RBIL subject to limitation under section 382(a) and (h).

B. Postpone reduction in NUBIL until RBIL from stock loss is absorbed under rules other than section 382

³⁷ 2003-2 C.B. 1243.

³⁸ Because S1 is already a member of the P group prior to the acquisition and troubled subsidiaries are often acquired in connection with the acquisition of the overall consolidated group, it seems appropriate to trigger the anti-abuse rule only upon showing that *the* principal purpose for S1's continued inclusion is to access unduplicated loss in its stock. A lower threshold, such as "a principal purpose," may sweep into the coverage of an anti-abuse rule a broad range of cases in which the acquirer is simply well advised as to the tax advantages associated with S1's continued inclusion in the group.

EXAMPLE 10



Example 10: On January 1 of Year 2, unrelated Corporation X purchases all of the P stock, causing an ownership change of the P group. At the time of the ownership change, P's assets consists solely of (i) all of the stock of S1, which has a \$101 basis and a \$1 value, and (ii) all of the stock of S2, which has a \$150 basis and a \$50 value. S1's sole asset consists of Asset A, which has a \$1 basis, and a \$1 value. S2's sole asset consists of Asset B, which has a \$150 basis, and a \$50 value. Under the current Reg. §1.1502-91(g), the P group has a \$100 NUBIL, i.e., P's separately computed NUBIG/NUBIL (\$0) + S1's separately computed NUBIG/NUBIL (\$0) + S2's separately computed NUBIL (\$100).

In Year 2, S2 recognizes \$10 of excess depreciation with respect to Asset B treated as RBIL and such excess depreciation constitutes pre-change loss subject to limitation under section 382(a) and (h).

On January 1 of Year 3, Corporation X causes P to sell the stock of S1 for \$1, resulting in recognition of a \$100 capital loss. None of P's capital loss on the sale of S1 is allowed because the X group does not have sufficient capital gains to absorb the loss. Under current law, it appears that the recognition of the capital loss eliminates the P loss group's remaining NUBIL.

In Years 3, 4, 5, and 6, S2 recognizes \$10 per year of excess depreciation. No portion of such excess depreciation is treated as pre-change loss subject to limitation under section 382(a) and (h) because the P group's remaining NUBIL has been reduced to zero.

Example 10 illustrates how, under current law, the recognition of a stock loss that cannot be absorbed because of other limitations nevertheless can free useable losses from the section 382 limitation. Allowing the excess depreciation in years 3 – 6 seems inappropriate as a policy matter because P’s stock loss is not absorbed for reasons unrelated to the application of section 382(a) (i.e., the capital loss limitations of section 1211). To address this issue, Reg. §1.1502-91(h)(2) could be modified to provide that stock loss (whether or not duplicated) is not treated as reducing remaining NUBIL until it is absorbed, determined by applying the normal ordering rules under the Code and Regulations (but disregarding any limitation under section 382(a)).

Under such an approach, the P group’s \$100 NUBIL would not be reduced by the unabsorbed loss on the sale of S1’s stock. Therefore, P’s excess depreciation deductions in Years 3-6 would continue to be RBIL treated as pre-change loss. To the extent that the P group had remaining NUBIL at the end of the recognition period, the capital loss carryover would be RBIL treated as a pre-change loss which could be offset against capital gain generated after Year 6 subject to the section 382(a) limitation.

VII. Conclusion

The majority’s preferred alternative seeks to circumscribe the potential for abuse posed by the current regulatory framework by targeting two potential transaction structures that could occur in the marketplace and that most clearly gain an unwarranted advantage under the current rules. Because it strives only to combat the clearest examples of abuse, this approach does not comprehensively address *all* circumstances in which unduplicated stock gain or loss distorts the determination of NUBIG and NUBIL. In particular, this approach does not address those cases in which a person (or group) acquires a loss group without a principal purpose of availing themselves of the benefit of an unduplicated loss with respect to stock or a member of such group. In not addressing such unduplicated loss, the majority’s preferred alternative, like the current regulations, understates the amount of loss available to the group. Nevertheless, based on the infrequency of such transactions in the marketplace in our experience and the complexities entailed by a more comprehensive approach, the majority believes that the preferred alternative strikes a reasonable balance between accuracy in measurement and the practicalities of administration.

In the minority’s view, a better balance between technical accuracy and administrative practicality can be struck by adopting Prop. Reg. §1.1502-91(g)(7) as a final regulation with the modifications described above.