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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

26 CFR Part 1

TD 9118

RIN 1545-BC84

Loss Limitation Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains amendments relating to certain aspects of the temporary regulations addressing the deductibility of losses recognized on dispositions of subsidiary stock by members of a consolidated group and to the consequences of treating subsidiary stock as worthless. In addition, this document contains temporary regulations that clarify when stock of a member of a consolidated group may be treated as worthless. These regulations apply to corporations filing consolidated returns. The text of these regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective March 18, 2004.

Applicability Date: For dates of applicability see ' ' 1.337(d)-2T(g), 1.1502-35T(f) and 1.1502-80T(c).

FOR FURTHER INFORMATION CONTACT: Regarding the amendments under section 337(d), Mark Weiss (202-622-7790) of the Office of Associate Chief Counsel (Corporate),

and, regarding the amendments under section 1502, Lola L. Johnson (202-622-7550) of the Office of Associate Chief Counsel (Corporate) (neither is a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On March 12, 2002, the IRS and Treasury published TD 8984 (67 FR 11034, 2002-1 C.B. 668), which included temporary regulations under sections 337(d) and 1502 that limit the deductibility of loss recognized by a consolidated group on the disposition of stock of a subsidiary and that require certain basis reductions on the deconsolidation of stock of a subsidiary. Those regulations are intended to prevent a corporation from avoiding the recognition of gain on the disposition of assets through the use of the consolidated return regulations.

Section 1.337(d)-2T disallows loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary to the extent that such loss is attributable to the recognition of built-in gain on the disposition of an asset. For this purpose, built-in gain is gain recognized on the disposition of an asset to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part, after applying section 1503(e) and other applicable provisions of the Internal Revenue Code and regulations.

On March 14, 2003, the IRS and Treasury published TD 9048 (68 FR 12287, 2003-13 I.R.B. 645), which included temporary regulations generally intended to prevent

consolidated groups from obtaining more than one tax benefit from a single economic loss.

In particular, §1.1502-35T(f) of those temporary regulations prescribes rules that are intended to prevent groups from obtaining more than one tax benefit from a single economic loss when a group member claims a worthless stock deduction with respect to stock of a subsidiary. In such cases, the regulation requires an apportionment of the group's consolidated net operating loss (CNOL) to the subsidiary under the principles of ' 1.1502-21T(b), and then treats the apportioned losses as expired.

On August 15, 1994, the IRS and Treasury Department published TD 8560 (59 FR 41666, 1994-2 C.B. 200) adding paragraph (c) to ' 1.1502-80. Section 1.1502-80(c) provides that, for consolidated return years beginning on or after January 1, 1995, stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of ' 1.1502-19(c)(1)(iii). Under ' 1.1502-19(c)(1)(iii), stock of a subsidiary is treated as disposed of, by reason of worthlessness, at the time substantially all of the subsidiary's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes, at the time of certain discharges of indebtedness of the subsidiary, or at the time a member takes into account certain deductions and losses with respect to indebtedness of the subsidiary. Section 1.1502-80(c) was promulgated to more fully implement the single entity treatment of consolidated groups. It also had the effects of preventing certain inappropriate disallowances of loss that occurred when ' 1.1502-20 governed the allowance of stock losses and of alleviating concerns regarding protecting the attributes of bankrupt subsidiaries.

Explanation of Provisions

Taxpayers have raised several questions regarding the interpretation and application of ' ' 1.337(d)-2T, 1.1502-35T(f), and 1.1502-80(c). The following paragraphs describe these questions and the manner in which they are addressed in these temporary regulations.

A. §1.337(d)-2T

Taxpayers have questioned whether, in computing the amount of stock loss that is attributable to the recognition of built-in gain, gain recognized on the disposition of an asset may be reduced by expenses directly attributable to the recognition of that gain. The IRS and Treasury Department believe that, because expenses attributable to the recognition of built-in gain reduce the basis of the subsidiary's stock, the computation of the amount of stock loss that is attributable to the recognition of built-in gain should take such expenses into account. Accordingly, this document amends ' 1.337(d)-2T to provide that stock loss is not disallowed to the extent the taxpayer establishes that the loss or basis is not attributable to recognized built-in gain reduced by expenses directly related to the recognition of that gain, including, in certain cases, Federal income taxes related to the recognition of such gain. In addition, this document makes a non-substantive technical correction to the example set forth in ' 1.337(d)-2T(c)(4).

The IRS and Treasury Department continue to consider alternative methods of implementing section 337(d) in the consolidated return context.

B. §1.1502-35T(f)

Taxpayers have commented that, in certain cases, ' 1.1502-35T(f) may eliminate losses where there is no risk of duplication. In particular, taxpayers are concerned that the rule appears to eliminate a subsidiary's apportioned part of the CNOL even if the subsidiary has a separate return year following the year in which a member of the group claims a worthless stock deduction with respect to the subsidiary's stock. The IRS and Treasury Department believe that the elimination of a subsidiary's apportioned CNOL is generally necessary to prevent duplication only if a member of the group claims a worthless stock deduction with respect to subsidiary stock and the subsidiary has no separate return year following the year in which the worthless stock deduction is claimed. These temporary regulations, therefore, amend ' 1.1502-35T(f) to provide that the subsidiary's apportioned part of the CNOL is treated as expired if a member (the claiming member) claims a worthless stock deduction with respect to the subsidiary's stock and, immediately following the taxable year in which the worthless stock deduction is claimed, the subsidiary is a member of a group that includes any corporation (other than a lower-tier subsidiary of the member the stock of which was treated as worthless) that, during that taxable year, was a member of the group that includes the claiming member.

The IRS and the Treasury Department continue to consider methods of preventing groups from obtaining more than a single tax benefit from a single economic loss other than the methods employed in ' 1.1502-35T.

C. §1.1502-80(c)

Taxpayers have also raised concerns that, in certain circumstances, ' 1.1502-80(c)

may prevent a group from claiming a worthless stock deduction with respect to subsidiary stock that is worthless within the meaning of section 165 if the subsidiary ceases to be a member of the group before it satisfies the requirements of ' 1.1502-19(c)(1)(iii). For example, assume that the stock of a subsidiary is worthless within the meaning of section 165 but the subsidiary has not disposed of, abandoned, or destroyed substantially all of its assets and the requirements of §1.1502-19(c)(1)(iii) are not otherwise satisfied. At that time, §1.1502-80(c) would prevent the group from treating the subsidiary's stock as worthless. If the subsidiary then cancels its outstanding shares and issues new shares to its creditors, which are not members of the group, the subsidiary will cease to be a member of the group before it satisfies the requirements of ' 1.1502-80(c). Taxpayers are concerned that, unless ' 1.1502-80(c) is treated as inapplicable immediately prior to the cancellation of the subsidiary's stock, the group will never be entitled to claim a worthless stock deduction with respect to that stock.

Section 1.1502-80(c) is intended to defer, not disallow, worthless stock deductions with respect to subsidiary stock. Therefore, these temporary regulations amend ' 1.1502-80(c) and add §1.1502-80T(c) to clarify that the deferral of an otherwise allowable loss under section 165 terminates immediately prior to the time that the subsidiary ceases to be a member of the group. Accordingly, in the example above, the group would be entitled to the worthless stock deduction in the taxable year in which the subsidiary ceases to be a member of the group.

Taxpayers have questioned whether ' 1.1502-80(c) remains necessary given that

' 1.1502-20 no longer governs the allowance of loss on sales of subsidiary stock. The IRS and Treasury are evaluating whether the rule of ' 1.1502-80(c) continues to be necessary or appropriate.

Effective Date

The amendments set forth in these temporary regulations are applicable to tax years beginning after March 18, 2004. However, taxpayers may apply these temporary regulations to certain prior periods.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding allowable loss and basis reductions in connection with dispositions and deconsolidations of subsidiary stock. These temporary regulations clarify existing rules and simplify their application in order to ease taxpayer compliance. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3). For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of the regulations under section 337(d) is Mark Weiss, Office of Associate Chief Counsel (Corporate). The principal author of the regulations under section 1502 is Lola L. Johnson, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.337(d)-2T is amended by revising paragraph (c)(2) and the example in paragraph (c)(4) to read as follows:

§1.337(d)-2T Loss limitation window period (temporary).

* * * * *

(c) * * *

(2) General rule. Loss is not disallowed under paragraph (a)(1) of this section and basis is not reduced under paragraph (b)(1) of this section to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain, net of directly related expenses, on the disposition of an asset (including stock and securities).

Loss or basis may be attributable to the recognition of built-in gain on the disposition of an asset by a prior group. For purposes of this section, gain recognized on the disposition of an asset is built-in gain to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part, after applying section 1503(e) and other applicable provisions of the Internal Revenue Code and regulations. Federal income taxes may be directly related to built-in gain recognized on the disposition of an asset only to the extent of the excess (if any) of the group's income tax liability actually imposed under Subtitle A of the Internal Revenue Code for the taxable year of the disposition of the asset over the group's income tax liability for the taxable year redetermined by not taking into account the built-in gain recognized on the disposition of the asset. For this purpose, the group's income tax liability actually imposed and its redetermined income tax liability are determined without taking into account the foreign tax credit under section 27(a) of the Internal Revenue Code. This paragraph (c)(2) applies to dispositions and deconsolidations on or after March 18, 2004. Taxpayers, however, may choose to apply this paragraph (c)(2) to dispositions and deconsolidations on or after March 7, 2002; otherwise, paragraph (c)(2) of ' 1.337(d)-2T as contained in 26 CFR part 1 edition revised as of April 1, 2003, shall apply.

* * * * *

(4) * * *

Example. Loss offsetting built-in gain in a prior group. (i) P buys all the stock of T for \$50 in Year 1, and T becomes a member of the P group. T has 2 assets. Asset 1 has

a basis of \$50 and a value of \$0, and asset 2 has a basis of \$0 and a value of \$50. T sells asset 2 during Year 3 for \$50 and recognizes a \$50 gain. Under the investment adjustment system, P's basis in the T stock increased to \$100 as a result of the recognition of gain. In Year 5, all of the stock of P is acquired by the P1 group, and the former members of the P group become members of the P1 group. T then sells asset 1 for \$0, and recognizes a \$50 loss. Under the investment adjustment system, P's basis in the T stock decreases to \$50 as a result of the loss. T's assets decline in value from \$50 to \$40. P then sells all the stock of T for \$40 and recognizes a \$10 loss.

(ii) P's basis in the T stock reflects both T's unrecognized gain and unrecognized loss with respect to its assets. The gain T recognizes on the disposition of asset 2 is built-in gain with respect to both the P and P1 groups for purposes of paragraph (c)(2) of this section. In addition, the loss T recognizes on the disposition of asset 1 is built-in loss with respect to the P and P1 groups for purposes of paragraph (c)(2) of this section. T's recognition of the built-in loss while a member of the P1 group offsets the effect on T's stock basis of T's recognition of the built-in gain while a member of the P group. Thus, P's \$10 loss on the sale of the T stock is not attributable to the recognition of built-in gain, and the loss is therefore not disallowed under paragraph (c)(2) of this section.

(iii) The result would be the same if, instead of having a \$50 built-in loss in asset 1 when it becomes a member of the P group, T has a \$50 net operating loss carryover and the carryover is used by the P group.

* * * * *

Par. 3. Section 1.1502-35T is amended by revising paragraph (f)(1) to read as follows:

' 1.1502-35T Transfers of subsidiary member stock and deconsolidations of subsidiary members (temporary).

* * *

(f) Worthlessness not followed by separate return years--(1) General rule.

Notwithstanding any other provision in the regulations under section 1502, if a member of a group (the claiming group) treats stock of a subsidiary as worthless under section 165 (taking into account the provisions of ' 1.1502-80(c)) and, on the day following the last day

of the claiming group's taxable year in which the worthless stock deduction is claimed, the subsidiary (or its successor, determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) is a member of a group that includes any corporation that, during that taxable year, was a member of the claiming group (other than a lower-tier subsidiary of the subsidiary) or is a successor (determined without regard to paragraphs (d)(5)(iii) and (iv) of this section) of such a member, then all losses treated as attributable to the subsidiary under the principles of ' 1.1502-21T(b)(2)(iv) shall be treated as expired as of the beginning of the day following the last day of the claiming group's taxable year in which the worthless stock deduction is claimed. In addition, notwithstanding any other provision in the regulations under section 1502, if a member recognizes a loss with respect to subsidiary stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable to the subsidiary under the principles of ' 1.1502-21T(b)(2)(iv) shall be treated as expired as of the beginning of the day following the last day of the group's taxable year in which the stock loss is claimed. For purposes of this paragraph (f), the determination of the losses attributable to the subsidiary shall be made after computing the taxable income of the group for the taxable year in which the group treats the stock of the subsidiary as worthless or the subsidiary liquidates and after computing the taxable income for any taxable year to which such losses may be carried back. The loss treated as expired under this paragraph (f) shall not be treated as a noncapital, nondeductible expense under ' 1.1502-32(b)(2)(iii). This paragraph (f) applies to worthlessness determinations and liquidations that occur

after March 18, 2004 and before March 12, 2006. However, the group may apply this paragraph (f) to worthlessness determinations and liquidations that occur on or after March 7, 2002 and before March 18, 2004; otherwise, paragraph (f) of ' 1.1502-35T as contained in 26 CFR part 1 edition revised as of April 1, 2003, shall apply to such determinations of worthlessness and liquidations.

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Par. 4. Section 1.1502-80 is amended by adding a sentence to the end of paragraph (c) to read as follows:

' 1.1502-80 Applicability of other provisions of law.

* * * * *

(c) * * * For further guidance, see ' 1.1502-80T(c).

Par. 5. Section 1.1502-80T is added to read as follows:

' 1.1502-80T Applicability of other provisions of law (temporary).

(a) and (b) [Reserved]. For further guidance, see ' 1.1502-80(a) and (b).

(c) Deferral of section 165. Stock of a member is not treated as worthless under section 165 before the stock is treated as disposed of under the principles of ' 1.1502-19(c)(1)(iii). If stock of a member would otherwise be treated as worthless under the principles of section 165, then, notwithstanding the previous sentence, such stock may be treated as worthless under section 165 immediately prior to the time such member ceases to be a member of the group. See ' ' 1.1502-11(c) and 1.1502-35T for additional rules relating to stock loss. This paragraph (c) applies to taxable years beginning after

March 18, 2004 and before March 18, 2007. Taxpayers, however, may apply this paragraph (c) to taxable years beginning on or after January 1, 1995 and before March 18, 2004; otherwise, paragraph (c) of ' 1.1502-80 as contained in 26 CFR part 1 edition revised as of April 1, 2003, shall apply to taxable years beginning on or after January 1, 1995, and on or before March 18, 2004.

(d) through (f) [Reserved]. For further guidance, see ' 1.1502-80(d) through (f).

Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: March 9, 2004

Gregory F. Jenner

Acting Assistant Secretary of the Treasury.