News Analysis: Elect Your Subsidiary Loss, Part 2

by Lee A. Sheppard

In news analysis, contributing editor Lee Sheppard critiques the new final regulations under section 337 on how to trace losses on the sale of subsidiary shares.

Date: Mar. 8, 2005

Full Text Published by taxanalysts™

These are tough times for white males. It isn't enough that the NASCAR dads vote for Bush, keep guns, and join the Promise Keepers, an organization dedicated to the idea that a man should boss the household because he is a man. No, things are worse than we think. *People* magazine named actor Jude Law the Sexiest Man Alive.

Another actor, so what? Being attractive is, after all, an actor's job. And Law specializes in playing smarmy guys who got through life on their looks. So apparently compelling is Mr. Law's presence that *Vogue* named his girlfriend -- who really is not very well dressed -- last year's best-dressed woman just so they could print a big picture of her with him. Even *The Onion*, satirizing *People's* choice, couldn't muster more than mild criticism.

So what's the problem? Most of our readers, male and female, could probably beat the skinny Mr. Law arm-wrestling. He should stay out of pubs, because he'd be broke in a hurry if he ever had to compete to decide who had to buy the next round. Yet this sort of creature is held up as a masculine ideal. Let's send Mr. Law to Iraq, or at least to the boxing gym.

The corporate division of the IRS chief counsel's office could use some toughening up as well. At the 11th hour, just before large groups have to file their 2004 consolidated returns, the IRS finalized some unsatisfactory temporary regulations on how to trace losses on the sale of subsidiary shares. These final regulations are a stopgap necessitated by the expiration of temp. reg. section 1.337(d)-2T, which was published on March 7, 2002. We are told that we will have an alternative method for calculating the allowable loss on the sale of subsidiary shares sometime in our lifetimes. (For the regulations, see *Doc 2005-4227* [**PDF**] or *2005 TNT 41-4*.)

Background

In Notice 2004-58, 2004-39 IRB 520, *Doc 2004-17157* [**PDF**] or *2004 TNT 166-7*, the IRS announced that it would accept a method called the "basis disconformity method" for determining the extent to which loss could be attributed to built-in gain. The regulation accompanying the notice allows taxpayers to reverse prior elections to use reg. section 1.337(d)-2T or not. Taxpayers will be able to reverse prior elections made under reg. section 1.1502-20T(i) and have the additional choice of the basis disconformity method if they elect reg. section 1.337(d)-2T.

The basis disconformity method presumes that any gain realized by the subsidiary on a disposition of an asset was built-in when the subsidiary was acquired. This is the effect of counting all asset gains without asking when the asset was acquired. The notice itself confirms this reading of the gain amount when it suggests a basis disconformity method that would not employ that factor. Practitioners and former government officials have criticized this method heavily, but that has not stopped the IRS from forging ahead with it.

The basis disconformity rule would disallow loss and reduce basis on a sale of subsidiary shares. The amount of the basis reduction would be the smallest of three amounts: the "gain amount," the "basis disconformity amount," and the "positive investment adjustment amount."

The gain amount is the total amount of gain realized on dispositions of the subsidiary's assets, no matter when acquired. The basis disconformity amount is the amount of the differential between the subsidiary's basis in its built-in gain asset and the parent's basis in the shares of the subsidiary. The positive investment adjustment amount is the net positive basis adjustments made to the parent's basis in the subsidiary shares under reg. section 1.1502-32, ignoring adjustments caused by distributions from the subsidiary.

The New Old Rules

The new rules are basically the old rules with add-ons. Reg. section 1.337(d)-2T is adopted as reg. section 1.337(d)-2, without change, as a final rule. The regulation presumptively disallows loss on the sale of a subsidiary but permits a taxpayer to recognize loss on the sale of subsidiary shares to the extent it can show that the loss was not attributable to recognized built-in gain. It is a de facto tracing rule. The regulation presumes that the loss was attributable to recognized built-in gain unless the taxpayer proves otherwise, and proof may require tracing. The regulation also requires netting of gains and losses on sales of shares of the same issuer having the same material terms.

The new rule further establishes that the IRS will accept the basis disconformity method to determine whether a loss on the sale of subsidiary shares should be disallowed or whether the basis of subsidiary shares should be reduced on deconsolidation. For this method, taxpayers will still have to refer to the above-described notice. (Another reason to buy our products. We pull it all together for you, even if the IRS can't be bothered.)

So taxpayers and their advisers can busy themselves figuring out whether the basis disconformity method would help them. They have a lot of choices. The new rules would also allow taxpayers to elect to use the old loss disallowance rule without regard to the duplicated loss factor for older transactions and older binding contracts that have not been consummated. (The law is a seamless web; we wouldn't want the time spent learning the loss disallowance rules to have been wasted.)

The example brought over from the temporary regulations shows a subsidiary's built-in loss and built-in gain exactly offseting each other. The parent buys the target for $50 at a time when the latter has a built-in gain asset (basis zero, value $50) and a built-in loss asset (basis $50, value zero). Two years later, the target sells the gain asset, increasing the parent's basis in its shares to $100. Two years after that, the parent is acquired by another group, taking all of its affiliates with it. In that same year, the target sells the loss asset, reducing the parent's basis in its shares to $50. After further declines, the parent sells those shares of target for $40 and claims a $10 loss.

Reg. section 1.337(d)-2(c)(2) states that loss on the sale of subsidiary shares is not disallowed to the extent that the taxpayer can demonstrate that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset. Here's the key to the example: "Loss or basis may be attributable to the recognition of built-in gain on the disposition of an asset by a prior group." Cross-group netting is allowed. There is not much of a way to prove it. Taxpayers don't keep entity-specific ledgers allocating assets to specific legal entities.

Son of Mirrors Problem

Section 7805(e) states that temporary regulations expire within three years. Did Congress want the tax administrator to finalize temporary regulations without change? On the one hand, it is not unusual for a small, inconsequential temporary regulation to be taken final.

On the other hand, this is not a small, inconsequential regulation. The tax administrator is well aware that tracing does not work, and that its replacement, the basis disconformity model, also does not work. But the top level of tax officialdom is not much interested in this project, and even less enamored of the alternative choices. So the act of finalizing the existing rules was an act of desperation on the eve of calendar-year filing.

The good news is that, for all the dithering, the IRS has a more complete understanding of the problem, and an understanding that tracing with presumptions, hitherto the preferred approach, will not work any better than tracing is working now.

So what's the answer? This week's preferred approach within the government appears to be the basis disconformity rule with a loss duplication rule added on. Certainly it has been amply demonstrated that the basis disconformity rule has flaws and can be used to foment inappropriate losses. The IRS is worried about those inappropriate losses. (For description, see *Doc 2004-17292* [**PDF**] or *2004 TNT 169-5*.)

Oh, but isn't any loss duplication rule illegal under *Rite Aid Corp. v. U.S.*, 255 F.3d 1357 (Fed. Cir. 2001), *Doc 2001- 18688* [**PDF**] or *2001 TNT 132-10*? Not necessarily.

The American Jobs Creation Act of 2004 (P.L. 108-357) reaffirmed the tax administrator's power to make legislative regulations for corporations filing consolidated returns. Section 844 of the new law provides that, in exercising its authority to issue consolidated return regulations, Treasury may issue regulations that treat corporations filing consolidated returns differently from corporations filing separate returns. Code section 1502 is amended by adding at the end the following new sentence: "In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." (*Doc 2004-19791* [**PDF**] or *2004 TNT 196-10*.)

How does that help? As the legislative history suggests, it means the *Rite Aid* case can be confined to its facts, and that not every perceived detriment that comes with consolidated filing is automatically illegal. If the situation is wholly within the realm of consolidated returns, there is no *Rite Aid* problem.

The chief target of the rules being discussed here, the "Son of Mirrors" problem, is such a case. A Son of Mirrors transaction creates an artificial loss in the shares of a subsidiary by means of an upward basis adjustment caused by reg. section 1.1502-32, which uses the word "positive" for increases. In the land of separate returns, there are no positive basis adjustments for subsidiary shares; there are no basis adjustments, period. So section 1502 clearly empowers the IRS to take away a positive basis adjustment that was made under reg. section 1.1502-32.

Suppose the subsidiary has a built-in gain asset and a built-in loss asset. It sells the gain asset, causing its parent to have a positive adjustment to basis in its shares in the amount of the gain. If the parent then sells the shares at fair market value and claims a loss, the loss was occasioned by that positive basis adjustment. The IRS has the power to claw it back under section 1502. The government granted the positive basis adjustment, and the government can take it away.

The basis disconformity rule is supposed to take care of that problem, by only allowing the net loss, but does not succeed because in our example, the loss asset was not sold. So an add-on loss duplication rule would basically say that a group cannot take a loss to the extent of net positive basis adjustments. Thus the loss on the built-in loss asset would be taken into account. That simple rule would solve a lot of the problems with the basis disconformity rule. The only trouble is that it would require a certain amount of tracing. It also might allow a taxpayer group that subsequently lost money to use postacquisition losses to shelter acquired built-in gain. (This is the case of the dumb purchase.)

Bank of America Problem

What if the artificial loss on subsidiary shares was not caused by a positive basis adjustment under the consolidated return rules?

If it was a Bank of America problem caused by the contribution of a built-in loss asset to a subsidiary, then new section 362(e), enacted as part of the American Jobs Creation Act, would take care of it. Section 362(e) states that if the taxpayer's basis in assets contributed to an 80-percent-controlled corporation in a section 351 transaction exceeds their fair market value, the taxpayer's basis in the shares is limited to that fair market value. To the extent that section 362(e) acts, temporary reg. section 1.1502-35T could be repealed. (For discussion, see *Doc 2002-6844* [**PDF**] or *2002 TNT 54-7*.)

If it was not a Bank of America problem, then it could be a problem attributable to the sale of different blocks of shares or the sale of different classes of shares. Those problems are addressed by temporary reg. section 1.1502-35T, which sunsets next year. So temporary reg. section 1.1502-35T would have to be preserved to the extent that it takes care of these problems, or reg. section 1.1502- 32 would have to be reopened to address them. Reopening the latter regulation is not unthinkable.

Temporary reg. section 1.1502-35T sometimes reallocates basis and sometimes defers losses. When a subsidiary leaves the group, the basis redetermination rule reduces basis in the shares being sold and reallocates it to any remaining shares group members continue to own to the extent of the unrecognized losses the subsidiary took with it. That addresses the block problem. (For discussion, see *Doc 2002- 23899* [**PDF**] or *2002 TNT 205-4*.)

When preferred shares of a subsidiary are sold, but the parent retains enough common shares so that the subsidiary remains a member of the group, the basis redetermination rule would aggregate all group members' shares in a particular subsidiary, then reallocate the aggregate basis, according to fair market value, first to the preferred shares to the extent of their fair market value, then to the common shares. That is the class problem.

If the law must recognize the existence of subsidiary shares despite the issuer's being a member of an affiliated group filing a consolidated return, there are more straightforward ways to address these problems. If different blocks of shares are being sold, the tax administrator could use section 1502 to impose an average basis rule, which is pretty much what temporary reg. section 1.1502-35T does.

If the parent owns 100 percent of the subsidiary and creates a new class of shares, there is monkey business going on and the tax law should not put up with it. As the government noted when promulgating the basis redetermination rule, parents don't have different classes of shares in controlled subsidiaries for nontax reasons. At the moment, the tax law gives recognition to different classes and asks that basis be allocated according to the economics of the arrangement. (Reg. section 1.1502-32(c)(2)(ii) and (3).)

What Direction?

There's a Yogi Berra malapropism about not being able to get there if you don't know where you're going. To some extent, the IRS does not have a direction for consolidated return rules. Having a direction means aiming for something more than dealing with *Rite Aid*, and not wanting loss duplication. The direction ought to be toward single entity treatment for taxpayers filing consolidated returns, meaning that basis in (and the existence of) subsidiary shares should be ignored. The whole problem is shares as the carrier for built-in asset gain.

Financial accounting rules treat every purchase of shares as an asset purchase, then write up the basis of the assets to the purchase price, which is recouped through depreciation and amortization. Thus there is conformity of inside and outside basis. If this method were to be imported to the tax law, there would have to be a tax on the assets coming into the group, to pay for the basis step-up. The tax law is not in the habit of giving corporations free basis step-ups. Practitioners refer to this as a "mandatory section 338(h)(10) election" which causes one to ponder the elective nature of section 338. Basis in shares could then be ignored. Financial accounting also forces combination of controlled entities.

This would require a legislative change. The now two-decades-old Subchapter C Revision Act of 1985, colloquially called the Senate "green book," suggested a conforming basis rule. The Senate Finance staff would have installed a new section 1020 to conform basis regardless of whether the subsidiary was consolidated. Foolishly, however, the staff would not tax asset gain on the way in, but permit acquirers to continue to elect between cost and carryover basis of assets of an acquired corporation. (Staff Sen. Fin. Comm., The Subchapter C Revision Act of 1985; Final Report Prepared by the Staff, S. Prt. 47, 99th Cong. 2d Sess. (1985).)

In opposing the loss disallowance rule when it was promulgated, the American Bar Association Section of

Taxation reiterated that suggestion, arguing that basis in shares of a controlled subsidiary should be equal to the subsidiary's basis in its net assets for share selling purposes. Like the Finance staff, the Tax Section would have created a special account to track the differences in inside and outside basis to ensure the economic loss was recognized, except that the Tax Section's account would have been permanent, while the Finance staff's account would have been a transition rule. (*90 TNT 213-32* .)

Tax Analysts Information

Code Section: Section 337 -- Nonrecognition
Geographic Identifier: United States
Subject Area: Corporate taxation
Magazine Citation: Tax Notes, March 7, 2005, p. 1129; 106 Tax Notes 1129 (March 7, 2005)
Author: Sheppard, Lee A.
Institutional Author: Tax Analysts
Tax Analysts Document Number: Doc 2005-4409
Tax Analysts Electronic Citation: 2005 TNT 44-4