

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions

REG-131478-02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain dispositions and deconsolidations of such stock. In addition, this document contains proposed regulations that suspend certain losses recognized on the disposition of such stock. The regulations apply to corporations filing consolidated returns. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 21, 2003. Outlines of topics to be discussed at the public hearing scheduled for January 15, 2003, at 10 a.m. must be received by December 27, 2002.

ADDRESSES: Send submissions to CC:ITA:RU (REG-131478-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG-131478-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at:

www.irs.gov/regs. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Aimee K. Meacham (202) 622-7530; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya M. Cruse (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by December 22, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in § 1.1502-35(c) and § 1.1502-35(f). This information is required by the IRS to verify compliance with section 1502. This information will be used

to determine whether the amount of tax has been calculated correctly. The collection of information is required to properly determine the amount permitted to be taken into account as a loss. The respondents are corporations filing consolidated returns. The collection of information is required to obtain a benefit.

Estimated total annual reporting and/or recordkeeping burden: 10,500 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 5,250.

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1502 of the Internal Revenue Code (Code) states that

[t]he Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

The legislative history regarding that grant of authority states that “[a]mong the regulations which it is expected that the commissioner will prescribe are [regulations addressing the] extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group [and] the basis of property . . . acquired, during the period of affiliation, by a member of the affiliated group, including the basis of such property after

such period of affiliation.” S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928).

In 1991, the IRS and Treasury Department promulgated § 1.1502–20, which set forth rules regarding the extent to which a loss recognized by a member of a consolidated group on the disposition of stock of a subsidiary member of the same group was allowed. Section 1.1502–20 provided that a loss recognized by a group member on the disposition of subsidiary member stock was allowable only to the extent it exceeded the sum of “extraordinary gain dispositions,” “positive investment adjustments,” and “duplicated loss.” The rule not only implemented section 337(d), which directed the Secretary to promulgate regulations to prevent the circumvention of corporate tax on appreciated property through the filing of a consolidated return, but also was intended to further single entity principles by preventing the deduction of stock losses that reflected a subsidiary member’s loss carryforwards, deferred deductions, and unrecognized losses inherent in its assets.

In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the United States Court of Appeals for the Federal Circuit considered the validity of the duplicated loss component of § 1.1502–20. The court held that the duplicated loss component of § 1.1502–20 was an invalid exercise of regulatory authority.

In response to the *Rite Aid* decision, the IRS and Treasury Department issued Notice 2002–11, 2002–7 I.R.B. 526, stating that the interests of sound tax administration would not be served by the continued litigation of the validity of the duplicated loss component of § 1.1502–20. Notice 2002–11 announced that, because of the interrelationship in the operation of all of the loss disallowance factors of § 1.1502–20, the IRS and Treasury Department had decided that new rules governing loss disallowance on sales of subsidiary stock by members of consolidated groups should be implemented.

On March 7, 2002, the IRS and Treasury Department filed with the **Federal Register** temporary regulations (T.D. 8984, 2002–13 I.R.B. 668 [67 F.R. 11034]) under sections 337(d) and 1502 governing the determination of a consolidated group’s allowable stock loss on a disposition of subsidiary member stock. Those regulations included § 1.337(d)–2T, which generally al-

lows a loss on the disposition of subsidiary member stock only to the extent that a taxpayer can establish that the stock loss is not attributable to the recognition of built-in gain. Section 1.337(d)–2T does not disallow stock loss that reflects loss carryforwards, deferred deductions, or built-in asset losses of the subsidiary member.

Concurrently with the filing of § 1.337(d)–2T with the **Federal Register**, the IRS and Treasury Department issued Notice 2002–18, 2002–12 I.R.B. 644, which stated that regulations would be promulgated that would defer or otherwise limit the utilization of a loss on stock (or another asset that reflects the basis of stock) in transactions that facilitate the group’s utilization of a single economic loss more than once. Notice 2002–18 is based on the principle that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) (disallowing a worthless stock deduction recognized on a liquidation of a subsidiary member because the group had already obtained the tax benefit from the operating losses that gave rise to the deduction). The notice stated that the regulations would apply to dispositions occurring on or after March 7, 2002.

Explanation of Provisions

These proposed regulations reflect the principle set forth in Notice 2002–18 that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. The proposed regulations consist primarily of two rules: a basis redetermination rule and a loss suspension rule. The proposed regulations also include a basis reduction rule to address certain cases not within the scope of the loss suspension rule. Finally, the proposed regulations include certain anti-avoidance rules to address certain transactions designed to avoid the application of the basis redetermination and loss suspension rules.

The rules in these proposed regulations are intended to address at least two types of transactions that may allow a group to obtain more than one tax benefit from a single economic loss. In the first type of transaction, a group absorbs an inside loss (e.g., a loss carryforward, a deferred deduction, or a loss inherent in an asset) of a subsidiary member and then a member of

the group recognizes a loss on a disposition of stock of that subsidiary member that is duplicative of the inside loss. For example, assume that in Year 1, P, a member of a group, forms S with a contribution of \$80 in exchange for 80 shares of common stock of S (representing all of the outstanding stock of S). In Year 2, P contributes Asset A with a basis of \$70 and a value of \$20 to S in exchange for an additional 20 shares of S common stock. In Year 3, S sells Asset A and recognizes a \$50 loss, which offsets income of P on the group’s return. Under the investment adjustment rules of § 1.1502–32, P’s basis in each share of S common stock it holds is reduced by a *pro rata* share of the \$50 loss, with the result that the shares acquired in Year 1 have a basis of \$40 and the shares acquired in Year 2 have a basis of \$60. In Year 4, P sells the shares acquired in Year 2 for \$20 and recognizes a \$40 loss, which offsets income of P on the group’s return. In this transaction, the group has obtained a total of \$90 tax benefit from the single \$50 loss.

Alternatively, assume that, in Year 1, P forms S with a contribution of \$100 in exchange for all of the common stock of S. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 to S in exchange for all of the preferred stock of S. In Year 3, S sells Asset A and recognizes a \$30 loss, which offsets income of P on the group’s return. Under the investment adjustment rules of § 1.1502–32, P’s basis in each share of S common stock it holds is reduced by a *pro rata* share of the \$30 loss. P’s basis in its preferred shares, however, is not reduced. In Year 4, P sells the preferred stock of S for \$20 and recognizes a \$30 loss, which offsets income of P on the group’s return. In this transaction, the group has obtained a \$60 tax benefit from the single \$30 economic loss in Asset A.

Although, in both cases, a taxable disposition of the S common stock acquired in Year 1 would offset the excess tax benefit, the group has various non-taxable alternatives by which to ensure that the excess tax benefit is not reduced, including retention of the remaining shares of S or the liquidation of S in a transaction described in section 332.

In the second type of transaction, a member of the group recognizes a loss on a disposition of subsidiary member stock that is duplicative of an inside loss of the

subsidiary member, the subsidiary remains a member of the group, and the group subsequently recognizes the inside loss of that subsidiary member. For example, assume that in Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of the common stock of S. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 to S in exchange for an additional 20 shares of S common stock. In Year 3, P sells the 20 shares of S common stock that it acquired in Year 2 for \$20 and recognizes a \$30 loss, which offsets income of P on the group's return. The sale of the 20 shares of S common stock does not result in the deconsolidation of S. In Year 4, S sells Asset A and recognizes a \$30 loss, which also offsets income of P on the group's return. In this transaction, the group has obtained the use of two losses from the single economic loss in Asset A. Again, although a taxable disposition by P of its remaining S common stock would offset the tax benefit of one of the losses, the group has various non-taxable alternatives by which to ensure that the excess tax benefit is not reduced, including retention of the remaining shares of S or the liquidation of S in a transaction described in section 332.

A. Basis Redetermination Rule

The investment adjustment rules of § 1.1502-32 are premised on certain assumptions regarding the shareholders' interests in the subsidiary. One assumption is that the subsidiary's losses are borne by the holders of the common stock before the holders of the preferred stock. Another assumption is that each share within a class is entitled to an equal portion of the subsidiary's items of income and gain, and, in the case of common stock, of deduction and loss. The investment adjustment rules, therefore, generally allocate basis adjustments without regard to differences in members' bases in their shares of the stock of the subsidiary member and without regard to whether a basis adjustment reflects an item of income, gain, deduction, or loss that was built-in with respect to contributed property. These assumptions can give rise to the results illustrated in the transactions described above.

The basis redetermination rule attempts to mitigate the effect of the assumptions underlying the investment adjustment rules by reversing certain investment adjustments to

take into account the source of certain items of deduction and loss. In addition, where the subsidiary member remains a member of the group, the basis redetermination rule equalizes members' bases in subsidiary stock such that the loss suspension rule, described below, need not include inordinately complex rules to address the method by which inside losses reduce stock basis under § 1.1502-32.

The proposed regulations require the redetermination of the basis of subsidiary member stock held by members of the group immediately before a disposition or deconsolidation of a share of subsidiary member stock when the basis of such stock exceeds its value. The rule applies differently when the subsidiary remains a member of the group after its stock is disposed of or deconsolidated from when the subsidiary does not remain a member of the group.

If a subsidiary remains a member of the group, the basis redetermination rule requires that all members of the group aggregate their bases in all shares of the subsidiary member. That basis is then allocated first to the shares of the subsidiary member's preferred stock that are owned by the members of the group in proportion to, but not in excess of, their value on the date of the disposition or deconsolidation. After the allocation of the aggregated basis to all shares of the preferred stock of the subsidiary member held by members of the group, any remaining basis is allocated among all common shares of subsidiary member stock held by members of the group in proportion to their value on the date of the disposition or deconsolidation. This rule reallocates past adjustments to reflect an economic allocation of the built-in items of deduction and loss with respect to contributed property. The rule also reallocates stock basis that arose from capital contributions of property and stock basis that arose as a result of positive investment adjustments. The reallocation of basis obviates the need for complex rules addressing basis adjustments resulting from an inside loss that was reflected in a stock loss that is suspended pursuant to the loss suspension rule described below.

If the subsidiary is no longer a member of the group immediately after the disposition or deconsolidation of its stock, the basis redetermination rule requires a reallocation of a certain amount of the basis of

the stock of the subsidiary member owned by group members. In particular, the amount of basis subject to reallocation is equal to the lesser of (1) the loss inherent in the stock disposed of or deconsolidated, and (2) the subsidiary member's items of deduction and loss that were taken into account in computing the adjustment to the basis of any share of stock of the subsidiary member, other than the shares disposed of or deconsolidated, during the time such subsidiary member was a member of the group. However, only those items of deduction and loss that are attributable to formerly unrecognized or unabsorbed items reflected in the basis of the subsidiary member stock disposed of or deconsolidated are included in the computation of the amount of basis subject to reallocation. For example, if a share of stock has a basis in excess of value because the stock was acquired in exchange for a built-in loss asset, the stock's basis reflects that unrecognized loss. If that loss is later recognized, the basis adjustment resulting from that recognition is an item of loss attributable to a formerly unrecognized item reflected in the basis of such stock. The proposed regulations contain a presumption that all items of deduction and loss included in the computation of prior investment adjustments to the basis of members' shares of the subsidiary member are attributable to the recognition and absorption of a deduction or loss reflected in the basis of the shares that are disposed of or deconsolidated. The regulations do, however, permit groups to establish that particular items of deduction and loss are not reflected in the basis of the shares disposed of or deconsolidated, and, therefore, are not reallocated to other shares.

If the subsidiary is no longer a member of the group immediately after the disposition or deconsolidation of its stock, the basis in the shares of subsidiary member stock disposed of or deconsolidated is reduced by the amount of basis subject to reallocation. Then, to the extent of the amount of basis subject to reallocation, the basis of all preferred shares of stock of the subsidiary member that are held by members of the group immediately after the disposition or deconsolidation is increased such that the basis of each such share equals, but does not exceed, its value immediately before the disposition or deconsolidation. Finally, to the extent that the amount of basis subject to reallocation does not increase the ba-

sis of such preferred shares of the subsidiary member, such amount increases the basis of all common shares of stock of the subsidiary member held by members of the group immediately after the disposition or deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

The basis redetermination rule does not apply if the group disposes of all its stock of the subsidiary member within a single taxable year, in one or more fully taxable transactions, or is allowed a worthless stock deduction with respect to all of the subsidiary member stock owned by the members. Under those circumstances, if a second tax benefit has been derived from an economic loss, the second tax benefit will be recaptured in the taxable year in which it was obtained.

The proposed regulations also include a look-through rule that applies the basis redetermination rule to stock of lower-tier subsidiary members when there is a disposition or deconsolidation of stock of a higher-tier member. In addition, the proposed regulations provide that basis adjustments made pursuant to the basis redetermination rule result in basis adjustments to higher-tier member stock.

While the basis redetermination rule may prevent the recognition of a current loss on a particular share of subsidiary member stock, it does not prevent a group from obtaining a benefit from its investment in the subsidiary member. The basis redetermination rule affects only the timing of the group's loss and, in so doing, prevents the group from inappropriately duplicating a single economic loss.

B. Loss Suspension Rule

The loss suspension rule prevents duplication of an economic loss by effectively disallowing a stock loss if the economic loss giving rise to that stock loss is later reflected on the group's return as in the second type of transaction described above.

1. Suspension of Stock Loss

Under the loss suspension rule, if, after application of the basis redetermination rule, a member of a consolidated group recognizes a loss on the disposition of stock of a subsidiary member of the same group, and the subsidiary member is a member of

the same group immediately after the disposition, then the selling member's stock loss is suspended to the extent of the duplicated loss with respect to such stock. The proposed regulations also include a special rule that applies the loss suspension rule in cases of a disposition of stock of a subsidiary member that leaves the group where the subsidiary owns stock of another subsidiary that remains a member of the group. In addition, the proposed regulations include a substitute asset rule that suspends a member's loss recognized on a disposition of an asset other than stock of a subsidiary member where such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary member with respect to which there was a duplicated loss, and immediately after the disposition, the subsidiary member is a member of such group.

The amount of duplicated loss is the excess of (1) the sum of the aggregate basis of the subsidiary member's assets (excluding stock in other subsidiary members of the group), the subsidiary member's losses that are carried to its first taxable year after the disposition, and the subsidiary member's deductions that have been recognized but deferred under another provision, over (2) the sum of the value of stock of the subsidiary member and the subsidiary member's liabilities that have been taken into account for tax purposes. Each of these items in the computation (except stock value) includes the subsidiary member's allocable share of the same items of any lower-tier subsidiary. This definition of duplicated loss is substantially identical to the one in former § 1.1502-20, except that securities of other members of the group are not excluded from the computation of the subsidiary's aggregate asset basis.

The application of the loss suspension rule can be illustrated as follows. Assume P, the common parent of a consolidated group, forms S in Year 1 by contributing \$100 to S in exchange for all 10 shares of S's outstanding stock. Immediately after the contribution, S purchases a building for \$100. In Year 2, the value of the building declines to \$10. At the end of Year 2, P sells one share of S stock for \$1 and recognizes a \$9 loss. (Because the basis of P's shares of S stock is uniform at the time of the disposition, the basis redetermination rule does not alter P's basis in the share

sold.) Immediately after the sale, S is still a member of the P group because P continues to own 90% of the S stock. On the date of the stock sale, S's duplicated loss is \$90, the excess of its asset basis (\$100) over the value of the assets (deemed to be equal to the aggregate stock value, \$10). Of the total duplicated loss, 10%, or \$9, is allocable to the share sold. Thus, under the loss suspension rule the \$9 stock loss is suspended.

2. Reduction of Suspended Stock Loss

Because a suspended stock loss reflects the subsidiary member's unrecognized or unabsorbed deductions and losses, the suspended loss is reduced, with the result that it will not later be allowed, as the subsidiary member's deductions and losses are taken into account (*i.e.*, absorbed) in determining the group's consolidated taxable income (or loss). The reduction of suspended loss is appropriate because, once the group takes the inside loss into account in determining consolidated taxable income (or loss), the group should not be able to take such loss (in the form of the stock loss or otherwise) into account again in determining consolidated taxable income or loss. Using the facts of the above example, assume that, in Year 3, S sells its building for \$10 and recognizes a \$90 loss. The P group uses the entire \$90 loss to offset income of another member of the group. Under these proposed regulations, the absorbed loss (\$90) reduces the suspended loss amount (\$9), but not below zero. Thus, P will benefit from the economic loss once on its return, no suspended stock loss will remain, and P's basis in its remaining S stock will be reduced by its allocable share of the loss (\$81).

The proposed regulations generally presume that all deductions and losses are attributable first to the duplicated loss that gave rise to a suspended stock loss. The presumption, however, is rebuttable. If a taxpayer can establish that an item of deduction or loss was not part of the duplicated loss that gave rise to a suspended stock loss, the taxpayer will not be required to reduce its suspended stock loss. To illustrate, assume that, instead of selling the building, S retained the building and, in Year 3, earned \$50 which it then used to purchase a truck. In Year 4, S sells the truck, recognizing a \$25 loss. That loss offsets income of another member of the P

group. Assuming that P and S have kept adequate records, P should be able to establish that the loss on the truck was not reflected in the stock loss (because it was attributable to an asset that was acquired after the disposition of stock that gave rise to the suspended stock loss). In that case, P would not be required to reduce its suspended stock loss. The IRS and Treasury Department are concerned about, and specifically request comments regarding, the administrability aspects of this exception.

3. Allowance of Suspended Stock Loss

The proposed regulations provide that any suspended stock loss remaining at the time the subsidiary member leaves the group is allowed, to the extent otherwise allowable under applicable provisions of the Code and regulations thereunder. The loss is allowed on a return filed for the taxable year that includes the last day that the subsidiary member is a member of the group. Once the subsidiary member is no longer a member of the group, the group will not typically be able to use the subsidiary member's deductions or losses on the group's return. Accordingly, it is appropriate to allow any suspended stock loss remaining at the time the subsidiary member leaves the group.

The proposed regulations also provide that any suspended stock loss remaining is allowed at the time the group is allowed a worthless stock deduction with respect to all of the subsidiary member stock owned by members. In such cases, the basis reduction rule, described below, may reduce a worthless stock deduction effectively to prevent any second tax benefit that could be derived from the economic loss that gave rise to the suspended stock loss.

The proposed regulations require that in order for a group to be allowed a loss that was recognized on the disposition of a subsidiary member and that was suspended, the group must file a statement of allowable loss with the consolidated return for the year in which the loss is allowable.

C. Application of the Basis Redetermination and Loss Suspension Rules Generally

The IRS and Treasury Department do not expect that the basis redetermination and the loss suspension rules will apply frequently. This expectation is based on the assumption that, when a group seeks to raise

capital, the common parent will typically issue stock directly or sell all of the stock of a subsidiary member. Alternatively, groups sometimes seek to raise capital by creating minority interests in a subsidiary member. In such cases, however, the group will typically cause the subsidiary member to issue shares directly to the nonmember. Thus, the IRS and Treasury Department believe that a member's sale of less than all of the stock of a subsidiary member to a nonmember, which may trigger application of the basis redetermination and loss suspension rules, is not a common transaction in the absence of tax incentives.

D. Basis Reduction Rule

The loss suspension rule applies only if there has been a disposition of subsidiary member stock and the subsidiary member is a member of the group immediately after the disposition. The IRS and Treasury Department, however, are concerned that a group may obtain more than one tax benefit from a single economic loss in certain cases in which a group member recognizes a loss with respect to subsidiary member stock and, in connection with such recognition event, the subsidiary member ceases to exist. For example, suppose P owns all of the stock of S. P's basis in its S stock is \$100 and the value of the S stock is \$0 because S is insolvent. S liquidates into P. In that case, P will recognize a loss of \$100 on the disposition of the S stock. Because S is not a member of the P group immediately after the disposition of S stock, the loss suspension rule will not apply. The portion of the group's consolidated net operating and net capital loss carryforwards attributable to S, however, may remain with the P group. Therefore, to that extent, any loss on the stock of the subsidiary duplicates those losses. To address this case, these proposed regulations provide that if a member disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then the basis of the subsidiary member stock is reduced to the extent of the consolidated net operating loss and net capital loss carryforwards attributable to such subsidiary member, as though they were absorbed immediately prior to the disposition.

Similarly, where the subsidiary becomes worthless under the standards of § 1.1502-

80(c), the group may be allowed a worthless stock loss while consolidated net operating and net capital loss carryforwards attributable to the worthless subsidiary member remain unabsorbed. Although the subsidiary may be viewed as remaining in the group, rather than rely on existing rules, including the excess loss account recapture rules, to prevent the possible duplication of the unabsorbed losses, these proposed regulations provide for a negative stock basis adjustment similar to that described above in such cases.

E. Anti-avoidance Rules

The IRS and Treasury Department are concerned that, in certain cases, taxpayers may structure transactions to avoid the application of the basis redetermination and loss suspension rules in a manner that is not consistent with the purpose of the proposed regulations to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss. In particular, suppose P acquires 80 shares of S common stock in exchange for \$80. In a later year, P contributes an asset with a basis of \$50 and a value of \$20 to S in exchange for 20 shares of S preferred stock. The following year, S sells the contributed asset, recognizing a loss of \$30. As a result of the sale of the asset, P's basis in the S common stock is reduced by \$30 from \$80 to \$50. In contemplation of the sale of the S preferred stock, P contributes the 80 shares of S common stock to PS, a partnership, in a transaction described in section 721. Because P's basis in the S common stock does not exceed the value of such stock, the deconsolidation of the S common stock does not trigger the application of the basis redetermination rule. In the same year, but after the contribution of the S common stock to PS, P sells the S preferred stock, recognizing \$30 of loss. Absent the application of an anti-avoidance rule, the P group will have obtained more than one tax benefit from the single economic loss inherent in the contributed asset. Accordingly, the proposed regulations provide that if a share of subsidiary member stock is deconsolidated and such deconsolidation is with a view to avoiding application of the basis redetermination rule prior to the disposition of loss stock of the subsidiary member, then the basis redetermination rule will apply immediately prior to the deconsolidation.

In addition, suppose in Year 1, P forms S with a contribution of \$100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in a transaction described in section 721. In Year 3, P contributes an asset with a basis of \$50 and a value of \$20 to PS in a transaction described in section 721. Also in Year 3, PS contributes the built-in loss asset to S and P contributes an additional \$80 to S in transfers to which section 351 applies. In Year 4, S sells the built-in loss asset for \$20, recognizing a loss of \$30. The P group uses that loss to offset income of P. Also in Year 4, P sells its entire interest in PS for \$40, recognizing a loss of \$30, or PS sells its S stock for \$20, recognizing a loss of \$30. In either case, the P group would obtain more than one tax benefit from the single economic loss in the contributed asset. Accordingly, the proposed regulations provide that where a member of a consolidated group contributes a built-in loss asset to a partnership or a deconsolidated corporation, that partnership or deconsolidated corporation subsequently contributes the built-in loss asset to a subsidiary member of the group, and those contributions are with a view to avoiding the application of the basis redetermination rule or the loss suspension rule, adjustments must be made to prevent the consolidated group from obtaining more than one tax benefit from a single economic loss in the case.

The IRS and Treasury Department are also concerned that it may be possible to avoid the loss suspension rule by disposing of a sufficient amount of subsidiary member stock to cause a deconsolidation of the subsidiary member, but then engage in a transaction that has the effect of re-importing to the group losses of that subsidiary member. To address this concern, the proposed regulations include an anti-avoidance rule that prevents the group from obtaining the tax benefit of the re-imported loss. The rule applies whenever (1) a group recognizes and is allowed a loss on the disposition of subsidiary member stock with respect to which there is a duplicated loss, (2) as a result of that disposition or another disposition, the subsidiary member leaves the group, and (3) within ten (10) years after the date the subsidiary member leaves the group, a loss of the subsid-

iary member is re-imported into the group. A loss of a subsidiary may be re-imported into the group when the subsidiary member rejoins the group at a time when it has losses or deferred deductions that it had on the date of the disposition or has losses or deferred deductions that are attributable to built-in loss assets held by the subsidiary member on the date of the disposition, or has built-in loss assets that were built-in loss assets of the subsidiary member on the date of the disposition. A loss of a subsidiary member may also be re-imported into the group when a member of the group succeeds to losses or deferred deductions of the subsidiary member that were losses or deferred deductions of the subsidiary member on the date of the disposition, or losses or deferred deductions that are attributable to assets that were built-in loss assets of the subsidiary member on the date of the disposition, or acquires built-in loss assets that were built-in loss assets of the subsidiary member on the date of the disposition. If the anti-avoidance rule applies, then these proposed regulations generally prohibit the use of the re-imported item of deduction or loss to offset income of the group.

F. Application of Anti-Abuse Rules

Finally, the proposed regulations make clear that the proposed rules do not preclude the application of anti-abuse rules of the Code and regulations thereunder, including to a transaction entered into to invoke the basis redetermination rule to avoid the effect of any other provision of the Code or regulations.

G. Request for Comments

The IRS and Treasury Department are considering alternative approaches to the basis redetermination rule that would mitigate basis disparities in stock of a subsidiary member. In this regard, the IRS and Treasury Department are considering an approach that would adjust the bases of all shares of subsidiary member stock held by group members upon any acquisition of subsidiary member stock. Comments are requested regarding the appropriateness and desirability of such an approach as well as suggestions for alternative approaches.

In addition, under the proposed regulations, the basis redetermination and loss suspension rules apply only to certain events involving stock that has a basis in excess

of value. The IRS and Treasury Department, however, are considering the appropriateness and feasibility of a rule that applies the principles of the basis redetermination and loss suspension rules to certain events involving stock that has a value in excess of basis. With respect to the application of the principles of the loss suspension rule to dispositions of stock that has a value in excess of basis and that reflects duplicated gain, a rule might require taking into account the stock gain upon the disposition of the stock but would eliminate gain recognized on the disposition of assets that had a built-in gain at the time of the stock transaction. The IRS and Treasury Department request comments on appropriate and administrable applications of the principles of the basis redetermination and loss suspension rules to dispositions and deconsolidations of stock that has a built-in gain.

Finally, as an alternative or supplement to the rule providing for basis reduction for unabsorbed losses in certain cases where the subsidiary member ceases to exist or the group is allowed a worthless stock deduction with respect to the stock of such subsidiary member, the IRS and Treasury Department are considering whether it would be more appropriate to restrict the losses pursuant to the approach set forth in section 382(g)(4)(D). Comments are requested regarding whether such an approach would be appropriate, desirable and administrable, as well as the application of such an approach in the context of consolidated attributes.

Proposed Effective Date

These regulations, other than the anti-avoidance rule that relates to the re-importing of losses, are proposed to apply to transactions that occur on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**. The anti-avoidance rule that relates to the re-importing of loss is proposed to apply to losses re-imported as a result of an event that occurs on or after October 18, 2002, that triggers the application of such rule, but only if such event occurs during a taxable year the original return for which is due (without regard to extensions) after the date

these regulations are published as temporary or final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 15, 2003, beginning at 10 a.m. in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the

building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by December 27, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Aimee K. Meacham of the Office of the Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows: Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1502-32 is amended by:

1. Revising paragraph (a)(2).
2. Adding paragraphs (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(3)(vi).

The revision and additions read as follows:

§ 1.1502-32 Investment adjustments.

(a) * * *

(1) * * *

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), § 1.1502-11(b) (limitations on the use of losses), § 1.1502-19 (treatment of excess loss accounts), § 1.1502-31 (basis after a group structure change), and § 1.1502-35 (additional rules relating to stock loss). P's basis in S's stock

must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if pursuant to § 1.1502-35(c)(3) and paragraph (b)(3)(iii)(C) of this section the basis in stock is reduced to take into account a loss suspended under § 1.1502-35(c)(1), such basis shall not be further reduced to take into account such loss, or a portion of such loss, if any, that is later allowed pursuant to § 1.1502-35(c)(5). See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

* * * * *

(b) * * *

(3) * * *

(iii) * * *

(C) *Loss suspended under § 1.1502-35(c).* Any loss suspended pursuant to § 1.1502-35(c) is treated as a noncapital, nondeductible expense incurred during the tax year that includes the date of the disposition to which such section applies. See § 1.1502-35(c)(3). Consequently, the basis of a higher-tier member's stock of P is reduced by the suspended loss in the year it is suspended.

(D) *Loss disallowed under § 1.1502-35(g)(3)(iii).* Any loss the use of which is disallowed pursuant to § 1.1502-35(g)(3)(iii)(A) or (B) is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the date on which such loss is recognized. Any loss the use of which is disallowed pursuant to § 1.1502-35(g)(3)(iii)(C) and with respect to which no waiver described in paragraph (b)(4) of this section is filed is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the day after the event described in § 1.1502-35(g)(3)(iii)(C) that gives rise to the application of § 1.1502-35(g)(3). See § 1.1502-35(g)(3)(iv).

* * * * *

(vi) *Special rules in the case of certain transactions subject to § 1.1502-35.* If a member of a group disposes of a share of subsidiary member stock or a share of subsidiary member stock is deconsolidated, and, at the time of such disposition or deconsolidation, the basis of such share exceeds its value, all members of the group are subject to the provisions of § 1.1502-35, which generally require a re-

determination of members' basis in all shares of subsidiary stock.

Par. 3. Section 1.1502-35 is added to read as follows:

§ 1.1502-35 Disposition or deconsolidation of subsidiary member stock.

(a) *Purpose.* The purpose of this section is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of this section shall be construed in a manner consistent with that purpose and in a manner that reasonably carries out that purpose.

(b) *Redetermination of basis on disposition or deconsolidation of subsidiary member stock*—(1) *Application.* Except as provided in paragraph (b)(4) of this section, this paragraph (b) applies if a member of a consolidated group disposes of stock of a subsidiary member or a share of subsidiary member stock is deconsolidated, and such disposed of or deconsolidated stock has a basis that exceeds its value immediately prior to such disposition or deconsolidation. If, immediately after such disposition or deconsolidation, the subsidiary member remains a member of the group, then, immediately before such disposition or deconsolidation, the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of paragraph (b)(2) of this section. If, immediately after such disposition or deconsolidation, the subsidiary is not a member of the group, then immediately before such disposition or deconsolidation, the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of paragraph (b)(3) of this section.

(2) *Redetermination of subsidiary member stock basis if subsidiary member remains a member of the same group.* If the subsidiary member the stock of which is disposed of or deconsolidated remains a member of the group, all of the members' basis in the shares of subsidiary member stock shall be aggregated. Such aggregated basis shall be allocated first to the shares of the subsidiary member's preferred stock that are owned by the members of the group, in proportion to, but not in excess of, the value of those shares on the date of the disposition or deconsolidation that gave rise to the application of this paragraph (b). After allocation of the ag-

gregated basis to all shares of the preferred stock of the subsidiary member held by members of the group, any remaining basis shall be allocated among all common shares of subsidiary member stock held by members of the group in proportion to the value of such shares on the date of the disposition or deconsolidation that gave rise to the application of this paragraph (b).

(3) *Redetermination of subsidiary member stock basis if subsidiary member does not remain a member of the group*—(i) *Calculation of Reallocable Basis Amount.* The reallocable basis amount shall equal the lesser of—

(A) The amount by which the basis of the disposed of or deconsolidated stock exceeds the value of such stock immediately prior to the disposition or deconsolidation that gave rise to the application of this paragraph (b); and

(B) The total of the subsidiary member's (and any predecessor's) items of deduction and loss, and the subsidiary member's (and any predecessor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that were taken into account in computing the adjustment to the basis of any share of stock of the subsidiary member (and any predecessor) under § 1.1502-32 other than the stock of the subsidiary member the disposition or deconsolidation of which gave rise to the application of this paragraph (b), during the time such subsidiary member (or any predecessor) was a member of the group, except to the extent the group can establish that all or a portion of such items would not have been reflected in a computation of the duplicated loss with respect to the disposed of or deconsolidated stock of the subsidiary member (or any predecessor) at any time prior to such disposition or deconsolidation.

(ii) *Allocation of reallocable basis amount.* If the subsidiary member the stock of which is disposed of or deconsolidated does not remain a member of the group, the basis in the shares of subsidiary member stock that were disposed of or deconsolidated shall be reduced by the reallocable basis amount. Then, to the extent of the reallocable basis amount, the basis of all the preferred shares of stock of the subsidiary member that are held by members of the group immediately after the disposition or deconsolidation shall be increased such that the basis of each such share shall

equal, but not exceed, its value immediately before the disposition or deconsolidation. If the reallocable basis amount is not sufficient to increase the basis of each such share of preferred stock to its value immediately before the disposition or deconsolidation, the basis of each such share shall be increased in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. Then, to the extent the reallocable basis amount does not increase the basis of shares of subsidiary member preferred stock pursuant to the second sentence of this paragraph (b)(3)(ii), such amount shall increase the basis of all common shares of subsidiary member stock held by members of the group immediately after the disposition or deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such other share to be the same.

(4) *Exception to application of redetermination rules.* This paragraph (b) shall not apply to a disposition of subsidiary member stock if, within the taxable year of such disposition, in one or more fully taxable transactions, the group disposes of its entire equity interest in the subsidiary member or is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502-80(c)) with respect to all of the subsidiary member stock owned by members.

(5) *Special rule for lower-tier subsidiaries.* If—

(i) A member of a consolidated group disposes of stock of a subsidiary member of the same group or a share of subsidiary member stock is deconsolidated, and, immediately before the disposition or deconsolidation, the member's basis in the disposed of or deconsolidated share of subsidiary member stock exceeds its value;

(ii) The subsidiary member owns stock of another subsidiary member of the same group and, immediately before the disposition or deconsolidation, the basis of some or all of such stock exceeds its value; and

(iii) Immediately after the disposition or deconsolidation, another member of the same group owns stock of such other subsidiary member, then the basis in each share of such other subsidiary member shall be redetermined pursuant to this paragraph (b) as if the stock of such other subsidiary member owned by the subsidiary member had been disposed of or deconsoli-

dated. This paragraph (b)(5) shall not apply in the case of a disposition of subsidiary member stock if, within the taxable year of the disposition of subsidiary member stock, in one or more fully taxable transactions, the group disposes of its remaining equity interests in the other subsidiary member or is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502–80(c)) with respect to such other subsidiary member. These same principles shall apply to stock of subsidiary members of the same group that are owned by such other subsidiary member.

(6) *Stock basis adjustments for higher-tier stock.* The basis adjustments required under this paragraph (b) result in basis adjustments to higher-tier member stock. The adjustments are applied in the order of the tiers, from the lowest to highest. For example, if a common parent owns stock of a subsidiary member that owns stock of a lower-tier subsidiary member and the subsidiary member recognizes a loss on the disposition of a portion of its shares of the lower-tier subsidiary member stock, the common parent must adjust its basis in its subsidiary member stock under the principles of § 1.1502–32 to reflect the adjustments that the subsidiary member must make to its basis in its stock of the lower-tier subsidiary member.

(7) *Ordering rule.* The rules of this paragraph (b) apply after the rules of § 1.1502–32 are applied. Paragraph (b)(5) of this section (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(6) of this section) applies prior to paragraph (b)(2) or (b)(3) of this section (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(6) of this section).

(c) *Loss suspension—(1) General rule.* Any loss recognized by a member of a consolidated group with respect to the disposition of a share of subsidiary member stock shall be suspended to the extent of the duplicated loss with respect to such share of stock if, immediately after the disposition, the subsidiary is a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group).

(2) *Special rule for lower-tier subsidiaries.* This paragraph (c)(2) applies if neither paragraph (c)(1) nor (f) of this section

applies to a member's disposition of a share of stock of a subsidiary member (the departing member), a loss is recognized on the disposition of such share, and the departing member owns stock of one or more other subsidiary members (a remaining member) that is a member of such group immediately after the disposition. In that case, such loss shall be suspended to the extent the duplicated loss with respect to the departing member stock disposed of is attributable to the remaining member or members.

(3) *Treatment of suspended loss.* For purposes of the rules of § 1.1502–32(b)(3)(iii), any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section is treated as a noncapital, nondeductible expense of the member that disposes of subsidiary member stock incurred during the taxable year that includes the date of the disposition of stock to which paragraph (c)(1) or (c)(2) of this section applies. See § 1.1502–32(b)(3)(iii)(C). Consequently, the basis of a higher-tier member's stock of the member that disposes of subsidiary member stock is reduced by the suspended loss in the year it is suspended.

(4) *Reduction of suspended loss—(i) General rule.* The amount of any loss suspended pursuant to paragraphs (c)(1) and (c)(2) of this section shall be reduced, but not below zero, by the subsidiary member's (and any successor's) items of deduction and loss, and the subsidiary member's (and any successor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that are allocable to the period beginning on the date of the disposition that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the group of which it was a member immediately prior to the disposition (or any successor group), and that are taken into account in determining consolidated taxable income (or loss) of such group for any taxable year that includes any date on or after the date of the disposition and before the first date on which the subsidiary member (or any successor) is not a member of such group. The preceding sentence shall not apply to items of deduction and loss to the extent that the group can establish that all or a portion of such items was not reflected in the computation of the dupli-

cated loss with respect to the subsidiary member stock on the date of the disposition of such stock.

(ii) *Operating rules—(A) Year in which deduction or loss is taken into account.* For purposes of paragraph (c)(4)(i) of this section, a subsidiary member's (or any successor's) deductions and losses are treated as taken into account when and to the extent they are absorbed by the subsidiary member (or any successor) or any other member. To the extent that the subsidiary member's (or any successor's) deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction is treated as taken into account in the year in which it is absorbed. To the extent that a subsidiary member's (or any successor's) deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is treated as taken into account in the year in which it arises and not in the year in which it is absorbed.

(B) *Determination of items that are allocable to the post-disposition, pre-deconsolidation period.* For purposes of paragraph (c)(4)(i) of this section, the determination of whether a subsidiary member's (or any successor's) items of deduction and loss and allocable share of items of deduction and loss of all lower-tier subsidiary members are allocable to the period beginning on the date of the disposition of subsidiary stock that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group) is determined pursuant to the rules of § 1.1502–76(b)(2), without regard to § 1.1502–76(b)(2)(ii)(D), as if the subsidiary member ceased to be a member of the group at the end of the day before the disposition and filed separate returns for the period beginning on the date of the disposition and ending on the day before the first date on which it is not a member of such group.

(5) *Allowable loss—(i) General rule.* To the extent not reduced under paragraph (c)(4) of this section, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section shall be allowed, to the extent otherwise allowable under applicable provisions of the Internal Revenue Code and

regulations thereunder, on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss (or any successor group) for the taxable year that includes the day before the first date on which the subsidiary (or any successor) is not a member of such group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of § 1.1502-80(c)) with respect to all of the subsidiary member stock owned by members.

(ii) *No tiering up of certain adjustments.* No adjustments shall be made to a member's basis of stock of a subsidiary member (or any successor) for a suspended loss that is taken into account under paragraph (c)(5)(i) of this section. See § 1.1502-32(a)(2).

(iii) *Statement of allowed loss.* Paragraph (c)(5)(i) of this section applies only if the separate statement required under this paragraph (c)(5)(iii) is filed with, or as part of, the taxpayer's return for the year in which the loss is allowable. The statement must be entitled "ALLOWED LOSS UNDER § 1.1502-35(c)(5)" and must contain the name and employer identification number of the subsidiary the stock of which gave rise to the loss.

(6) *Special rule for dispositions of certain carryover basis assets.* If—

(i) A member of a group recognizes a loss on the disposition of an asset other than stock of a subsidiary member;

(ii) Such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary member and, at the time of the determination of the member's basis in the assets disposed of, there was a duplicated loss with respect to such stock of the subsidiary member; and

(iii) Immediately after the disposition, the subsidiary member is a member of such group, then such loss shall be suspended pursuant to the principles of paragraphs (c)(1) and (c)(2) of this section to the extent of the duplicated loss with respect to such stock at the time of the determination of basis of the asset disposed of. Principles similar to those set forth in paragraphs (c)(3), (4), and (5) of this section shall apply to a loss suspended pursuant to this paragraph (c)(6).

(7) *Coordination with loss deferral, loss disallowance, and other rules—(i) In gen-*

eral. Loss recognized on the disposition of subsidiary member stock or another asset is subject to redetermination, deferral, or disallowance under other applicable provisions of the Internal Revenue Code and regulations thereunder, including sections 267(f) and 482. Paragraphs (c)(1), (c)(2), and (c)(6) of this section do not apply to a loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply when the loss would otherwise be taken into account under such other provision. However, if an overriding event described in paragraph (c)(7)(ii) of this section occurs before the deferred loss is taken into account, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply to the loss immediately before the event occurs, even though the loss may not be taken into account until a later time.

(ii) *Overriding events.* For purposes of paragraph (c)(7)(i) of this section, the following are overriding events—

(A) The stock ceases to be owned by a member of the consolidated group;

(B) The stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock); or

(C) The stock is treated as disposed of under § 1.1502-19(c)(1)(ii)(B) or (c)(1)(iii).

(d) *Definitions—(1) Disposition.* *Disposition* means any event in which gain or loss is recognized, in whole or in part.

(2) *Deconsolidation.* *Deconsolidation* means any event that causes a share of stock of a subsidiary member that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value.* *Value* means fair market value.

(4) *Duplicated loss—(i) In general.* Duplicated loss is determined immediately after a disposition and equals the excess, if any, of—

(A) The sum of—

(1) The aggregate adjusted basis of the subsidiary member's assets other than any stock that subsidiary member owns in another subsidiary member; and

(2) Any losses attributable to the subsidiary member and carried to the subsidiary member's first taxable year following the disposition; and

(3) Any deductions of the subsidiary member that have been recognized but are deferred under a provision of the Internal

Revenue Code (such as deductions deferred under section 469); over

(B) The sum of—

(1) The value of the subsidiary member's stock; and

(2) Any liabilities of the subsidiary member that have been taken account for tax purposes.

(ii) *Special rules.* (A) The amounts determined under paragraph (d)(4)(i) of this section with respect to a subsidiary member include its allocable share of corresponding amounts with respect to all lower-tier subsidiary members. If 80 percent or more in value of the stock of a subsidiary member is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary member's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), using the language "10 percent" instead of "50 percent" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(B) The amounts determined under paragraph (d)(4)(i) of this section are not applied more than once to suspend a loss under this section.

(5) *Predecessor and Successor.* A predecessor is a transferor of assets to a transferee (the successor) in a transaction—

(i) To which section 381(a) applies;

(ii) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(iii) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the transferor's basis in such assets, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(iv) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(6) *Successor group.* A surviving group is treated as a successor group of a consolidated group (the terminating group) that ceases to exist as a result of—

(i) The acquisition by a member of another consolidated group of either the as-

sets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(ii) The application of the principles of § 1.1502-75(d)(2) or (3).

(7) *Preferred stock, common stock.* Preferred stock and common stock shall have the meanings set forth in § 1.1502-32(d)(2) and (3), respectively.

(8) *Lower-tier.* A subsidiary member is lower-tier with respect to a member if or to the extent investment basis adjustments under § 1.1502-32 with respect to the stock of the former member would affect investment basis adjustments with respect to the stock of the latter.

(e) *Examples.* For purposes of the examples in this section, unless otherwise stated, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of paragraphs (a) through (d) of this section are illustrated by the following examples:

Example 1. (i) P owns 100 percent of the common stock of each of S1 and S2. S1 and S2 each have only one class of stock outstanding. P's basis in the stock of S1 is \$100 and in the stock of S2 is \$120. P, S1, and S2 are all members of the P group. S1 and S2 form S3. In Year 1, in transfers to which section 351 applies, S1 contributes \$100 to S3 in exchange for all of the common stock of S3 and S2 contributes an asset with a basis of \$50 and a value of \$20 to S3 in exchange for all of the preferred stock of S3. S3 becomes a member of the P group. In Year 3, in a transaction that is not part of the plan that includes the formation of S3, S2 sells the preferred stock of S3 for \$20. Immediately after the sale, S3 is a member of the P group.

(ii) Under paragraph (b)(1) of this section, because S2's basis in the preferred stock of S exceeds the value of such shares immediately prior to the sale and S is a member of the P group immediately after the sale, all of the P group members' bases in the stock of S3 is redetermined pursuant to paragraph (b)(2) of this section. Of the group members' total basis of \$150 in the S3 stock, \$20 is allocated to the preferred stock, the fair market value of the preferred stock on the date of the sale, and \$130 is allocated to the common stock. S2's sale of the preferred stock results in the recognition of \$0 of gain/loss. Pursuant to paragraph (b)(6) of this section, the redetermination of S1's and S2's bases in the stock of S3 results in adjustments to P's basis in the stock of S1 and S2. In particular, P's basis in the stock of S1 is increased by \$30 to \$130 and its basis in the stock of S2 is decreased by \$30 to \$90.

Example 2. (i) P owns 75 shares of common stock of S each with a basis and value equal to \$1. S is a member of the P group. On January 1st of Year 1, in a transfer to which section 351 applies, P contributes Asset A, which has a basis of \$100 and value of \$25, to S in exchange for 25 shares of common stock

of S. In Year 1, S incurs \$40 of ordinary operating expenses and takes a depreciation deduction in the amount of \$10 with respect to Asset A. Those deductions offset income of P in Year 1. Pursuant to § 1.1502-32, the negative investment adjustment of \$50 with respect to the stock of S reduces the basis of each share of S common stock by \$0.50. Therefore, P's original 75 shares of S common stock each has a basis of \$0.50 and each of the 25 shares of S common stock that P acquired in Year 1 has a basis of \$3.50. In Year 3 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells the 25 shares of common stock it acquired in Year 1 for \$12.50. As a result of that sale, S ceases to be a member of the P group.

(ii) Under paragraph (b)(1) of this section, because P's basis in the 25 shares of common stock it acquired in Year 1 exceeds its value immediately prior to the sale and S is not a member of the P group immediately after the disposition, P's basis in its shares of S common stock is redetermined pursuant to paragraph (b)(3) of this section. Pursuant to paragraph (b)(3)(i) of this section, the reallocable basis amount is \$37.50 (the lesser of the amount by which P's basis in the S common stock sold exceeds the value of such stock immediately prior to the sale (\$87.50 minus \$12.50, or \$75) and the aggregate amount of S's items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the S common stock other than the stock disposed of, under § 1.1502-32, during the time that S was a member of the P group (\$37.50)). P, however, may be able to establish that \$30 of the \$37.50 of items of deduction and loss taken into account in computing the adjustment to the basis of the S common stock (other than the S common stock disposed of) in Year 1 was not attributable to a loss that was already reflected in P's basis in its shares of S common stock disposed of. Assuming that P can establish this fact, pursuant to paragraph (b)(3)(i) of this section, the reallocable basis amount would be \$7.50. In that case, P's basis in the 25 shares of S common stock sold would be reduced from \$87.50 to \$80 pursuant to paragraph (b)(3)(ii) of this section. Accordingly, P would recognize a loss of \$67.50 on the sale of the 25 shares of S common stock for \$12.50. In addition, the basis of each remaining share of S common stock would be increased in an aggregate amount of \$7.50 in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such other share to be equal. In this case, the basis of each of the 75 shares of S common stock retained would be increased by \$0.10 to \$0.60.

Example 3. (i) In Year 1, P forms S by contributing Asset A with a basis of \$90 and a value of \$10 in exchange for one share of S common stock (CS1) in a transfer to which section 351 applies. In Years 2 and 3, in successive but unrelated transfers to which section 351 applies, P transfers \$10 to S in exchange for one share of S common stock (CS2), Asset B with a basis of \$2 and a value of \$10 in exchange for one share of S common stock (CS3), and Asset C with a basis of \$100 and a value of \$10 in exchange for one share of S common stock (CS4). In Year 4, S sells Asset A, recognizing \$80 of loss that is used to offset income of P recognized during Year 4. As a result of the sale of Asset C, the basis of each of P's four shares of S common stock is reduced by \$20. Therefore, the basis of CS1 is \$70. CS2 has an excess loss account of \$10. CS3 has an excess loss account of \$18. CS4

has a basis of \$80. In Year 5 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells CS1 for \$10. Immediately after the sale of CS1, S is not a member of the P group.

(ii) Under paragraph (b)(1) of this section, because P's basis in CS1 exceeds its value immediately prior to the sale and S is not a member of the P group immediately after the disposition, P's basis in its shares of S common stock is redetermined pursuant to paragraph (b)(3) of this section. Pursuant to paragraph (b)(3)(i) of this section, the reallocable basis amount is \$60 (the lesser of the amount by which P's basis in the S common stock sold exceeds the value of such stock immediately prior to the sale (\$60) and the aggregate amount of S's items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the S common stock other than the stock disposed of, under § 1.1502-32, during the time that S was a member of the P group (\$60)). Pursuant to paragraph (b)(3)(ii) of this section, P's basis in CS1 is reduced from \$70 to \$10. On the sale of CS1, therefore, P recognizes \$0 gain/loss. Then, P's basis in the remaining S common stock is increased in an aggregate amount of \$60 in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be same. In this case, \$20 of the reallocable basis amount is allocated to CS2 and \$28 of the reallocable basis amount is allocated to CS3 so as to increase the basis of such shares to \$10, the basis of CS1. The remaining \$12 of the reallocable basis amount is allocated equally to CS2 and CS3 so as to increase the basis of each such share from \$10 to \$16.

Example 4. (i) In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of the common stock of S, which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of the common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of the plan that includes the Year 2 contribution, P sells the 20 shares of the common stock of S that it acquired in Year 2 for \$20. At that time, S has \$80 and Asset A, the basis and value of which have not changed. In Year 4, S sells Asset A for \$20, recognizing a \$30 loss. That \$30 loss is used on the P group return to offset income of P. In Year 5, P sells its remaining S common stock for \$80.

(ii) Under paragraph (b)(1) of this section, because P's basis in the common stock sold exceeds its value immediately prior to the sale and S is a member of the P group immediately after the sale, P's basis in all of the stock of S is redetermined pursuant to paragraph (b)(2) of this section. Of P's total basis of \$130 in the S common stock, a proportionate amount is allocated to each of the 100 shares of S common stock. Accordingly, \$26 is allocated to the common stock of S that is sold and \$104 is allocated to the common stock of S that is retained. On P's sale of the 20 shares of the common stock of S for \$20, P recognizes a loss of \$6. Because the sale of the 20 shares of common stock of S does not result in the deconsolidation of S, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is \$6. Therefore, the entire \$6 loss is suspended. Pursuant to paragraph (c)(4) of this section, the amount of the

suspended loss is reduced, but not below zero, by S's items of deduction and loss that are allocable to the period beginning on the date of the Year 2 disposition of the S stock and ending on the day before the first date on which S is not a member of the P group and that are taken into account in determining consolidated taxable income (or loss) of the P group for any taxable year that includes any date on or after the date of the Year 2 disposition and before the first date on which S is not a member of the P group, except to the extent the P group can establish that all or a portion of such items was not included in the calculation of the duplicated loss with respect to the shares of S sold on the date of the Year 2 disposition. Because the loss recognized on the sale of Asset A was included in the calculation of the duplicated loss with respect to the S common stock sold on the date of the sale and is absorbed by the P group, the suspended loss is reduced to zero pursuant to paragraph (c)(4) of this section. Accordingly, no amount of suspended loss is allowed under paragraph (c)(5) of this section. Under § 1.1502-32, P's basis in its S stock is reduced by \$24. Accordingly, such basis is reduced from \$104 to \$80. P recognizes \$0 gain/loss on the Year 5 sale of its remaining S common stock.

Example 5. (i) The facts are the same as in *Example 4*, except that instead of selling Asset A for \$20, S sells Asset A for \$45, recognizing a \$5 loss. In addition in Year 5, P sells its remaining S common stock for \$100.

(ii) As in *Example 4*, P recognizes a loss of \$6 on the sale of the 20 shares of the common stock of S and that loss is suspended under paragraph (c)(1) of this section. Pursuant to paragraph (c)(4) of this section, assuming the P group cannot establish that only a portion of the loss recognized on the sale Asset A was reflected in the computation of the duplicated loss with respect to the 20 shares of S common stock sold, the amount of the suspended loss is reduced by the \$5 loss recognized on the sale of Asset A to \$1. Under § 1.1502-32, P's basis in its S stock is reduced by \$4 from \$104 to \$100. In Year 5, when P sells its remaining S common stock for \$100, it recognizes \$0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining \$1 of the suspended loss is allowed on the P group's return for Year 5.

Example 6. (i) The facts are the same as in *Example 4*, except that S does not sell Asset A prior to the sale of its remaining S common stock.

(ii) As in *Example 4*, P recognizes a loss of \$6 on the sale of the 20 shares of the common stock of S and that loss is suspended under paragraph (c)(1) of this section. In Year 5 when P sells its remaining S common stock for \$80, it recognizes a loss of \$24. Pursuant to paragraph (c)(5) of this section, for the year that includes the date of the deconsolidation of S, the suspended loss attributable to its Year 2 sale of S common stock is allowed to the extent it has not been reduced pursuant to paragraph (c)(4) of this section. Because S had no items of loss and deduction that are allocable to the period beginning on the date of the Year 2 disposition of the S stock and ending on the day before the first date on which S is not a member of the P group, the suspended loss is not reduced pursuant to paragraph (c)(4) of this section. Accordingly, pursuant to paragraph (c)(5) of this section, the entire \$6 suspended loss is allowed on the P group's return for Year 5.

Example 7. (i) In Year 1, P forms S1 with a contribution of \$200 in exchange for all of the com-

mon stock of S1, which represents all of the outstanding stock of S1. In the same year, S1 forms S2 with a contribution of \$80 in exchange for 80 shares of the common stock of S2, which at that time represents all of the outstanding stock of S2. S1 and S2 become members of the P group. In the same year, S2 purchases Asset A for \$80. In Year 2, S1 contributes Asset B with a basis of \$50 and a value of \$20 in exchange for 20 shares of the common stock of S2 in a transfer to which section 351 applies. In Year 3, S1 sells the 20 shares of the common stock of S2 that it acquired in Year 2 for \$20. At that time, the bases and values of Asset A and Asset B are unchanged. In Year 4, S2 sells Asset A for \$50, recognizing a \$30 loss. That \$30 loss is used on the P group return to offset income of P. In Year 5, S1 sells its remaining S2 common stock for \$56.

(ii) Under paragraph (b)(1) of this section, because S1's basis in the S2 common stock sold exceeds its value immediately prior to the sale and S2 is a member of the P group immediately after the sale, S1's basis in all of the stock of S2 is redetermined pursuant to paragraph (b)(2) of this section. Of S1's total basis of \$130 in the S2 common stock, a proportionate amount is allocated to each of the 100 shares of S2 common stock. Accordingly, a total of \$26 is allocated to the common stock of S2 that is sold and \$104 is allocated to the common stock of S2 that is retained. On S1's sale of the 20 shares of the common stock of S2 for \$20, S1 recognizes a loss of \$6. Because the sale of the 20 shares of common stock of S2 does not result in the deconsolidation of S2, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is \$6. Therefore, the entire \$6 loss is suspended. Pursuant to paragraph (c)(3) of this section and § 1.1502-32(b)(3)(iii)(C), the suspended loss is treated as a noncapital, nondeductible expense incurred by S1 during the tax year that includes the date of the disposition of stock to which paragraph (c)(1) of this section applies. Accordingly, P's basis in its S1 stock is reduced from \$200 to \$194. Pursuant to paragraph (c)(4) of this section, the amount of the suspended loss is reduced, but not below zero, by S2's items of deduction and loss that are allocable to the period beginning on the date of the Year 3 disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group, and that are taken into account in determining consolidated taxable income (or loss) of the P group for any taxable year that includes any date on or after the date of the Year 3 disposition and before the first date on which S2 is not a member of the P group, except to the extent the P group can establish that all or a portion of such items was not included in the calculation of the duplicated loss with respect to the S2 stock sold on the date of the disposition. Assuming the P group can establish that the \$30 loss generated by S2 on the sale of Asset A was not included in the calculation of the duplicated loss with respect to the S2 stock sold on the date of the disposition, such loss does not reduce the suspended loss. In that case, for the taxable year that includes the day before the first date in Year 5 on which S is not a member of the P group, the P group is allowed to take into account the \$6 suspended loss. On the other hand, if the P group cannot establish that the \$30 loss generated by S2 on the sale of Asset A was not included in the calculation of the duplicated loss with respect to the

S2 stock sold on the date of the disposition, pursuant to paragraph (c)(4) of this section, such loss reduces the suspended loss to zero, and no amount of suspended loss is allowed under paragraph (c)(5) of this section. In either case, under § 1.1502-32, S1's basis in its remaining S2 stock is reduced by \$24 from \$80 to \$56. S1 recognizes \$0 gain/loss on the sale of its remaining S2 stock.

Example 8. (i) In Year 1, P forms S1 with a contribution of Asset A with a basis of \$50 and a value of \$20 in exchange for 100 shares of common stock of S1 in a transfer to which section 351 applies. Also in Year 1, P and S1 form S2. P contributes \$80 to S2 in exchange for 80 shares of common stock of S2. S1 contributes Asset A to S2 in exchange for 20 shares of common stock of S2 in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 contributions, P sells its 100 shares of S1 common stock for \$20. At that time, S1 owns 20 shares of common stock of S2 and S2 has \$80 and Asset A, the basis and value of which have not changed. In Year 4, S2 sells Asset A for \$20, recognizing a \$30 loss. That \$30 loss is used on the P group return to offset income of P. In Year 5, P sells its S2 common stock for \$80.

(ii) Because the P group disposes of its entire equity interest in S1 within a single taxable year, pursuant to paragraph (b)(4) of this section, paragraph (b) of this section does not apply immediately prior to the disposition to cause a redetermination of P's basis in its S1 common stock. Pursuant to paragraph (b)(5) of this section, however, because, immediately prior to the disposition of the S1 stock, P's basis in such stock exceeds its value, S1 owns stock of S2 (another subsidiary member of the same group) and, immediately prior to the disposition of the S1 stock, such S2 stock has a basis that exceeds its value, and, immediately after the disposition of the S1 stock, P owns stock of S2, the basis in each share of S2 that is owned by members of the P group must be redetermined as provided in paragraph (b) of this section as if S1's S2 stock had been disposed of or deconsolidated. Because S2 is a member of the group immediately after the disposition of the S1 stock, the group member's basis in the S2 stock is redetermined pursuant to paragraph (b)(2) of this section immediately prior to the sale of the S1 stock. Of the group members' total basis of \$130 in the S2 stock, \$26 is allocated to S1's 20 shares of S2 common stock and \$104 is allocated to P's 80 shares of S2 common stock. Pursuant to paragraph (b)(6) of this section, the redetermination of S1's basis in the stock of S2 results in an adjustment to P's basis in the stock of S1. In particular, P's basis in the stock of S1 is decreased by \$24 to \$26. On P's sale of its 100 shares of S1 common stock for \$20, S1 recognizes a loss of \$6. Because S1 is not a member of the P group immediately after S1's disposition of the S2 stock, paragraph (c)(1) of this section does not apply to suspend such loss. Pursuant to paragraph (c)(2) of this section, however, because P recognizes a loss with respect to the disposition of the S1 stock and S1 owns stock of S2 (which is a member of the P group immediately after the disposition), such loss is suspended up to \$6, an amount equal to the amount by which the duplicated loss with respect to the stock of S1 sold is attributable to S2's adjusted basis in its assets, loss carryforwards and deferred deductions. Pursuant to paragraph (c)(4) of this section, the amount of the suspended loss is reduced, but not below zero,

by S2's items of deduction and loss that are allowable to the period beginning on the date of the Year 3 disposition of the S1 stock and ending on the day before the first date on which S2 is not a member of the P group and that are taken into account in determining the consolidated taxable income (or loss) of the P group for any taxable year that includes any date on or after the date of the Year 3 disposition and before the first date on which S2 is not a member of the P group, except to the extent the P group can establish all or a portion of such items were not included in the calculation of the duplicated loss with respect to the S1 stock sold or were not attributable to S2's adjusted basis in its assets, loss carryforwards, or deferred deductions. Because the loss recognized on the sale of Asset A was included in the calculation of the duplicated loss with respect to the S1 stock on the date of the sale of the S1 stock and is absorbed by the P group, the suspended loss is reduced to zero pursuant to paragraph (c)(4) of this section. Accordingly, no amount of suspended loss is allowed under paragraph (c)(5) of this section. Under § 1.1502-32, P's basis in its S2 stock is reduced by \$24 from \$104 to \$80. P recognizes \$0 gain/loss on the sale of its S2 common stock.

Example 9. (i) In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S common stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 4, P sells its interest in PS for \$20, recognizing a \$30 loss.

(ii) Under paragraph (b)(1) of this section, because P's basis in the S common stock contributed to PS exceeds its value immediately prior to its deconsolidation and S is a member of the P group immediately after the deconsolidation, P's basis in all of the S stock is redetermined pursuant to paragraph (b)(2) of this section. Of P's total basis of \$130 in the common stock of S, a proportionate amount is allocated to each share of S common stock. Accordingly, \$26 is allocated to the S common stock that is contributed to PS and, under section 722, P's basis in its interest in PS is \$26. P recognizes a \$6 loss on its disposition of its interest in PS. Because P's basis in its interest in PS was determined by reference to the basis of S stock and at the time of the determination of P's basis in its interest in PS such S stock had a duplicated loss of \$6, and, immediately after the disposition, S is a member of the P group, such loss is suspended to the extent of such duplicated loss. Principles similar to those of paragraphs (c)(3), (4), and (5) of this section shall apply to such suspended loss.

(f) *Basic reduction on worthlessness and certain dispositions not followed by separate return years.* If a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then, immediately prior to the recognition of any gain or loss

with respect thereto, and immediately after all other adjustments under § 1.1502-32 with respect thereto, the basis of upper-tier members in the stock of the subsidiary member shall be reduced to the extent of the consolidated net operating losses and net capital losses that would be treated as attributable to such subsidiary member (and lower-tier members) under the principles of § 1.1502-21(b)(2)(iv), as though such losses were absorbed by the group. In addition, if, taking into account the provisions of § 1.1502-80(c), stock of a subsidiary member is treated as worthless under section 165, then, immediately prior to the allowance of any loss or inclusion of an excess loss account with respect thereto, and immediately after all other adjustments under § 1.1502-32 with respect thereto, the basis of upper-tier members in the stock of the worthless member shall be reduced to the extent of the consolidated net operating losses and net capital losses that would be treated as attributable to such subsidiary member (and lower-tier members) under the principles of § 1.1502-21(b)(2)(iv), as though such losses were absorbed by the group.

(g) *Anti-avoidance rules.* (1) *Disposition or deconsolidation of gain share in avoidance.* If a share of subsidiary member stock has a basis that does not exceed its value and the share is deconsolidated with a view to avoiding application of the rules of paragraph (b) of this section prior to the disposition of a share of subsidiary member stock that has a basis that does exceed its value, the rules of paragraph (b) of this section shall apply immediately prior to the deconsolidation.

(2) *Transfers of loss property in avoidance.* If a member of a consolidated group contributes an asset with a basis that exceeds its value to a partnership in a transaction described in section 721 or a corporation that is not a member of such group in a transfer described in section 351, such partnership or corporation contributes such asset to a subsidiary member in a transfer described in section 351, and such contributions are undertaken with a view to avoiding the rules of paragraph (b) or (c) of this section, adjustments must be made to carry out the purposes of this section.

(3) *Anti-loss reimportation*—(i) *Application.* This paragraph (g)(3) applies if—

(A) A member of a group recognizes and is allowed a loss on the disposition of a

share of stock of a subsidiary member with respect to which there is a duplicated loss;

(B) As a result of that disposition or another disposition, the subsidiary member ceases to be a member of such group; and

(C) Within the 10-year period beginning on the date the subsidiary member ceases to be a member of such group—

(1) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date;

(2) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date;

(3) In a transaction described in section 381 or section 351, any member of such group (or any successor group) acquires any asset of the subsidiary member (or any successor) that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of its value on such date, or any asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of its value on such date, and, immediately after the acquisition of such asset, such asset has a basis in excess of its value;

(4) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that were losses or deferred deductions of the subsidiary member on the date of the disposition;

(5) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that was owned by

the subsidiary member on the date of the disposition and that had a basis in excess of value on such date;

(6) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date; or

(7) Any member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor) that were losses or deferred deductions of the subsidiary member on the date of the disposition, that are attributable to any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date, or that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date.

(ii) *Operating rules*—(A) For purposes of paragraph (g)(3)(i)(C) of this section, assets shall include stock and securities and the subsidiary member (or any successor) shall be treated as having its allocable share of losses and deferred deductions of all lower-tier subsidiary members and as owning its allocable share of each asset of all lower-tier subsidiary members.

(B) For purposes of paragraphs (g)(3)(i)(C)(4), (5), and (6) of this section, unless the group can establish otherwise, if the subsidiary member (or any successor) again becomes a member of such group (or any successor group) at a time when the subsidiary member (or any successor) has any losses or deferred deductions, such losses and deferred deductions shall be treated as losses or deferred deductions of the subsidiary member on the date of the disposition, losses or deferred deductions that are attributable to assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date, or losses or deferred deductions that are attributable to assets that had bases that re-

flected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date.

(C) For purposes of paragraph (g)(3)(i)(C)(7) of this section, unless the group can establish otherwise, if a member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor), such losses and deferred deductions shall be treated as losses or deferred deductions of the subsidiary member on the date of the disposition, losses or deferred deductions that are attributable to assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date, or losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member on the date of the disposition and that had bases in excess of value on such date.

(iii) *Loss disallowance*. If paragraph (g)(3) of this section applies, then, to the extent that the aggregate amount of loss recognized by members of the group (and any successor group) on dispositions of the subsidiary member stock was attributable to a duplicated loss of such subsidiary member, and such loss was allowed, such group (or any successor group) will be denied the use of—

(A) Any loss recognized that is attributable to, directly or indirectly, an asset that was owned by the subsidiary member on the date of the disposition and that had a basis in excess of value on such date, to the extent of the lesser of the loss inherent in such asset on the date of the disposition of the subsidiary member stock and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(C) of this section that gives rise to the application of this paragraph (g)(3); and

(B) Any loss recognized that is attributable to, directly or indirectly, an asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary on the date of the disposition and that had a basis in excess of its value on such date, to the extent of the lesser of the loss inherent in the asset that was owned by the

subsidiary on the date of the disposition the basis of which is reflected, directly or indirectly, in whole or in part, in the basis of such asset on the date of the disposition and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(C) of this section that gives rise to the application of this paragraph (g)(3); and

(C) Any loss or deferred deduction described in paragraph (g)(3)(i)(C)(4), (5), (6), or (7) of this section.

(iv) *Treatment of disallowed loss*. For purposes of § 1.1502–32(b)(3)(iii), any loss the use of which is disallowed pursuant to paragraph (g)(3)(iii)(A) or (B) of this section is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the date on which such loss is recognized. See § 1.1502–32(b)(3)(iii)(D). In addition, any loss or deferred deduction the use of which is disallowed pursuant to paragraph (g)(3)(iii)(C) of this section and with respect to which no waiver described in § 1.1502–32(b)(4) is filed is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the day after the event described in paragraph (g)(3)(iii) of this section that gives rise to the application of this paragraph (g)(3).

(4) *Examples*. The principles of this paragraph (g) are illustrated by the following examples.

Example 1. (i) In Year 1, P forms S with a contribution of \$80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of \$50 and a value of \$20 in exchange for 20 shares of preferred stock of S in a transfer to which section 351 applies. In Year 3, S sells Asset A for \$20, recognizing a loss of \$30. Under § 1.1502–32, P's basis in its common stock of S is reduced from \$80 to \$50. With a view to avoiding the application of the basis redetermination rule prior to a sale of the S preferred stock, in Year 4, P contributes the 80 shares of S common stock it acquired in Year 1 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Also in Year 4, P sells its preferred stock of S for \$20, recognizing a \$30 loss.

(ii) Under paragraph (g)(1) of this section, the rules of paragraph (b) of this section shall apply immediately prior to the deconsolidation of the S common stock.

Example 2. (i) In Year 1, P forms S with a contribution of \$100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transac-

tion described in section 721. In Year 3, P contributes Asset A with a basis of \$50 and a value of \$20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional \$80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for \$20, recognizing a loss of \$30. The P group uses that loss to offset income of P. Also in Year 4, P sells its entire interest in PS for \$40, recognizing a loss of \$30.

(ii) Pursuant to paragraph (g)(2) of this section, if P's contributions of S stock and Asset A to PS were undertaken with a view to avoiding the basis redetermination or the loss suspension rule, adjustments must be made such that the group does not obtain more than one tax benefit from the \$30 loss inherent in Asset A.

Example 3. (i) In Year 1, P forms S with a contribution of Asset A with a value of \$100 and a basis of \$120, Asset B with a value of \$50 and a basis of \$70, Asset C with a value of \$90 and a basis of \$100 in exchange for all of the common stock of S and S becomes a member of the P group. In Year 2, in a transaction that is not part of a plan that includes the contribution, P sells the stock of S for \$240, recognizing a loss of \$50. At such time, the bases and values of Assets A, B, and C have not changed since their contribution to S. In Year 3, S sells Asset A, recognizing a \$20 loss. In Year 3, S merges into M in a reorganization described in section 368(a)(1)(A). In Year 4, P purchases all of the stock of M for \$300. At that time, M has a \$10 net operating loss. In addition, M owns Asset D, which was acquired in an exchange described in section 1031 in connection with the surrender of Asset B. Asset C has a value of \$80

and a basis of \$100. Asset D has a value of \$60 and a basis of \$70. In Year 5, P has operating income of \$100 and M recognizes \$20 of loss on the sale of Asset C. In Year 6, P has operating income of \$50 and M recognizes \$50 of loss on the sale of Asset D.

(ii) P's \$50 loss on the sale of S stock is entirely attributable to duplicated loss. Therefore, pursuant to this paragraph (g)(3), assuming the P group cannot establish otherwise, M's \$10 net operating loss is treated as attributable to assets that were owned by S on the date of the disposition and that had bases in excess of value on such date. Without regard to any other limitations on the group's use of M's net operating loss, the P group cannot use M's \$10 net operating loss pursuant to paragraph (g)(3)(iii)(C) of this section. Pursuant to paragraph (g)(3)(iv) of this section and § 1.1502-32(b)(3)(iii)(D), such loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the day after the reorganization. In addition, the P group is denied the use of \$10 of the loss recognized on the sale of Asset C. Finally, the P group is denied the use of \$10 of the loss recognized on the sale of Asset D. Pursuant to paragraph (g)(3)(iv) of this section and § 1.1502-32(b)(3)(iii)(D), each such disallowed loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the date of the disposition of the asset with respect to which such loss was recognized.

(h) *Application of anti-abuse rules.* The rules of this section do not preclude the application of anti-abuse rules under other provisions of the Internal Revenue Code and regulations thereunder, including to a trans-

action that is entered into to invoke the basis redetermination rule to avoid the effect of any provision of the Internal Revenue Code or regulations thereunder.

(i) [Reserved].

(j) *Effective date.* This section, except for paragraph (g)(3) of this section, applies with respect to dispositions and deconsolidations occurring on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**. Paragraph (g)(3) of this section applies to events described in paragraph (g)(3)(iii) of this section occurring on or after October 18, 2002, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after the date these regulations are published as temporary or final regulations in the **Federal Register**.

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*