

group upon certain dispositions and deconsolidations of subsidiary member stock. The rule applies differently when the subsidiary remains a member of the group from when the subsidiary does not remain a member of the group. The IRS and Treasury Department received several technical comments regarding the basis redetermination rule applicable when a subsidiary member leaves the group. The temporary regulations revise that rule in a manner that addresses these comments and clarifies its application.

In particular, under the temporary regulations, subject to certain exceptions, the rule applies upon a deconsolidation of a subsidiary member when any stock of the subsidiary member owned by a member of the group has a basis in excess of value. The revised rule generally applies regardless of whether the subsidiary member is deconsolidated as a result of a transfer of a gain share, a transfer of a loss share, or a stock issuance because, in each case, the effect is the same, *i.e.*, each share of subsidiary member stock owned by group members is deconsolidated. Further, in computing the basis that is reallocated, the revised rule takes into account all loss on members' shares of the subsidiary's stock and all prior negative basis adjustments to members' shares of the subsidiary stock that are not loss shares. The revised rule reflects that, unless all deconsolidations and all deconsolidated shares are treated similarly, opportunities to duplicate losses will continue to exist.

B. Application of Loss Suspension Rule

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. Because a suspended stock loss reflects the subsidiary member's unrecognized or unabsorbed deductions and losses, under the proposed regulations, 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). One comment received regarding the proposed regulations was that, in certain cases, the loss suspension rule could disallow a tax loss for an economic loss. This

result was not intended. Accordingly, these temporary regulations include two changes from the proposed regulations that are intended to prevent this result.

First, the temporary regulations provide that the amount by which a suspended stock loss is reduced cannot exceed the excess of the amount of the subsidiary member's items of loss and deduction over the amount of such items that are taken into account in determining the basis adjustments made to stock of the subsidiary member (or any successor) owned by members of the group under the investment adjustment rules.

Second, they also include a provision stating that the loss suspension rule is not to be applied in a manner that permanently disallows an otherwise allowable deduction for an economic loss. Whether the loss suspension rule has resulted in such a disallowance is determined on the earlier of the date of the deconsolidation of the subsidiary (or any successor) the stock of which gave rise to the suspended stock loss and the date on which the stock of such subsidiary is determined to be worthless. When it is determined that the application of the loss suspension rule has permanently disallowed a deduction for an economic loss, the taxpayer will be permitted to treat the suspended stock loss as restored to the extent of such disallowance. The restoration of the suspended loss is deemed to occur immediately prior to the deconsolidation of the subsidiary or the determination of worthlessness.

C. Basis Reduction Rule for Worthless Stock and Stock of a Subsidiary With No Separate Return Year

The proposed regulations include a basis reduction rule intended to prevent the duplication of unabsorbed losses generated by a subsidiary member and loss with respect to the stock of that member if either (i) the stock of the subsidiary member becomes worthless or (ii) the stock of the subsidiary is disposed of and, immediately after the disposition, the subsidiary is no longer a member of the group and does not have a separate return year. Under this rule, immediately before a determination of worthlessness, or immediately before a disposition of a subsidiary that is not followed by a separate return year, the basis of the subsidiary's stock is reduced by the amount of any loss carryforwards that would be treated as attributable to the subsidiary under the principles of § 1.1502-21. This provision was included because neither situation was subject to the loss suspension rule and, without such a rule, taxpayers might

take the position that a group is entitled to a subsidiary member's loss carryforwards even after the group has enjoyed full basis recovery through a worthless stock or other deduction. Such a result, however, would be in contravention of the principles of Notice 2002-18.

The proposed provision raised questions about the operation of the existing rules governing this situation. Commentators contended that the basis reduction rule could deny the group a single tax loss for its economic loss. As stated above, the proposed regulations, including the basis reduction rule, were not intended to disallow a tax loss for an economic loss, but rather were intended only to ensure that a group obtains no more than a single tax loss for an economic loss.

The temporary regulations address this situation by providing that the unabsorbed losses generated by the subsidiary do not remain available to the group. Specifically, the temporary regulations provide that, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of § 1.1502-80(c)), or 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 all losses treated as attributable to the subsidiary member under the principles of § 1.1502-21, after computing the taxable income of the group, the subsidiary member, or a group of which the subsidiary member was previously a member for the taxable year that includes the determination of worthlessness or the disposition and any prior taxable year, shall be treated as expired, but not as absorbed by the group, as of the beginning of the group's taxable year that follows the taxable year that includes the determination of worthlessness or the disposition. Under this rule, the stock loss (or reduced stock gain), unreduced by any loss carryforwards attributable to the subsidiary member, is allowed. Moreover, because the losses are treated as expired, there is no possibility of a later, duplicative use of the loss carryforwards. This approach is consistent with the nature of a loss realized upon such a determination or disposition, *i.e.*, a loss on an investment in the subsidiary member.

Because the provisions of the proposed regulations raised questions about the operation of the existing rules, the temporary regulations include a special election for determinations of worthlessness and dispositions that occurred on or after March 7, 2002, and