

before March 14, 2003. In such cases, as an alternative to the treatment described above, the common parent of the group may make an irrevocable election to reattribute to itself all or a portion of the losses attributable to the subsidiary member under the principles of § 1.1502-21. For purposes of applying the investment adjustment rules to stock of the subsidiary member owned by the group, the reattributed losses are treated as absorbed by the group immediately prior to the allowance of any loss or inclusion of any income or gain with respect to the determination of worthlessness or the disposition. The common parent, however, is treated as succeeding to the subsidiary's losses in a transaction described in section 381.

The IRS and Treasury Department request comments regarding whether a subsidiary member the stock of which is determined to be worthless (under the standards of § 1.1502-80(c)) should be treated as a new corporation for purposes of the Internal Revenue Code as of the date of the determination of worthlessness. In addition, the IRS and Treasury Department request comments regarding the desirability of further clarification or changes regarding the standards that govern determinations of worthlessness and the deductibility of losses (or the inclusion of excess loss accounts) when stock of a subsidiary member is determined to be worthless.

#### *D. Deferral and Elimination of Gain*

One comment noted that the basis redetermination rule of the proposed regulations could be used to shift the location of gain and loss within a consolidated group and even to eliminate gain in a manner that is unintended and contrary to the purposes underlying section 337(d). The following example illustrates this concern.

P, the common parent of a consolidated group, owns all of the stock of S1 and S2. The S2 stock has a basis of \$400 and a value of \$500. S1 owns 50% of the stock of the S3 common stock with a basis of \$150 and value equal to such amount. S2 owns the remaining 50% of the S3 common stock with a basis of \$100 and a value of \$200 and one share of S3 preferred stock with a basis of \$10 and a value of \$9. P intends to sell all of its S2 stock to an unrelated buyer that does not want to acquire S3. P, therefore, engages in the following steps to dispose of S2 without recognizing a substantial portion of the built-in gain in S2. First, P causes a recapitalization of S3 in which S2's S3 common stock is exchanged for new S3 preferred shares. P then sells all of its S2 stock. Although

the sale does not deconsolidate S3 (because all the S3 common stock is still held by S1), it does deconsolidate the S3 preferred shares held by S2, including the one share with a built-in loss. Accordingly, under the proposed regulations, the bases of all shares of S3 stock must be redetermined immediately before P's sale of S2. Under the basis redetermination rule, the total basis of S3 stock held by members of the P group is allocated first to the S3 preferred shares, up to their value of \$209, and then to the remaining shares of S3 common held by S1. S2's aggregate basis in the S3 preferred stock is increased from \$110 to \$209. This increase tiers up and increases P's basis in the S2 stock from \$400 to \$499. Accordingly, P will recognize only \$1 of gain on the sale of its S2 stock. Afterwards, P can cause S3 to redeem its preferred stock for \$209. S2 will recognize no gain or loss from the redemption. Although the unrecognized gain is preserved in P's basis in S1, and S1's basis in S3, the group can defer or avoid recognizing that gain.

In this case, there is no significant duplication of loss. Moreover, the steps were structured with a view to avoiding the recognition of gain on a disposition of stock. The IRS and Treasury Department do not intend that the basis redetermination rule be applied to defer or eliminate gain in such cases. The IRS and Treasury Department considered adopting a mechanical test to prevent the application of the basis redetermination rule in such cases. They concluded that such a rule would not provide the flexibility necessary to obtain an appropriate balancing of the concerns underlying this regulation and those underlying section 337(d). Therefore, these temporary regulations include an anti-abuse rule that provides that, if a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking application of the basis redetermination rule, and the stock loss attributable to the transferred shares or the duplicated loss of the subsidiary member that is reflected in subsidiary member stock owned by members of the group is not significant, the basis redetermination and loss suspension rules will not apply.

#### *E. Request for Comments*

As described above, the IRS and Treasury Department are continuing to study the comments received regarding the proposed regulations. In addition, the IRS and Treasury Department are considering alternative regimes that

would prevent the duplication of loss within the group.

In particular, the IRS and Treasury Department are studying a comment that suggested applying the principles of section 704(c) to allocate negative investment adjustments arising from loss items at the subsidiary member level where there have been transfers of loss property to the subsidiary member. The comment asserts that this approach would address the case where the recognition and absorption of the inside loss precedes the recognition of the stock loss. The IRS and Treasury Department are concerned that this alternative approach addresses only duplicative losses that arise as a result of contributions of loss property, not duplicative losses that arise as a result of a loss incurred by a subsidiary member. In addition, the IRS and Treasury Department are concerned that the application of the principles of section 704(c) may be complex, especially in cases where there have been issuances of subsidiary member stock at different times. The IRS and Treasury Department request comments regarding how the principles of section 704(c) should be applied in the consolidated return context to prevent the duplication of loss.

The IRS and Treasury Department are also studying a suggestion that the type of transaction in which the stock loss is recognized prior to the absorption of the inside loss be addressed by a rule that allows the stock loss but limits the use of the subsidiary member's items of loss and deduction if there have been contributions of loss property with respect to the subsidiary member and there is any loss duplication at the subsidiary member level at the time the stock loss is recognized. That rule would not permit the use of the subsidiary's items of loss and deduction that are duplicative of the stock loss to offset income of another member of the group, but would permit such items to offset income of the subsidiary.

This rule effectively would permit the acceleration of stock loss. The IRS and Treasury Department request comments regarding whether permitting such acceleration would clearly reflect the income of the group.

In addition, because this rule would permit the subsidiary's losses to offset its items of income and gain, it would not prevent the duplication of losses within the group to that extent. The IRS and Treasury Department request comments regarding whether this duplication is appropriate given that the benefits associated with the subsidiary and its shareholder being members of the group (e.g., positive basis