Tackling Taxes

Tax Planning with Respect to an Insolvent Subsidiary in a Consolidated Return Group—Part IV

*By Paul C. Lau and Ronald Marcuson**

PAUL C. LAU is a Tax Partner with Plante Moran in Chicago.

RONALD MARCUSON is a Professor and Director of MST Program at De Paul University.

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In previous columns in this series on insolvent subsidiaries in a consolidated return context, we explored the deemed satisfaction and reissuance rule for transactions in intercompany obligations, cancellation of non-intercompany indebtedness, timing of worthless stock loss, tax attribute reduction caused by cancellation of indebtedness income, triggering of excess loss accounts (ELA), and the circular basis adjustment rules with respect to the disposition of stock in an insolvent subsidiary.

We will now address the amount of loss the corporate shareholder can claim with respect to an insolvent subsidiary. The loss could be generated by various events including the worthlessness of the subsidiary or the liquidation of the subsidiary. Usually the amount of a loss with respect to an asset is the tax basis of such asset. However, when the asset is the stock of a consolidated subsidiary, we unfortunately must consider the highly complex unified loss rule (ULR) regulations.[1]

General Background

For many years, the IRS struggled with the issue of the possibility that a consolidated group could recognize either a noneconomic loss or a duplicated loss with respect to the disposition of stock in a subsidiary. After various attempts, the IRS issued, in September 2008, extensive and complex guidance under Reg. §1.1502-36 for assessing and adjusting stock loss and tax attributes in the consolidated return context.[2]

The final ULR regulations apply when a member of a consolidated group transfers any "loss share" of a subsidiary's stock. These regulations operate on a share-by-share basis. A loss share is a share of stock that has a tax basis in excess of its "value," defined as the amount realized, if any, on the transfer or its fair market value (FMV).[3] A transfer is broadly defined.[4] Subject to a few exceptions for nontaxable transactions, a share of stock is treated as transferred when: (1) the member ceases to own the share and would otherwise recognize (but for the application of the ULR regulations) income, gain, loss or deduction on the share, (2) the member and the subsidiary cease to be members of the same consolidated group, (3) a nonmember acquires the share, or (4) the share is worthless under

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Code Sec. 165 in accordance with Reg. §1.1502-80(c).[5] Based on this definition of transfer, the ULR regulations clearly can apply to a loss with respect to the stock of an insolvent subsidiary.

The intent of these ULR regulations is to prevent deductions of noneconomic losses and duplicative losses. To illustrate, assume that P purchases all of S's stock for $100. At that time, S owns an asset with a basis of $50 and value of $100. S later sells the asset for $100, and recognizes a $50 gain. Under the investment adjustment rules in Reg. §1.1502-32, P increases its basis in S stock to $150 to account for the $50 gain. Without the ULR, if P were to sell the S stock for $100,[6] it could claim a $50 noneconomic loss on the sale.

Similarly, a single economic loss could be duplicated. For example, assume P formed S by contributing $100 to S in exchange for all of S's stock. S invested the $100 in land, which declined in value to $50. If P then sold the stock of S for $50, P would recognize a $50 loss. This same $50 loss is also reflected in S's basis in the land. Without the ULR, S could then sell the land and generate another $50 loss. In essence, a single economic loss generates a loss for P on the sale of S stock and a loss for S when it sells the land.

General Rules

The ULR regulations apply three levels of adjustments in the following sequential order for determining the tax consequences of the transfer of any loss share:

1. The basis redetermination rule[7]
2. The basis reduction rule[8]
3. The attribute reduction rule[9]

The basis redetermination rule applies only if some loss shares of a subsidiary are transferred and the subsidiary has different classes of stock or different blocks of stock within a single class of stock. This rule does not apply if there is no disparity among members' bases in the common stock and no member owns any share of preferred stock that has unrecognized gain or loss. This rule applies immediately before the transfer of the stock and only reallocates the basis adjustments previously applied to shares of stock. It does not change the aggregate amount of basis in the shares of stock. Unless otherwise elected by the taxpayer, this rule does not apply if all shares of stock in the subsidiary are transferred in a taxable transaction, become worthless or in a combination thereof.[10] Therefore, this rule should have no application to a liquidation of an insolvent subsidiary and will not be addressed further in this column.

The basis reduction rule reduces the basis of a loss share, but not below its value, by the lesser of the share's net positive adjustment amount or the share's disconformity amount.[11] Since the basis reduction cannot reduce a share's basis below its value, this provision only operates to eliminate a stock loss but cannot create a taxable gain.

The attribute reduction rule requires that the loss subsidiary's attributes be reduced if there is a deductible stock loss after the loss share's stock basis is adjusted and reduced by the basis redetermination and reduction rules.[12] It does not reduce the shareholder's loss on the transfer unless certain elections are made.

In this column, we will look at key provisions of the ULR that may affect an insolvent subsidiary. First we will look at the rules. We will then give an example of how they apply in general (*i.e.,* to a solvent subsidiary). Finally, we will look at examples of their application to an insolvent subsidiary.

Note that these ULR provisions become extremely complex when an insolvent subsidiary owns shares in a lower-tier subsidiary. This column only provides a limited discussion of ULR provisions applicable to the ownership of shares in a lower-tier subsidiary. Unfortunately, when dealing with a large consolidated group in bankruptcy, these complex rules become important.

The Basis Reduction Rule

The basis reduction rule is intended to eliminate any noneconomic loss inherent in the basis of a loss share. As stated above, the stock basis is reduced by the lesser of the share's net positive adjustment or the share's disconformity amount. The basis reduction rule for a loss share of the subsidiary (herein also referred to as the loss subsidiary) potentially encompasses the following analyses and rules:

- Determine the loss share's net positive adjustment.
- Determine the loss share's allocable amount of net inside attribute amount of the loss subsidiary.
- Determine the loss share's disconformity amount.
- Determine the stock loss and, if applicable, net gains and losses from shares in the loss subsidiary that are transferred in accordance with the netting rule in Reg. §1.1502-36(c)(7).

The Net Positive Adjustment

The net positive adjustment of a share is the greater of zero or the sum of all investment adjustments (not including the reduction for distributions) reflected in the basis of the share during the period the corporation was a member of a consolidated group.[13] This amount cannot be less than zero.[14] The investment adjustments for a subsidiary of a consolidated group are similar to

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the stock basis adjustments for S corporations. The investment adjustments eliminate virtually all of the disparity between a subsidiary's inside and outside basis (except for pre-consolidation differences and unutilized losses). The investment adjustment rules, which are extensive and briefly described in our October 2014 tax column, basically require that basis be increased by a subsidiary's taxable and tax-exempt income and decreased by the subsidiary's tax loss that is absorbed in the consolidated return, nondeductible and non-capital expenses, and distributions.[15]

Disconformity Amount

The disconformity amount is the excess of the basis in the share of stock over the share's allocable amount of the loss subsidiary's net inside attribute amount. The net inside attribute amount is the sum of the loss subsidiary's money, basis in assets other than money, net operating and capital loss carryovers, and deferred deductions, minus its liabilities.[16] In essence, the disconformity amount is the difference between outside stock basis as computed under Reg. §1.1502-32 and the inside tax basis of assets and attributes.

Example 1: Solvent Subsidiary

Facts. P owns 100 percent of S stock with basis of $100. S owns two assets, Asset A with a basis of $20 and FMV of $60, and Asset B with a basis of $60 and FMV of $40. In year 1, S sells Asset A for $60 and recognizes a gain of $40. On December 31, year 1, P sells S stock for $100. After taking into account the effects of all applicable rules of law, P's basis in S stock is $140 (*i.e.,* initial $100 basis increased by $40 of gain from the sale of Asset A[17]). Since S stock is sold for $100 with a basis of $140, the sale is a transfer of loss share.

Analysis.

1. Since all S shares were sold, there is no redetermination of basis under Reg. §1.1502-36(b).
2. Based on Reg. §1.1502-36(c), P's basis in S stock ($140) is reduced, but not below the FMV (*i.e.,* the selling price of $100), by the lesser of (a) S's net positive adjustment, or (b) the disconformity amount.
3. The net positive adjustment is the $40 gain recognized from sale of Asset A.
4. The disconformity amount is the excess of the stock basis ($140) over S's net inside attribute amount, which is $120 (*i.e.,* cash of $ 60 from sale of Asset A plus $ 60 of basis in Asset B). The resulting disconformity amount is $20 (*i.e.,* $140 basis minus $120 of net inside attribute amount).
5. Accordingly, the basis of S stock is reduced from $140 by the lesser of: (1) $40 of net positive adjustment, or (2) $20 of disconformity amount. This results in a stock basis of $120 (*i.e.,* $ 140 – $20).

Example 2: Insolvent Subsidiary

Facts. P formed S with cash of $100. In year 1, S makes $40. In year 2, S loses $150. On December 31 of year 2, S liquidates when it has no assets and a liability to P of $10 (*i.e.,* it is insolvent). S's loss for year 2 was not utilized since P also had losses in year 1 and year 2.

After four columns, it seems we are just scratching the surface of the tax issues of an insolvent and/or worthless subsidiary in a consolidated return context.

After taking into account the effects of all applicable rules of law, P's basis in S stock is $140 (*i.e.,* initial $100 basis increased by $40 of income). At the end of year 2, P will have a loss of $140 on S stock before applying the ULR.

Analysis.

1. Since all S shares were transferred, there is no redetermination of basis under Reg. §1.1502-36(b).
2. Based on Reg. §1.1502-36(c), P's basis in S stock ($140) is reduced, but not below the FMV, by the lesser of (a) S's net positive adjustment, or (b) the disconformity amount.
3. The net positive adjustment is the $40 of income in year 1.
4. The disconformity amount is the excess of the stock basis ($140) over S's net inside attribute amount, which is $140 (S's year 2 loss which has not been utilized of $140; that is, the $150 loss from operations decreased by the cancellation of indebtedness income of $10 from the liability to P). The resulting disconformity amount is $0.
5. Accordingly, the basis of S stock is reduced from $140 by the lesser of (a) $40 of net positive adjustment, or (b) $0 of disconformity amount. This means there is no basis reduction.

Example 3: Insolvent Subsidiary

Facts. P purchased 100 percent of S stock for $100. S owns Asset A with a basis of $20 and FMV of $60 and $40 cash. In year 1, S sells Asset A for $60 and recognizes

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a gain of $40. In year 2, S loses $110 from operations. On December 31, year 2, S liquidates when it has no assets and a liability to P of $10 (*i.e.,* it is insolvent). S's loss for year 2 was not utilized since P also had losses in year 1 and year 2.

After taking into account the effects of all applicable rules of law, P's basis in S stock is $140 (*i.e.,* initial $100 basis increased by $40 of gain from the sale of Asset A). At the end of year 2, P will have a loss of $140 on S stock before applying the ULR.

For many years, the IRS struggled with the issue of the possibility that a consolidated group could recognize either a noneconomic loss or a duplicated loss with respect to the disposition of stock in a subsidiary.

Analysis.

1. Since all S shares were transferred, there is no redetermination of basis under Reg. §1.1502-36(b).
2. Based on Reg. §1.1502-36(c), P's basis in S stock ($140) is reduced, but not below the FMV, by the lesser of (a) S's net positive adjustment, or (b) the disconformity amount.
3. The net positive adjustment is the $40 gain recognized from sale of Asset A in year 1.
4. The disconformity amount is the excess of the stock basis ($140) over S's net inside attribute amount, which is $100 (S's year 2 loss which has not been utilized of $100; that is, the $110 loss from operations decreased by the cancellation of indebtedness income of $10 from the liability to P). The resulting disconformity amount is $40.
5. Accordingly, the basis of S stock is reduced from $140 by the lesser of (a) $40 of net positive adjustment, or (b) $40 of disconformity amount. This results in a stock basis and loss of $100 (*i.e.,* $ 140 - $40).

As illustrated by Examples 2 and 3, the basis reduction rule generally applies to reduce basis in situations where the stock of the subsidiary was acquired at a value greater than the subsidiary's net asset basis (*i.e.,* adjusted basis of assets net of liabilities) and no Code Sec. 338 election was made. The disconformity amount limitation should prevent, in most instances, a stock basis reduction if a subsidiary has always been a member of the consolidated group.

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Deductible Stock Loss

If a loss share still has a tax basis after the basis redetermination and basis reduction adjustments, this remaining basis should be deductible as a loss for ULR purposes to the extent it exceeds the consideration received in the transfer. However, there are elections that can be made under the Attribute Reduction Rule that will reduce the amount of deductible loss.

Netting Gains and Losses on Transferred Shares

Solely for purposes of the basis reduction rule, Reg. §1.1502-36(c)(7) allows a netting of gains and losses recognized on the transfer of shares in the same transaction. The basis of each transferred loss share is treated as reduced in proportion to losses of all loss shares by the amount of any gain or income recognized by members on the transfer of gain shares in the same transaction. The netting rule does not apply to a gain that is deferred.

This netting rule does not actually reduce the basis in the loss share. It acts as a shield and restricts the basis reduction rule from disallowing a portion of the loss on the loss shares by the amount of gain recognized and not deferred on the transferred gain shares. In effect, the basis reduction amount that would otherwise apply to a loss share is reduced by the gain allocated to the share. Even if the basis in the loss share would have been reduced to its value, the netting rule provides a loss equal to the amount of gain allocated to the loss share.

The Attribute Reduction Rule

The purpose of the attribute reduction rule is to avoid duplication of loss (*i.e.,* an economic loss being deducted both as a stock loss as well as a loss inside the subsidiary). By reducing the loss subsidiary's attributes, it generally prevents a single economic loss from being duplicated and recognized. Under this rule, the loss subsidiary's attributes are reduced by the lesser of (1) the net stock loss, or (2) the loss subsidiary's aggregate inside loss. If the aggregate attribute reduction amount is less than five percent of the aggregate value of the shares transferred, the attribute reduction rule does not apply unless the taxpayer affirmatively elects to apply the rule.[18]

The net stock loss, as defined in Reg. §1.1502-36(d)(3)(ii), is the aggregate basis of all shares transferred over the aggregate value of these shares.

A loss subsidiary's aggregate inside loss is the excess of the subsidiary's net inside attribute amount over the value of all outstanding shares in such subsidiary.[19] The net inside attribute amount, as stated earlier, is the sum of the subsidiary's money, basis in assets other than money, NOL and capital loss carryovers, and deferred deductions, minus liabilities. Solely for this purpose, the basis of stock in a lower-tier subsidiary owned by the loss subsidiary is subject to an attribute imputation rule, adding another layer of complexity.[20]

The attribute reduction rule is more complex and burdensome than the basis reduction rule. The following analyses and rules are generally applicable:

1. Determine the net stock loss under Reg. §1.1502-36(d)(3)(ii), which is the aggregate basis of all shares transferred over the aggregate value of these shares.
2. Determine the loss subsidiary's net inside attribute amount. If the loss subsidiary owns shares in a lower-tier subsidiary, apply an "attribute imputation rule" provided in Reg. §1.1502-36(d)(3)(iv) and (d)(5), which provides specific rules for treating and determining the stock basis of shares owned in a lower-tier subsidiary as a single share of stock.[21]
3. Determine the loss subsidiary's aggregate inside loss, which is the excess of the net inside attribute amount over the value of all outstanding shares in the loss subsidiary.[22]
4. Determine the attribute reduction amount, which is the lesser of the net stock loss or the aggregate inside loss.[23]
5. Apply the attribute reduction amount to reduce the loss subsidiary's four classes of attributes in the sequential order provided in Reg. §1.1502-36(d)(4).
6. If there is an attribute reduction amount allocated to assets (*i.e.,* the last attribute class) owned by the loss subsidiary, apply the rules under Reg. §1.1502-36(d)(4)(ii)(B) and (d)(5), which allocate the attribute reduction amount between stock in lower-tier subsidiaries, if any, and other assets in proportional to basis. For this allocation, Reg. §1.1502-36(d)(5)(i) treats shares owned in a lower-tier subsidiary as a single share with a deemed single basis and Reg. §1.1502-36(d)(5)(ii) treats other assets as a single asset with an aggregate basis. In addition, the deemed single basis in a lower-tier subsidiary must be reduced by an amount computed in accordance with the deemed basis reduction rule in Reg. §1.1502-36(d)(5)(ii) to account for the lower-tier subsidiary's net assets (*e.g.,* cash net of all liabilities) that lack the potential of creating duplicate losses.[24]
7. The attribute reduction amount allocated to other assets is applied to reduce basis in individual assets under Reg. §1.1502-36(d)(4)(ii)(B)(2) in the reverse order of classes of assets listed in Reg. §1.338-6(b)(2).
8. The attribute reduction amount allocated to a deemed share of stock in a lower-tier subsidiary, if any, is apportioned to individual shares of stock under Reg. §1.1502-36(d)(5)(iii) to first reduce loss in and basis disparity among loss shares of preferred stock and then reduce basis disparity among common shares.
9. The attribute reduction amount allocated to a deemed share of stock in a lower-tier subsidiary becomes an attribute reduction amount of the lower-tier subsidiary under Reg. §1.1502-36(d)(5)(v) to reduce its assets.
10. Unless elected otherwise by the taxpayer, a conforming limitation rule is provided in Reg. §1.1502-36(d)(5)(v)(B) to limit the reduction of attributes in the lower-tier subsidiary from being reduced below the aggregate stock basis. A corresponding basis restoration rule is also provided under Reg. §1.1502-36(d)(5)(vi) to restore basis in a lower-tier subsidiary so that the basis in a share of such stock conforms to its allocable share of the lower-tier subsidiary's net inside attribute amount.

The last three steps (Steps 8 to 10) apply only when the loss subsidiary owns shares in a lower-tier subsidiary. We now look at how some of these complex rules work with a focus on examples where the loss subsidiary does not own stock in a lower-tier subsidiary.

Sequential Order in Reducing Attributes

Once the attribute reduction amount is determined, tax attributes of the loss subsidiary are reduced in the descending order of the following four categories (unless elected otherwise)[25]:

1. Capital loss carryovers (Category 1)
2. NOLs (Category 2)
3. Deferred deductions (Category 3)
4. Basis in assets other than cash (Category 4)

The attribute reduction amount first reduces and eliminates the attributes in Category 1 and moves downward to sequentially reduce and eliminate attributes in Categories 2 and 3. In principle, the reduction starts with the short-lived attributes and moves to longer-lived attributes and then to attributes with no set life.

To the extent that there is an attribute reduction amount remaining after absorbing attributes in Categories 1 to 3, this residual amount is applied to reduce basis of assets (Category 4) and is allocated between two classes of assets—stock in lower-tier subsidiaries and other assets. The allocation is based on the relative basis of these assets.[26]

As mentioned above, special rules under Reg. §1.1502-36(d)(4) and (5) are provided for determining

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the basis of stock in lower-tier subsidiaries. Once the basis in the stock of each lower-tier subsidiary is determined, the residual attribute reduction amount (*i.e.,* amount remains after absorbing attributes in Categories 1 through 3) is then allocated between stock in each of the lower-tier subsidiaries and other assets based on relative basis. For the purpose of this allocation, Reg. §1.1502-36(d)(5)(ii) treats other assets (*i.e.,* assets other than lower-tier subsidiary stock) as one single asset with a basis equal to the aggregate bases of all such other assets. The attribute reduction amount is allocated proportionately (by basis) between (among) the other assets (as a single asset) and the deemed single share(s) of lower-tier subsidiary stock.

The amount allocated to the deemed single share of stock in a lower-tier subsidiary is then apportioned to the individual shares of lower-tier subsidiary stock in accordance with the rules under Reg. §1.1502-36(d)(5)(iii).[27]

Apportionment of Attribute Reduction Amount to Other Assets

The portion of attribute reduction amount allocated to other assets (as a single asset) under Reg. §1.1502-36(d)(5)(ii) is allocated to reduce basis in assets in the reverse order of classes of assets listed in Reg. §1.338-6(b)(2).[28] In essence, the basis reduction applies a "reverse residual method" for this allocation. Therefore, the basis reduction first applies to Class VII assets (goodwill and ongoing concern value) and moves successively upward to the next Class when the bases of assets in the lower Class are fully absorbed. This upward movement in reduction of basis stops at Class II assets. If the remaining reduction amount allocated to a class of assets is less than the aggregate basis in those assets, it is applied proportionally (by basis) to reduce the bases in such assets.

If the attribute reduction amount exceeds attributes available for reduction, the excess amount is available to reduce subsequent deductions and/or basis in assets that are derived from liabilities of the subsidiary that are not taken into account for tax purposes (contingent liabilities) at the time of the transfer.[29]

Example 4: Computing the Attribution Reduction Amount for Solvent Subsidiary

Facts. Let's continue on with the facts in Example 1, which determined that the basis in S stock is $120 after the basis reduction rule under Reg. §1.1502-36(c). As a result, the sale of S's stock for $100 results in a transfer of a loss share with a deductible $20 net stock loss ($120 basis over $100 selling price).

Analysis.

1. Under Reg. §1.1502-36(d)(3), S's attribute reduction amount is the lesser of P's net stock loss of $20 or S's aggregate inside loss. S's aggregate inside loss is the excess of S's net inside attribute amount over the value of the S share. The value of S share is $100, the selling price. The net inside attribute amount in S share is $120 ($60 cash from the sale of Asset A and $60 basis in Asset B).
2. Therefore, S's aggregate inside loss is $20 ($120 of net inside attribute amount over the $100 selling price in the S share).
3. Under Reg. §1.1502-36(d), S's attribute reduction amount is $20, the lesser of $20 of net stock loss or $20 of aggregate inside loss.

Therefore, S's attribute reduction amount is $20 and the basis in Asset B is reduced by $20 from $60 to $40.

Attribution Reduction Amount for Insolvent Subsidiary

A parent corporation may be eligible to claim a worthless stock loss on the subsidiary's stock basis after the basis reduction adjustment required under Reg. §1.1502-36(c). The worthless stock loss is an ordinary loss if the subsidiary meets the ownership test and the gross receipts test of Code Sec. 165(g)(3).

In many cases, the loss will be triggered by the liquidation of the insolvent subsidiary. Since the liquidation does not qualify for tax treatment under Code Secs. 332 and 337, the insolvent subsidiary's tax attributes (*e.g.,* NOL) will not be carried over to the parent corporation under Code Sec. 381. Therefore, it seems at first that the attribution reduction rules under Reg. §1.1502-36(d) would play no role in the liquidation of an insolvent subsidiary. However, in *United Dominion*,[30] the Supreme Court suggested that a subsidiary's share of consolidated attributes may survive as carryovers for the consolidated group. To avoid any doubt, Reg. §1.1502-36(d)(7) makes it clear that a subsidiary's share of any consolidated attribute is extinguished and not available to the group if either:

- the subsidiary remains as a member of the group after a worthless loss or deduction is claimed on its stock; or
- the subsidiary ceases to exist after a loss is claimed on its stock.

This elimination of attributes is not a noncapital, nondeductible expense requiring a stock basis adjustment and is made immediately before the transfer (*i.e.,* liquidation or worthless stock deduction).

Example 5—Liquidation of an Insolvent Subsidiary

Facts. Let's continue on with the facts in Example 2, which determined that the basis in S stock is $140 after the basis reduction rule under Reg. §1.1502-36(c). As a result, the liquidation of S results in a transfer of a loss share with a deductible $140 net stock loss.

Analysis.

1. Under Reg. §1.1502-36(d)(3), S's attribute reduction amount is the lesser of P's net stock loss of $140 or S's aggregate inside loss. S's aggregate inside loss is the excess of S's net inside attribute amount over the value of S. The value of S is $0. The net inside attribute amount in S share is $140 (*i.e.,* S's allocable share of the consolidated NOL).
2. Therefore, S's aggregate inside loss is $140 ($140 of net inside attribute amount over $0, the fair market value of S).
3. Under Reg. §1.1502-36(d), S's attribute reduction amount is $140, the lesser of $140 of net stock loss or $140 of aggregate inside loss.

Therefore, S's attribute reduction amount is $140 and the S's allocable share of the consolidated NOL is reduced to zero.

Example 6—Liquidation of an Insolvent Subsidiary

Facts. Let's continue on with the facts in Example 3 with the additional fact that S had a $50 NOL carryover when it was acquired. The net inside attribute and the disconformity amount will be increased by the additional $50 NOL carryover. However, the basis reduction remains the same since it is the lesser of the disconformity amount and the net positive basis adjustment (which remained the same). Therefore, the basis in S stock is $100 after the basis reduction rule under Reg. §1.1502-36(c). As a result, the liquidation of S results in a transfer of a loss share with a deductible $100 net stock loss.

Analysis.

1. Under Reg. §1.1502-36(d)(3), S's attribute reduction amount is the lesser of P's net stock loss of $100 or S's aggregate inside loss. S's aggregate inside loss is the excess of S's net inside attribute amount over the value of S. The value of S is $0. The net inside attribute amount in S share is $150 (*i.e.,* $100 of S's allocable share of the consolidated NOL and $50 of SRLY NOL).
2. Therefore, S's aggregate inside loss is $150 ($150 of net inside attribute amount over $0, the fair market value of S).
3. Under Reg. §1.1502-36(d), S's attribute reduction amount is $100, the lesser of $100 of net stock loss or $150 of aggregate inside loss.

Therefore, S's attribute reduction amount is $100 and the S's NOL's are reduced by $100. In addition, the remaining $50 of NOL is also reduced to zero pursuant to Reg. §1.1502-36(d)(7) since S ceases to exist after a loss is claimed on its stock. They would also be eliminated because the liquidation is not pursuant to Code Sec. 332.

Elections to Reduce Loss Duplication

In summary, the final regulations allow a stock loss after the stock basis of the loss share is adjusted in accordance with the basis redetermination and basis reduction rules, but also require a reduction of tax attributes of the loss subsidiary to prevent the same loss from being claimed twice. To provide some flexibility in reducing potential loss duplication, Reg. §1.1502-36(d)(6) allows the taxpayers the choice, subject to some limitations, to:

- recognize the stock loss and reduce the tax attributes of the loss subsidiary;
- forgo the stock loss (by reducing the stock basis) and preserve the tax attributes;
- reattribute the tax attributes; or
- any combinations thereof (*e.g.,* recognize part of the stock loss and preserve and reattribute part of the tax attributes).

An election is irrevocable. However, the election has no effect if there is no attribute reduction amount or to the extent that the attribute reduction amount is less than the election amount. This effectively permits the use of a protective election.[31]

Reg. §1.1502-36(d)(6)(iii)(B) provides ordering rules and effects for the elections when multiple subsidiaries are transferred and elections are made on such transfers. The election to reattribute attributes is available only if the subsidiary becomes a nonmember of the consolidated group and does not become a member of any group that includes the transferor.[32] The reattribution of attributes only applies to Categories 1 through 3 and is considered a noncapital, nondeductible expense described in Reg. §1.1502-32(b)(2)(iii).

At first, it may seem that these rules are not relevant in the case of an insolvent subsidiary. For example, why would a shareholder elect to reduce basis in the insolvent subsidiary (which would reduce its loss) when the preserved attributes would be eliminated pursuant to Reg. 1.1502-36(d)(7) (*i.e.,* S ceases to exist after a loss is claimed

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on its stock)? On the other hand, what if the shareholder is not entitled to an ordinary loss under Code Sec. 165(g)(3). Could the shareholder elect to reattribute some of the insolvent subsidiary's NOL to itself thereby converting a capital loss to an ordinary loss? It appears this can only be done in certain circumstances.

Where the subsidiary, or any higher tier subsidiary, is insolvent within the meaning of Code Sec. 108(d)(3) at the time of the transfer, losses of the subsidiary may be reattributed only to the extent such losses exceed the sum of the separate insolvencies of the subsidiary and its higher-tier subsidiaries that are insolvent.[33] Special rules are provided in Reg. §1.1502-36(d)(6)(iv)(B) for the treatment of intercompany liabilities and preferred stock in determining insolvency.

There are also rules and limitations dealing with attribute reattribution from lower-tier subsidiaries and stock basis reduction.[34] In addition, if a net stock loss (after taking into account any elections) is permanently disallowed under other Code provisions (*e.g.*, loss disallowed under Code Sec. 311(a)), it is treated as if a stock basis reduction election equal to such net stock loss has been made.[35]

Conclusion

After four columns, it seems we are just scratching the surface of the tax issues of an insolvent and/or worthless subsidiary in a consolidated return context. We still have to explore issues like the implications of the ULR rules on solvent or insolvent second tier subsidiaries of the insolvent subsidiary. We have to look at the interrelationship between the circular basis rule and the ULR rule. Our exploration continues in the next column.

ENDNOTES

* This column represents the views of the authors and does not necessarily represent the view or professional advice of Plante Moran and De Paul University.
1 Reg. §1.1502-36.
2 T.D. 9424.
3 Reg. §1.1502-36(f)(7) and (11).
4 *See* Reg.§1.1502-36(f)(10)(i).
5 For worthless stock, the date of transfer varies. For stock that is not treated as a capital asset, it is transferred on the date the share becomes worthless. For a share that is treated as a capital asset, it is considered transferred on the last day of the tax year. *See* our October 2014 tax column for more in depth discussion.
6 P's value has not changed. P has just replaced an asset worth $100 with $100 cash.
7 Reg. §1.1502-36(b).
8 Reg. §1.1502-36(c).
9 Reg. §1.1502-36(d).
10 *See* Reg. §1.1502-36(b)(1)(ii)(B).
11 Reg. §1.1502-36(c)(2).
12 Reg. §1.1502-36(d)(2).
13 It also includes basis adjustments while it was a member of a different consolidated group.
14 Reg. §1.1502-36(c)(3).
15 Reg. §1.1502-32(b)(2).
16 Reg. §1.1502-36(c)(5). Computing the net inside attribute amount of the loss subsidiary becomes more complex when it owns stock in a lower-tier subsidiary. The complexity stems from the need to specially compute the basis of the stock in the lower-tier subsidiary in order to determine the net inside attribute amount of the loss subsidiary. Reg. §1.1502-36(c)(6) provides the rule for determining the loss subsidiary's basis in shares of any lower-tier subsidiary that are not transferred within the meaning of Reg. §1.1502-36(f)(10) at the time the share in the loss subsidiary is transferred. Under this regulation, the basis in a lower-tier subsidiary stock is reduced by the lesser of the lower-tier subsidiary's net positive adjustment or its disconformity amount. In essence, this basis reduction of lower-tier subsidiary stock is to eliminate potential noneconomic loss reflected in the stock basis of the lower-tier subsidiary. This basis reduction is called the "tentative reduction amount" and the amount can be greater than the value of the stock. This tentative reduction amount, however, does not actually reduce the basis in the lower-tier subsidiary's stock under the investment basis adjustment rules of Reg. §1.1502-32.
In cases where the stock in the lower-tier subsidiary is also transferred at the same time, the tentative reduction amount rule does not apply. Instead, Reg. §1.1502-36(c) applies in computing the actual basis reduction for these transferred shares.
17 For the sake of simplicity, we are ignoring the federal tax on the income (which would be a negative basis adjustment) in this and all other examples in this column. We are also going to assume the circular basis rules have no impact on these examples until we have had a chance to examine the interrelationship between the two sets of provisions.
18 Reg. §1.1502-36(d)(2)(ii). Note that in the case of an insolvent subsidiary, its value is zero by definition so the *de minimis* exception is not applicable.
19 Reg. §1.1502-36(d)(3)(iii)(A).
20 Reg. §1.1502-36(d)(3)(iii)(B).
21 When the loss subsidiary owns stock in a lower-tier subsidiary, Reg. §1.1502-36(d)(3)(iv) and (d)(5) provides an attribute imputation rule for computing the basis in the stock of such lower-tier subsidiary and determining the loss subsidiary's net inside attribute amount. Under this attribute imputation rule, all shares owned in a lower-tier subsidiary are deemed as a single share of stock. The basis in this deemed single share of stock is the greater of: (1) total actual stock basis of all shares owned by the loss subsidiary, adjusted for any gain or loss recognized on shares that were also transferred in the same transaction the loss subsidiary's shares were transferred, or (2) the portion of the lower-tier subsidiary's net inside attribute amount allocable to shares owned by the loss subsidiary. In principle, the "deemed basis" in the deemed single share of stock in the lower-tier subsidiary is the greater of the outside stock basis (adjusted for gain or loss on any stock transferred) or the net inside attribute amount allocable to the deemed share of stock. This attribute imputation rule is intended to capture the largest duplicative loss amount of the lower-tier subsidiary, either inherent in the stock basis or the inside attributes. To compensate for this potential overstatement of duplicative loss, the regulations provide two different limitation rules in Reg. §1.1502-36(d)(5)(v) and (vi) to prevent excessive reduction in lower-tier attributes or lower-tier stock basis.
22 *See* Reg. §1.1502-36(d)(3)(iii).
23 *See* Reg. §1.1502-36(d)(3)(i).
24 The Preamble to the proposed regulations explained that this deemed basis reduction rule is intended to prevent the loss subsidiary's attribute reduction amount from being allocated to a lower-tier subsidiary (or a chain of lower-tier subsidiaries) to the extent attributable to assets held by the lower-tier subsidiary (or its chain of lower-tier subsidiaries) that cannot duplicate losses. In the IRS's view, this minimizes the risk that a portion of attribute reduction amount allocated to a loss subsidiary's stock that would not reduce attributes. *See* REG-157711-2 (Jan. 23, 2007).
25 Reg. §1.1502-36(d)(4).
26 Reg. §1.1502-36(d)(5)(ii).
27 Under these apportionment rules, no amount is allocated to shares that are transferred in which gain or loss is recognized (*i.e.,* a taxable

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transaction). For shares that are not transferred in a taxable transaction, the amount is apportioned among the shares to first reduce loss in and basis disparity among loss shares of preferred stock and then to reduce basis disparity among common shares. An amount apportioned to an individual share of stock reduces the stock basis, but not below its value if it is a preferred share or a common share that is transferred in a nontaxable transaction. The attribute reduction amount allocated to the deemed single share also becomes an attribute reduction amount of the lower-tier subsidiary (a tier-down attribute reduction amount) and reduces attributes inside the lower-tier subsidiary, subject to a conforming limitation under Reg. §1.1502-36(d)(5)(v)(B).

[28] Reg. §1.1502-36(d)(4)(ii)(B)(2).
[29] Reg. §1.1502-36(d)(4)(ii)(C).
[30] *United Dominion Industries Inc.*, SCt, 2001-1 USTC ¶50,430, 532 US 822, 121 SCt 1934.
[31] Reg. §1.1502-36(d)(6)(ii).
[32] Reg. §1.1502-36(d)(6)(iv).
[33] Reg. §1.1502-36(d)(6)(iv)(B).
[34] *See* Reg. §1.1502-36(d)(6)(iv)(C) and (v).
[35] Reg. §1.1502-36(d)(6)(v)(C).

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