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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9117

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Guidance Under Section 1502; Application of Section 108 to Members of a Consolidated Group

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations under section 1502 that govern the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income. These regulations affect corporations filing consolidated returns.

DATES: Effective Date: These regulations are effective March 15, 2004.

Applicability Dates: For dates of applicability, see §§1.1502-13T(1) and 1.1502-28T(d).

FOR FURTHER INFORMATION CONTACT: Candace Ewell or Marie Milnes-Vasquez at (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On September 4, 2003, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-132760-03, 68 FR 52542) and temporary regulations (TD 9089, 68 FR 52487) under section 1502 of the Internal

Revenue Code. The temporary regulations added §1.1502-28T, which provides guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income (excluded COD income) and the method for reducing those attributes. Section 1.1502-28T reflects a consolidated approach that is intended to make available for reduction attributes that are available to the debtor member. The regulations contain a rule governing the order in which attributes are reduced and a look-through rule that provides that when the basis of stock of a member (the lower-tier member) that is owned by another member is reduced, the lower-tier member must reduce its attributes as if it had realized excluded COD income in the amount of the basis reduction.

On December 11, 2003, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-153319-03, 68 FR 69062) and temporary regulations (TD 9098, 68 FR 69024) under section 1502 amending §1.1502-28T. Those regulations clarify that certain attributes that arise (or are treated as arising) in a separate return year are subject to reduction when no SRLY limitation applies to the use of such attributes.

The IRS and Treasury Department have received comments regarding certain technical issues that arise under the regulations. The temporary regulations included in this document address certain issues related to the application of section 1245 and the matching rule of §1.1502-13, and certain issues related to the inclusion of excess loss accounts in cases in which excluded COD income is not fully applied to reduce attributes. The IRS and Treasury Department anticipate that there may be further changes to the regulations but believe that immediate guidance on these issues is desirable. The

following sections describe these issues and the manner in which they are addressed in these temporary regulations.

A. Application of Section 1245

Under section 108(b), asset basis is an attribute that is subject to reduction in respect of excluded COD income. Under section 108(b)(5), the taxpayer may elect to apply any portion of excluded COD income to reduce basis in depreciable assets under the rules of section 1017 prior to reducing other attributes.

Section 1017 provides rules that apply in cases in which excluded COD income is applied to reduce the basis of property. Under section 1017(d)(1), any property the basis of which is reduced and which is neither section 1245 property nor section 1250 property is treated as section 1245 property and the basis reduction is treated as a deduction allowed for depreciation. Under section 1017(b)(3)(D), if a corporation that has excluded COD income is a member of a consolidated group, it can elect to treat the stock of another member as depreciable property if that other member consents to a corresponding reduction in the basis of its depreciable property.

Generally, if section 1245 property is disposed of, the amount by which the lower of (1) the recomputed basis of the property, or (2) in the case of a sale, exchange or involuntary conversion, the amount realized, or (3) in the case of any other disposition, the fair market value of such property, exceeds the adjusted basis of such property is treated as ordinary income (the recapture amount). The recomputed basis is the adjusted basis of property increased by adjustments reflected in that basis that are attributable to deductions allowed or allowable for depreciation or amortization. Application of the recapture rule of section 1245 to property the basis of which has been reduced by reason

of the realization of excluded COD income ensures that the character of the income deferred by reason of attribute reduction (i.e., the extra gain that may be recognized on the disposition of an asset the basis of which has been reduced) will be ordinary (even if the asset is held as a capital asset), which character the excluded COD income would have had if it had been included in income when realized.

Commentators have noted that if the basis of subsidiary stock is reduced in respect of a member's excluded COD income and then the basis of the assets of that subsidiary are reduced pursuant to the look-through rule, both the stock of the subsidiary as well as its assets would be treated as section 1245 property. As a result of that treatment, in certain cases, the group may be required to include in income an inappropriate amount of ordinary income. A similar result may obtain if a member consents under section 1017(b)(3)(D) to reduce the basis of its depreciable property when stock of the subsidiary is treated as depreciable property.

For example, assume a member (a higher-tier member) realizes excluded COD income that is applied to reduce the higher-tier member's basis in the stock of another member (a lower-tier member) and, as a result, a corresponding reduction to the basis of property of the lower-tier member is made. The following year, the lower-tier member transfers all of its assets to the higher-tier member in a liquidation to which section 332 applies. Under section 1245, recapture on the lower-tier member's property that is treated as section 1245 property by reason of section 1017(d)(1) is limited to the amount of the gain recognized by the lower-tier member in the liquidation. However, no similar limitation applies to the stock of the lower-tier member that is also treated as section 1245 property. Therefore, the higher-tier member would be required to include as

ordinary income the entire recapture amount with respect to the lower-tier member stock. In addition, when the higher-tier member sells the assets of the former lower-tier member the bases of which were reduced, the higher-tier member would be required to include as ordinary income the recapture amount with respect to such assets. In that case, the group may be required to include in consolidated taxable income the amounts representing the same excluded COD income more than once.

The IRS and Treasury Department believe that it is appropriate for the group to include in income as ordinary income amounts reflecting previously excluded COD income only once. Therefore, to prevent a double inclusion of ordinary income amounts representing the same excluded COD income, these regulations provide that a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of the look-through rule. This rule has the effect of limiting the ordinary income recapture amount to the amount of the stock basis reduction that does not result in a corresponding reduction of the tax attributes attributable to the subsidiary.

B. Application of Matching Rule

If the member that realizes excluded COD income is the creditor with respect to an intercompany obligation, it is possible that the basis of that intercompany obligation would be reduced under sections 108 and 1017, and §1.1502-28T. Section 1.1502-13 provides rules relating to the treatment of transactions between members of a consolidated group. In general, in the case of a transaction between two members (S and

B) of a consolidated group, the regulations operate to match the items of both members. In particular, under §1.1502-13(c)(1)(i), the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Under paragraph §1.1502-13(c)(6)(i), subject to certain limitations, S's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount.

Some commentators have asked whether the rule of §1.1502-13(c)(6)(i) operates to exclude from gross income any income recognized that is attributable to the application of excluded COD income to reduce the basis of an intercompany obligation. The application of the rule of §1.1502-13(c)(6)(i) in this manner would render without consequence the reduction of the basis of the intercompany obligation. These temporary regulations, therefore, reflect the IRS's and Treasury Department's position that, if the basis of an intercompany obligation held by a creditor member is reduced in respect of excluded COD income, §1.1502-13(c)(6)(i) will not apply to exclude income of the creditor member attributable to the basis reduction in the intercompany obligation.

C. Taking into Account of Excess Loss Account

Under ' ' 1.1502-19 and 1.1502-19T, when an indebtedness of a subsidiary is discharged and any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under ' ' 1.1502-32, if there is an excess loss account in the stock of the subsidiary, that excess loss account must be included in income to the extent of the amount discharged that is not treated as tax-exempt income. Questions have

arisen regarding the timing of the taking into account of excess loss accounts required pursuant to ' ' 1.1502-19 and 1.1502-19T.

The IRS and Treasury Department have considered whether an excess loss account that is required to be included as a result of the application of §1.1502-19(c)(1)(iii)(B) is properly included in the group's consolidated taxable income for the taxable year that includes the date on which the member realizes the excluded COD income. Some have suggested that, because pursuant to section 108(b)(4)(A) attributes are reduced only after the computation of tax for the year of the excluded COD income and, therefore, whether an excess loss account must be included in income is determined only after the computation of tax, the inclusion of the excess loss account should not be required on the return for the taxable year that includes the date on which the excluded COD income was realized. Because the inclusion of the excess loss account is required in connection with the realization of the excluded COD income, the IRS and Treasury Department believe that it is properly included on the return for the taxable year that includes the date on which the excluded COD income was realized.

Some have suggested that inclusion of the excess loss account on the return for the taxable year that includes the date on which the excluded COD income was realized could result in circular calculations. That is, the inclusion of the excess loss account would be offset by losses that would have otherwise been subject to reduction, potentially increasing the amount of excluded COD income that is not applied to reduce attributes and, therefore, the amount of excess loss account required to be taken into account. To address this concern, contemporaneously with the issuance of these temporary regulations, the IRS and Treasury Department are proposing regulations that address

these and other circular computations that would otherwise arise when there is an actual disposition of subsidiary stock, or an event that is treated as a disposition of subsidiary stock under §1.1502-19, in the year that a member of the group realizes excluded COD income. Those regulations are published elsewhere in the Rules and Regulations section of this issue of the **Federal Register**.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. These temporary regulations are necessary to provide taxpayers with immediate guidance regarding the application of section 108 when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income and the consequences of such application. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed applicability date pursuant to 5 U.S.C. 553(d)(3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Marie C. Milnes-Vasquez of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.1502-13T also issued under 26 U.S.C. 1502. * * *

Par. 2. Paragraph (g)(3)(ii)(B) of §1.1502-13 is revised to read as follows:

§1.1502-13 Intercompany transactions.

* * *

(g) * * *

(3) * * *

(ii) * * *

(B) [Reserved]. For further guidance, see §1.1502-13T(g)(3)(ii)(B).

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Par. 3. Section 1.1502-13T is added to read as follows:

§1.1502-13T Intercompany transactions (temporary).

(a) through (g)(3)(ii)(A) [Reserved]. For further guidance, see §1.1502-13(a) through (g)(3)(ii)(B).

(g)(3)(ii)(B) Timing and attributes. For purposes of applying the matching rule and the acceleration rule --

(1) Paragraph (c)(6)(ii) of this section (limitation on treatment of intercompany income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from being excluded from gross income;

(2) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091;

(3) The reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and §1.1502-28T does not result in the realization of any amount with respect to such obligation; and

(4) Paragraph (c)(6)(i) of this section (treatment of intercompany items if corresponding items are excluded or nondeductible) will not apply to exclude any amount of income or gain attributable to a reduction of the basis of an intercompany obligation pursuant to sections 108 and 1017 and §1.1502-28T.

(g)(3)(iii) through (k) [Reserved]. For further guidance, see §1.1502-13(g)(3)(iii) through (k).

(l) Effective dates. Paragraph (g)(3)(ii)(B) of this section applies to transactions or events occurring during a taxable year the original return for which is due (without extensions) after March 12, 2004.

Par. 4. Section 1.1502-28T is amended by:

1. Adding paragraphs (b)(4), (b)(5), and (b)(6).
3. Revising paragraph (d).

The additions and revision read as follows:

' 1.1502-28T Consolidated section 108 (temporary).

* * * * *

(b) * * *

(4) Application of section 1245. Notwithstanding section 1017(d)(1)(B), a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of paragraph (a)(3)(ii) of this section.

(5) Reduction of basis of intercompany obligations. See §1.1502-13T(g)(3)(ii)(B)(3) and (4) for special rules related to the application of the matching and acceleration rules of §1.1502-13 when the basis of an intercompany obligation is reduced pursuant to sections 108 and 1017 and paragraph (a)(2) or (3) of this section.

(6) Taking into account of excess loss account--(i) Determination of inclusion.
[Reserved.]

(ii) Timing of inclusion. To the extent an excess loss account in a share of stock of a subsidiary that realizes excluded COD income is required to be taken into account as a result of the application of ' 1.1502-19(c)(1)(iii)(B), such amount shall be included on the group's tax return for the taxable year that includes the date on which the subsidiary realizes such excluded COD income.

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(d) Effective dates. (1) This section, other than paragraphs (a)(4), (b)(4), (b)(5), and (b)(6) of this section, applies to discharges of indebtedness that occur after August 29, 2003.

(2) Paragraph (a)(4) of this section applies to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after December 11, 2003. However, groups may apply paragraph (a)(4) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before December 11, 2003. For discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or before December 11, 2003, paragraph (a)(4) of this section shall apply as in effect on August 29, 2003.

(3) Paragraphs (b)(4), (b)(5), and (b)(6)(ii) of this section apply to discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after March 12, 2004. However, groups may apply paragraphs (b)(4), (b)(5), and (b)(6) of this section to discharges of indebtedness that occur after August 29, 2003, and during a taxable year the original return for which is due (without regard to extensions) on or

before March 12, 2004.

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

Approved: March 4, 2004

Gregory F. Jenner
Acting Assistant Secretary of the Treasury.