Subsidiary Stock Loss Under Section 1.337(d)–2T

Notice 2004–58

I. Purpose

This notice sets forth a method that the Internal Revenue Service will accept for determining whether subsidiary stock loss is disallowed and subsidiary stock basis is reduced under § 1.337(d)–2T of the Income Tax Regulations. This notice also requests comments regarding the method that should be adopted in prospective regulations to ensure that the policies underlying the repeal of *General Utilities* are not circumvented through the operation of the consolidated return provisions.

II. Background

Section 1.337(d)–2T(a)(1) generally provides that no loss is allowed with respect to the disposition of subsidiary stock by a member of a consolidated group. Section 1.337(d)–2T(b)(1) generally requires the basis of a share of subsidiary stock to be reduced to its value immediately before a deconsolidation of the share. An exception to these general rules is found in § 1.337(d)–2T(c)(2), which provides that loss is not disallowed and basis is not reduced to the extent the taxpayer establishes that the loss or basis "is not attributable to the recognition of built-in gain on the disposition of an asset." Section 1.337(d)–2T(c)(2) defines the term "built-in gain" as gain that is "attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part".

In addition to other methods that may be appropriate, the IRS will accept the basis disconformity method described in Section III of this notice as a method for determining the extent to which loss or basis is attributable to the recognition of built-in gain on the disposition of an asset for purposes of applying the exception of § 1.337(d)–2T(c)(2). A consolidated group is not required to adopt the same method for each disposition or deconsolidation of a share of subsidiary stock.

III. Basis Disconformity Method

The basis disconformity method disallows loss on a disposition of subsidiary stock and reduces basis (but not below value) on a deconsolidation of subsidiary stock in an amount equal to the least of the "gain amount," the "disconformity amount," and the "positive investment adjustment amount." For this purpose, the gain amount is the sum of all gains (net of directly related expenses) recognized on asset dispositions of the subsidiary that are allocable to the share while the subsidiary is a member of the group. The disconformity amount is the excess, if any, of the share's basis over the share's proportionate interest in the subsidiary's "net asset basis." A subsidiary's net asset basis is the excess of (a) the sum of the subsidiary's money, basis in assets (other than stock of consolidated subsidiaries), loss carryforwards that would be carried to a separate return year of the subsidiary under the principles of § 1.1502–21, and deductions that have been recognized but deferred, over (b) the subsidiary's liabilities that have been taken into account for tax purposes. Both the gain amount and the disconformity amount include the subsidiary's allocable share of corresponding amounts of a subsidiary the items of which directly or indirectly adjust the basis of the subsidiary's stock. The positive investment adjustment amount is the excess, if any, of the sum of the positive adjustments made to the share under § 1.1502–32 over the sum of the negative adjustments made to the share under § 1.1502–32, excluding adjustments for distributions under § 1.1502–32(b)(2)(iv).

IV. Other Methods

As indicated above, the IRS will accept methods other than the basis disconformity method for determining the amount of stock loss or basis that is not attributable to the recognition of built-in gain on the disposition of an asset, including a tracing approach. Thus, a taxpayer generally may use tracing to establish that stock loss is not attributable to the recognition of built-in gain, and stock loss is not disallowed to that extent. Under a tracing approach, events subsequent to the acquisition of a share of subsidiary stock that create or alter the disconformity between the basis of the share and the share's interest in the aggregate basis of assets the disposition of which would adjust the basis of the share (for example, the acquisition by a subsidiary of stock of another corporation that joins the consolidated group, an intra-group spin-off under section 355, or a contribution of property to a subsidiary under section 351) may need to be taken into account to determine the extent to which stock loss or basis is attributable to the recognition of built-in gain on the disposition of an asset.

V. Reliance on Notice, Related Relief Provisions

The IRS and Treasury Department are publishing temporary regulations concurrently with this notice that permit taxpayers to make, amend, or revoke elections under § 1.1502–20T(i) (regarding the method to determine allowable loss and basis reduction upon certain dispositions and deconsolidations of subsidiary stock). Under those regulations, a taxpayer that was permitted to make an election under § 1.1502–20T(i), but did not previously make such an election, may make an election to apply either § 1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or § 1.337(d)–2T. The regulations also permit a taxpayer that previously made an election to apply § 1.1502–20 without regard to the duplicated loss factor to revoke the election and apply § 1.1502–20 in its entirety, or to amend the election in order to apply § 1.337(d)–2T. Finally, the regulations permit a taxpayer that previously made an election to apply § 1.337(d)–2T to revoke the election and apply § 1.1502–20 in its entirety or to amend the election in order to apply § 1.1502–20 without regard to the duplicated loss factor.

VI. Approaches Under Consideration

The IRS and Treasury Department are studying various approaches to implement the repeal of *General Utilities* in the consolidated return context pursuant to the mandate of section 337(d) and intend to promulgate regulations that will prescribe a single set of rules. Among the approaches that the IRS and Treasury Department are considering are a number of tracing regimes and a basis disconformity approach described below. The IRS and Treasury Department recognize that differing interpretations of what is necessary to implement the policies underlying the repeal of *General Utilities* in the consolidated return context may suggest differing approaches for regulations under section 337(d). It is clear that, in enacting section 337(d), Congress intended that the consolidated return regulations would not facilitate the circumvention of the recognition of corporate level gain on a corporation's sale or distribution of appreciated property. While some might argue that this concern was limited to stock losses created by the recognition of asset gain that existed when the stock or asset was acquired by the group, others might argue that this concern extended to losses created by any gain or income recognized.

Tracing Regimes

The IRS and Treasury Department recognize that there are a variety of ways to implement a tracing regime. Some of those regimes might disallow loss based on the recognition of gain that is actually reflected in the share's basis, as under § 1.337(d)–2T. Others might disallow loss solely by reference to the appreciation in an asset when the asset is introduced into the group, presuming such appreciation is reflected in the share's basis, as under a built-in items approach described below. In addition, a tracing regime could be implemented that operates not only to disallow loss, but also to increase stock gain by reducing the share's basis to the extent of recognized built-in gain, even below value. A tracing regime also could employ irrebuttable presumptions for determining whether recognized gain is built-in, to address administrability concerns inherent in rebuttable presumptions.

Under one type of a built-in items approach, the basis of a share of subsidiary stock would be reduced immediately prior to a disposition or deconsolidation of that share (but not below its value) in an amount equal to the "extraordinary disposition amount." The extraordinary disposition amount is the excess, if any, of the sum of the gain over the sum of the loss that is allocated to the share from asset dispositions. For this purpose, the gain or loss that is allocated to a share from an asset disposition is taken into account only to the extent that it does not exceed the "unrealized built-in gain" (UBIG) or "unrealized built-in loss" (UBIL) that is attributable to the asset disposed of and that is properly allocable to the share. The UBIG or UBIL attributable to an asset is generally measured on the first date that the asset is introduced into the group (the measurement date). For example, if an asset is held by a corporation at the time that all of the stock of that corporation is acquired by a group member, the UBIG (or UBIL) attributable to that asset is the excess of the asset's value over its basis (or, in the case of UBIL, the excess of the asset's basis over its value) immediately after the stock acquisition. In addition, if an asset is acquired by a corporation the stock of which is already wholly owned by group members, the UBIG (or UBIL) attributable to that asset is the excess of the asset's value over its basis (or, in the case of UBIL, the excess of the asset's basis over its value) immediately after the asset acquisition.

Under one variation of this type of a built-in items approach, all recognized gains would be presumed to be UBIG and all recognized losses would be presumed not to be UBIL unless the taxpayer established the contrary with clear and convincing evidence. Under another variation of the built-in items approach, the presumption that all recognized gains are UBIG and all recognized losses are not UBIL would be irrebutable. However, the aggregate amount of gains that could be treated as UBIG would be limited to the sum of the gain, if any, inherent in each of the assets on the measurement date.

Basis Disconformity Approach

The IRS and Treasury Department are considering a version of the basis disconformity method described in Section III of this notice. That version, however, would not distinguish between the recognition of gain and income and, therefore, would determine disallowed loss without regard to the gain amount factor described in Section III. Therefore, the stock loss disallowed or basis reduced would equal the lesser of the disconformity amount and the positive investment adjustment amount. This basis disconformity approach is based on the view that corporate tax is avoided whenever stock basis is increased under the investment adjustment rules of § 1.1502–32 for items of gain or income when the group already has enough stock basis to prevent a second tax on a disposition of the stock.

The rationale for the basis disconformity approach can be illustrated by the following example. Assume that P purchases the stock of S for $100, the value of the S stock is $100 at all relevant times, and S holds one asset with a basis of $0 on the date of its acquisition. If S recognizes $100 of income, regardless of the source of that income (for example, gain on the disposition of the original asset, or on the disposition of any after-acquired assets, or income produced in the consumption of the original or any after-acquired asset), P's $100 basis in the S stock is sufficient to protect P from further tax on a disposition of the S stock. Increasing P's basis in its S stock when the $100 of income is recognized would allow that $100 of income to be offset by a stock loss, thereby eliminating the corporate tax on the $100 of income.

VII. Request for Comments

The IRS and Treasury Department request comments regarding the appropriate scope of regulations implementing the mandate of section 337(d) and the specific approach that such regulations should adopt. In addition, the IRS and Treasury Department request comments on the treatment of lower tier entities, including partnerships and foreign subsidiaries, under future regulations and the need, if any, for transitional rules. Comments should refer to Notice 2004–58, and should be submitted to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:LPD:PR
Room 5203

or electronically via the Service internet site at: *Notice.Comments@irscounsel.treas.gov* (the Service comments e-mail address).

All comments will be available for public inspection and copying.

DRAFTING INFORMATION:

The principal authors of this notice are Theresa Abell and Martin Huck of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Abell at (202) 622–7700 or Mr. Huck at (202) 622–7750 (not toll-free numbers).